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Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

c/o

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Dear Sirs/Mesdames:

Notice and Request for Comment – Proposed National Instrument 93-101 *Derivatives: Business Conduct* and Proposed Companion Policy 93-101CP

Osler Hoskin & Harcourt LLP ("**Osler**") appreciates the opportunity to provide comments to the Canadian Securities Administrators ("**CSA**") in response to the notice and request for comments regarding the above-noted Proposed National Instrument 93-101 – *Derivatives: Business Conduct* ("**NI 93-101**") and Companion Policy ("**CP**") (together, the "**Proposed Instrument**").

As counsel to a wide array of financial and commercial entities, Osler has extensive involvement with derivatives transactions and derivatives regulation. Our perspective shared in this comment letter has been informed by input from clients that will be subject to the Proposed Instrument, and end-users who will be impacted by the changes in business conduct that the Proposed Instrument mandates. While we regard the Proposed

Instrument as a laudable step towards harmonizing business practices in the derivatives markets, we wish to outline in this letter the areas that we believe require further scrutiny and revision. Additionally, attached as Schedule 1, we have responded to the specific questions posed by the CSA.

1. Business trigger for derivatives adviser and derivatives dealer

We have two structural concerns with the business trigger guidance for derivatives dealers and derivatives advisers in the CP. First, we believe that the business trigger guidance should appear in the companion policy to planned National Instrument 93-102 – *Derivatives: Registration* ("**NI 93-102**"). The articulation of factors to determine whether a party is a derivatives dealer or derivatives adviser should be located in a registration rule, not a business conduct rule. The current placement of the business trigger factors in the CP begs the question of whether those factors will be duplicated in a future companion policy to NI 93-102, or whether the CSA could proceed with the introduction of the Proposed Instrument without a registration regime (an alternative which we would strongly oppose). While we acknowledge and accept that an entity exempt from the dealer or adviser registration requirements may still be subject to certain business conduct requirements, it does not logically follow that the determination of whether a party is a derivatives dealer or derivatives adviser should fall within a business conduct rule.

The second structural concern is that the business triggers for derivatives dealers and advisers have been combined into one list, which is similar to the approach taken in National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). We view this a step backwards from the approach proposed in CSA Consultation Paper: 91-407 - *Derivatives: Registration*, where there were separate business triggers articulated for dealers and advisers. Our clients that may be engaged in the business of advising in derivatives find it particularly difficult to parse through the proposed business trigger factors in the CP to determine what is relevant to their advisory business activities, given that most of the factors (e.g. "quoting prices or acting as a market maker", "intermediating transactions" and "providing derivatives clearing services" in particular) are dealer-centric. A related concern is that incidental advisory activities, such as advice provided by law, accounting or financial consulting firms on documenting or structuring a derivatives transaction are not clearly excluded from derivatives adviser business trigger factors. We believe that separate business trigger factors for derivatives dealers and derivatives advisers, with appropriate interpretive guidance for each set of factors, would be very beneficial for derivatives market participants. For example, for the derivatives dealer business trigger factors it could be clarified that derivatives end users are not dealers and for the derivatives adviser factors it could be clarified that pension fund administrators, lawyers, accountants and others that provide incidental advice related to derivatives are not in the business of advising in derivatives.

In addition, we urge the CSA to consider clear guidance in the CP that registered and exempt securities dealers and advisers are not subject to the Proposed Instrument simply by virtue of an occasional or incidental derivatives trade as principal or as agent for a client. Consider the example of a registered portfolio manager that trades a basket of equity securities for a client's managed account, and occasionally enters into a total return swap in order to maintain a balanced portfolio. In this example, the additional costs associated with complying with the Proposed Instrument are disproportionate to the very limited derivatives activity of the registered portfolio manager, especially given the fact that the registered portfolio manager is subject to the registrant conduct requirements in NI 31-103.

2. Definition and treatment of an "eligible derivatives party"

In our view, the Proposed Instrument should use the definition of "permitted client" in NI 31-103 to determine which business conduct requirements should apply to dealing with a client or counterparty. While there are many differences between the derivatives market and securities market, the thresholds for determining whether a client or counterparty should receive heightened protections are broadly the same. Requiring derivatives dealers and advisers to comply with another definition to categorize clients and counterparties would be extremely onerous. Any dealer or adviser that already collects and maintains information concerning a client's status as an "accredited investor" and as a "permitted client" should not be required to do the same for "eligible derivatives party" ("**EDP**") absent a compelling policy rationale.

