

2016 UPDATE: DERIVATIVES: LEGAL INSIGHTS FOR BUY-SIDE

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Derivative product determination

- OSC Rule 91-506 and equivalent in all provinces and territories since May 2016
- Certain FX transactions are in-scope
 - Number of conditions must be satisfied for trade to be an excluded FX trade
 - Result is that many industries and businesses that were not traditionally within the purview of the securities regulators (or thought they were not!) are now subject (ie. money services businesses, risk managers, commodity producers)
 - How the product is regulated elsewhere is not indicative of how it will be regulated in Canada
 - T+2? What about T+3, T+5 or T+7?
- Commodity transactions are in-scope – “delivery”



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Trade reporting

- Derivative trade reporting in effect since October 31, 2014 in Ontario, Manitoba and Quebec (91-506 and 91-507)
- Trade reporting came into force in the balance of Canada as of July 2016
 - Multilateral Instrument 91-101 Derivatives: Product Determination and the related Companion Policy and
 - Multilateral Instrument 96-101 Trade Repositories and Derivatives Data Reporting

91-507 versus 96-101 – Substantively Harmonized

	91-507	96-101
Local Counterparty	A derivatives dealer must be registered as a derivatives dealer to be a local counterparty.	Simply engaging in the business of trading in derivatives causes the dealer to be a local counterparty.
Substituted Compliance	Reporting obligation can be satisfied if the transaction is reported to a designated trade repository pursuant to the laws of a foreign jurisdiction (currently the United States and the European Union).	Same.
Reporting Counterparty	For a derivative that is not cleared and is between two derivatives dealers or two end-users, the parties can determine the reporting counterparty pursuant to the ISDA methodology.	For a derivative that is not cleared and is between two derivatives dealers or two end-users, the parties can designate one party as the reporting counterparty under a written agreement.
Exemption	Not available in Ontario.	96-101 exempts trades of commodity (other than currency) if the aggregate month-end gross notional amount under all outstanding derivatives of the non-currency commodity asset class of the local counterparty and certain affiliated entities, excluding derivatives with an affiliated entity, did not, in any calendar month in the preceding 12 calendar months, exceed \$250 million.



Clearing Requirements

- Proposed National Instrument 94-101 – *Mandatory Central Counterparty Clearing of Derivatives* was published for comment on February 24, 2016
- End-users in scope are local counterparties with a month-end gross notional amount of outstanding OTC derivatives of over \$500 billion (this threshold is subject to ongoing review)
- Intragroup exemption limited to end-users that enter into trades with affiliates and parties have consolidated financial statements

Clearing Requirements (cont'd)

- End-users need to determine
 - Are they subject to the mandatory clearing requirement; even if not subject to Canadian clearing requirements, are they subject to clearing mandates in the U.S. or Europe
 - If they are not required to clear, do they want to voluntarily clear
- Primary advantages
 - Mitigates counterparty risk
 - Portability of trades
- Primary disadvantages
 - Additional documentation required
 - Cost?

Clearing Requirements (cont'd)

- Issues to consider if an end-user clears derivative trades
 - Executing and clearing brokers must be properly registered or exempted from registration in applicable province
 - Clearing agency used must be recognized or exempted from recognition in the applicable province
 - Additional documents (generally a futures/options agreement, a cleared OTC derivatives addendum and cleared derivatives execution agreements) need to be negotiated and entered into
 - These are not Canadian agreements and need to be amended to reflect Canadian law and the status of the end-user

Collateral Requirements for Cleared Trades

- Proposed National Instrument 94-102 – *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* was published for comment on January 21, 2016
- Scope is limited to cleared trades involving a local end-user and to activities of regulated clearing agencies dealing with local and foreign end-users
- Applies to regulated clearing agencies and clearing intermediaries
- Focus is protection and portability of customer positions and collateral

Collateral Requirements for Cleared Trades (cont'd)

- While the proposed instrument does not place any requirements on end-users, end-users should be aware of
 - Type of acceptable collateral is not prescribed
 - Use and investment of collateral is limited
 - Canadian federal bankruptcy and insolvency laws and provincial personal property security laws are not compatible with the proposed collateral protection regime
 - End-users that are public mutual funds will need relief regarding the treatment of collateral they post

Derivatives registration regime – Same slide as last year...

- Three proposed registration categories
 - Derivatives dealer – entities or persons in business of, or holding themselves out as being in business of, trading derivatives
 - Derivatives adviser – entities or persons in business of, or holding themselves out as being in business of, advising others on derivatives
 - Large derivative participants – entities, other than derivatives dealers, that have substantial aggregate derivatives exposure
- Asset managers may be required to register as derivatives advisers
- Large end-users, such as mutual funds, may be required to register as large derivative participants

Developments in Derivatives Registration Exemption Regime

- Do NOT wait for a harmonized derivatives registration proposal before considering compliance issues
- For OTC Derivatives to Permitted Individuals – still need a registration and prospectus exemption [Note: purpose of “accredited investor” representations?]
- AFEX Order – Feb 2016
 - Relief from dealer registration and prospectus requirements that may be applicable to certain trades in OTC derivatives with “permitted clients”
 - Relief sought in Ontario and certain other jurisdictions as interim response to current regulatory uncertainty
 - Filer intends to rely on comparable exemptions in orders or rules of general application in certain jurisdictions for trades with “qualified parties” and “accredited counterparties”

Continued Evolution of Listed Derivatives Registration Exemptions

- Fall out from OSC Staff Notice 33-744
- Merrill Lynch relief to trade in Canadian-listed futures
- AMF Revocation decision No. 2015-PDG-0066
- CMRA Rules 91-501 Relief for Commercial Hedgers for OTC Derivatives Only
- International Adviser Equivalent in BC for Exchange-Traded Derivatives
- OSC is now clearly regulating introducing brokers (Prism Financial Products LLP)

Revisit Your Derivatives Policy

- Implement comprehensive derivatives policy
- Regulatory compliance
- Risk management
- Due diligence for portfolio managers, dealers, service providers including registration exemption status
- Consider current legislation and how to manage incoming legislation
- Update policy regularly as new rules are implemented

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If you have any
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