If, however, the CSA concludes that a distinct definition of EDP is necessary, we believe that the definition should be modified in several ways. To that end, we have the following suggestions:

a) In addition to including entities registered or authorized under securities legislation, paragraphs (d) and (k) should be amended to include firms that are registered under commodity futures legislation, including futures commission merchants and commodity trading managers.

b) The EPD definition should be amended to ensure that direct subsidiaries and other entities wholly-owned by EDPs (directly or indirectly) likewise qualify as EDPs. We suggest the following paragraph be added:

> "a person in respect of which all of the owners of interests, direct, indirect or beneficial, except the voting securities required by law to be owned by directors, are persons that are eligible derivatives parties."

c) EDPs who are individuals with net assets reaching an aggregate realizable value of $25 million should be treated in the same manner as EDPs that are not individuals. We submit that such persons are sufficiently sophisticated to warrant eliminating distinctions in treatment. We would therefore suggest amending sections 7(1) and 7(2) to read as follows:

> (1) " The requirements of this Instrument, other than the following requirements, do not apply to a derivatives firm in respect of a derivatives party that is an eligible derivatives party ~~and that is not an individual~~..."
>
> ~~(2) "The requirements of this Instrument, other than the requirements specified in subsection (1), do not apply to a derivatives firm in respect of a derivatives party who is an eligible derivatives party and who is an individual..."~~

d) Finally, we do not support the inclusion of section 7(3), which subjects a derivatives firm acting as an adviser in respect of a managed account of an EDP, to the entirety of the Proposed Instrument. Respectfully, this provision should be struck from NI 93-101. A derivatives adviser acting for a sophisticated party, that would otherwise be exempt from many of the proposed rules, should not be made to comply with the same requirements applicable to dealers and advisers trading for "retail" clients or accounts. If, however, the provision is to remain in NI 93-101, we would urge the CSA to include a carve-out that allows EDPs that have retained the services of a derivatives adviser for a managed account to waive the application of "retail" requirements.

3. Part 3: Dealing with or advising derivatives parties

a) *Fair Dealing and Conflicts of Interest*

We are generally supportive of the requirements set out in section 8 [fair dealing] and section 9 [conflicts of interest]. However, we believe that the sections should each be amended to include exemptions for derivative firms dealing with derivatives parties that are: (i) other derivative firms (whether registered, or exempt from registration), (ii) Canadian financial institutions or (iii) foreign financial institutions.

Also, it is not clear to us that there are any material differences between the fair dealing requirements set out in section 8 and the fair terms and pricing requirements set out in section 19. Perhaps section 19 can be interpreted to be specific manifestations of the more general requirements in section 8. If so, we believe that the discussion of fair terms

and pricing in section 19 is better suited to appear as part of the CP guidance on fair dealing.

b) *Know your Derivatives Party*

Section 10(2)(a) of NI 93-101 [know your derivatives party] requires derivative firms to "establish, maintain and apply reasonable policies and procedures to…obtain such facts as are necessary *to comply with applicable federal and provincial legislation* relating to the verification of a derivatives party's identity." Respectfully, this obligation is overly broad and should be removed from 93-101. It is not appropriate to include an undefined and general obligation to comply with "other" applicable legislation in the instrument. Should the CSA feel strongly that derivatives firms be reminded of their obligation to comply with other applicable legislation, this should appear in the CP or in a staff notice.

Also, although we support the exemption set out in section 10(5) (releasing derivatives firms from compliance with identity verification requirements in respect of derivatives parties that are registered firms or a Canadian financial institutions), we believe that the exclusion is unduly narrow. The provision should be revised to include derivatives firms that are exempt from registration requirements, as well as foreign financial institutions.

c) *Derivatives-Party Specific Needs and Objectives, and Suitability*

The information-collection requirements outlined in section 11 [derivatives-party specific needs and objectives] function as a pre-requisite to compliance with section 12 [suitability]. As such, we believe that they are better suited to appear as part of the CP guidance on suitability. Alternatively, if the section is to remain in the text of NI 93-101, sections 11 and 12 should be combined to form one clear and comprehensive set of obligations. We would also request that the language of section 12 be clarified to convey that a determination of suitability need not be made on a trade-by-trade basis if a discrete trade fits into a larger trading strategy or series of trades, for which suitability can be assessed.

4. <u>Reporting Material Non-Compliance</u>

We are concerned that section 34(b) [reporting material non-compliance] places a broad and onerous self-reporting burden on derivatives firms without precedent in Canadian securities legislation. The provision requires firms to:

> report to the regulator or securities regulatory authority… any circumstance where, with respect to the derivatives activities of the derivatives firm, the derivatives firm is not or was not in material compliance with this Instrument, *applicable securities legislation*, or the

> policies and procedures required under section 32 [Policies and procedures].

We believe that market participants should have strong gatekeeper systems to escalate and resolve compliance issues, and that market participants should be *encouraged* to self-report material violations of securities legislation. However, we strongly disagree with the proposed *requirement* for derivatives firms to self-report material non-compliance. We believe that imposing a self-reporting requirement in the business conduct rule greatly exceeds the scope of the Proposed Instrument. If members of the CSA consider it a worthwhile policy objective for market participants to self-report material non-compliance, we would expect each CSA jurisdiction to amend their local securities legislation to this effect, after seeking broad public comment and consulting with stakeholders. Therefore, in the context of NI 93-101, we request that section 34(b) be removed from the instrument.

5. Exemptions from the Application of the Proposed Instrument

a) *Clients and counterparties located outside Canada*

We believe that the CSA should clarify that the requirements in the Proposed Instrument apply only to clients or counterparties located in Canada. Given that non-Canadian derivatives firms would be subject to the Proposed Instrument, we suggest that an exemption should be added to Part 6 [Exemptions] to exclude the application of the Proposed Instrument from transactions between a derivatives firm and a derivatives party where neither are located in Canada. In order to continue to encourage foreign derivatives firms to participate in Canadian derivatives markets, there must be appropriate carve-outs for non-Canadian derivatives trading activities, in order to lessen the burden of compliance with multiple regulatory regimes.

b) *Dealer-to-dealer trading*

Derivatives dealers that engage in trading with other derivative dealers should be subject to Part 5 of the Proposed Instrument [Compliance and Record-Keeping] only in respect of such trading. Similarly, derivatives firms that engage in trading on a swap execution facility or similar platform should also be subject to Part 5 only in respect of such trading. Given that counterparties may be anonymous in trades that occur on an electronic platform, it would not be feasible to require derivatives firms to comply with many of the measures in the Proposed Instrument.

c) *Overlapping derivatives dealer and derivatives adviser requirements*

Where a derivatives adviser provides advice to a client on a non-discretionary basis in respect of a derivatives trade made with a derivatives dealer, we believe that the dealer is

in the best position to adhere to the business conduct obligations in respect of such trade. In such cases, we submit that many of the requirements in the Proposed Instrument should only apply to the derivatives dealer. In particular, derivatives advisers should be exempt from the requirements in Part 4 of the Proposed Instrument [Derivative Party Accounts], other than sections 20 and 23. This approach would avoid unnecessary redundancy and reduce the burden of compliance.

d) ***End-user exemption***

Although we support the exemption set out in section 39, we regret that it is only applicable to end-users that do not "regularly quote prices at which they would be willing to transact…" There may be a number of large institutional entities that may quote prices frequently enough to fall outside this exemption but that are otherwise end-users. Although such entities do not otherwise act as derivatives dealers or advisers, they would be denied access to the end-user exemption. Respectfully, we would urge the CSA to modify the language of this section so as not to exclude parties that regularly quote prices due to their size or due to a need to regularly hedge positions.

e) ***Exemption for portfolio managers***

We applaud the exemption for registered investment dealers set out in section 41, and we believe that a corresponding exemption for portfolio managers should be added to Part 6, Division 3. We would urge the CSA to ensure that each such exemption covers section 9 [conflicts of interest], section 10 [know your derivatives party], section 12 [suitability], section 13 [permitted referral arrangements], section 16 [disclosure regarding the use of borrowed money], section 17 [handling complaints], section 18 [tied selling], and section 20 [relationship disclosure information].

f) ***Foreign derivatives advisers and dealers***

We support the exemption in Section 44, which exempts foreign derivatives advisers from the application of the Proposed Instrument. Unfortunately, we believe that the exemption is too narrow in its current form. As proposed, in order to benefit from the exemption, the adviser must be *registered* in the foreign jurisdiction where it maintains its head office or principal place of business. This condition is problematic, as it would exclude those derivatives advisers that are exempt from registration in their home jurisdiction or based in jurisdictions without adviser registration requirements (including the U.S.). We therefore believe that the exemption should be amended to include foreign derivatives advisers that are exempt or not required to be registered in their principal jurisdiction, which would also better align with the international adviser exemption in NI 31-103.

Section 44(2) requires foreign derivatives advisers to maintain compliance with select provisions of the Proposed Instrument. Respectfully, we are concerned that this means of substituted compliance will not be practicable if the foreign derivatives adviser is not subject to a similar form of business conduct regulation in its principal jurisdiction. We therefore urge the CSA to consider an alternative substituted compliance approach for both foreign derivatives advisers and dealers, where compliance with the applicable laws of the dealer or adviser's home jurisdiction (appropriate jurisdictions could be determined by the CSA) suffice for compliance with all aspects of the Proposed Instrument.

Finally, section 44(3)(e) (in respect of foreign derivatives advisers) and section 40(1)(e) (in respect of foreign derivatives dealers) preclude foreign advisers and dealers from relying on exemptions in the Proposed Instrument if "the person or company is… in the business of trading in derivatives on an exchange or a derivative trading facility designated or recognized in the jurisdiction." This limitation would disqualify foreign advisers or dealers that subscribe to designated trading facilities or that are foreign approved participants on the Montreal Exchange. In the absence of a strong policy rationale for including this limitation, we respectfully request that it be struck for both foreign derivatives advisers and foreign derivatives dealers.

* * * *

Thank you for the opportunity to comment on the Proposed Instrument. We would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact Blair Wiley (416.862.5989 or bwiley@osler.com) or Mark DesLauriers (416.862.6709 or mdeslauriers@osler.com)

Yours very truly,

Osler, Hoskin & Harcourt LLP

Schedule A:

Specific Questions for Feedback:

1. Definition of "eligible derivatives party"

a) As currently drafted, the definition of "eligible derivatives party" is generally similar to the definition of "permitted client" in NI 31-103, with a few modifications to reflect the different nature of derivatives markets and participants. Do you agree this is the appropriate definition for this term? Are there additional categories that we should consider including, or categories that we should consider removing from this definition?

We believe that all entities that qualify as "permitted clients" under NI 31-103 should likewise be captured by the definition of EDP. Please see our comments above under section 2 of our letter for more detail, and further observations.

b) Should an individual qualify as an eligible derivatives party or should individuals always benefit from market conduct protections available to persons that are not eligible derivatives parties?

We agree with the inclusion of individuals as EDPs. Furthermore, we believe that financial assets provide an adequate indication of sophistication. Please see our comments above under section 2 of our letter for more detail.

2. Alternative definition of "eligible derivatives party"

In the CSA Consultation Paper 33-404, it was put forth that certain proposed targeted reforms relating to the client-registrant relationship be tailored in their application to "institutional clients." Proposed targeted reforms relating to suitability and KYC requirements would, for instance, not apply to registrants dealing with an institutional client.

The CSA Consultation Paper 33-404 proposed a definition of "institutional client" which is generally similar to the definition of a "permitted client" in section 1.1 of NI 31-103. However, in comparison to the definition of "permitted client" in NI 31-103 (which refers in paragraph (o) to individuals that beneficially own a specified threshold of financial assets), the definition of "institutional client" in the Consultation Paper did not include individuals. Moreover, in comparison to paragraph (q) of the definition of "permitted client" (which refers to "a person or company, other than an individual or an investment fund, that has net assets of at least $25 million as shown on its most recently prepared financial statements"), the following branch of the definition of "institutional client" proposed in the CSA Consultation Paper 33-404 would establish a higher financial threshold for non-individual entities:

> *(x) any other person or company, other than an individual, with financial assets, as defined in section 1.1 of National Instrument 45-106 Prospectus Exemptions, having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $100 million.*

Please comment on whether it would be appropriate to use the definition of "institutional client" proposed in the April 28, 2016 CSA Consultation Paper 33-404 as the basis for definition of "eligible derivatives party" in the Proposed Instrument.

We believe that the categories of "permitted clients" defined in National Instrument 31-103 form the correct basis for the definition of EDPs. Please see our comments above under section 2 of our letter for more detail.

3. Knowledge and experience requirements in clauses (m) and (n) of the definition of "eligible derivatives party"

a) Clauses (m) and (n) of the definition of "eligible derivatives party" provide that a person or company may be an eligible derivatives party if they have represented in writing that they have the requisite knowledge and experience to evaluate, among other things, "the characteristics of the derivatives to be transacted". The corresponding section of the companion policy notes that "some people or companies may only have the requisite knowledge and experience pertaining to derivatives of a certain asset class or product type".

If a person or company only has the knowledge or experience to evaluate a specific type of derivative (for example a commodity derivative), should they be limited to being an eligible derivatives party for that type of derivative or should they be considered to be an eligible derivatives party for all types of derivatives?

We believe that the knowledge and experience requirement should be removed from the definition of EDP. It is our position that financial assets provide an adequate indication of sophistication, and that section 10 of the Proposed Instrument will ensure that derivatives firms gain sufficient insight into the specific needs and circumstances of their clients.

b) Is it practical for a derivatives dealer or adviser to make the eligible derivatives party determination (and manage its relationships accordingly) at the product-type level, or it is only practicable for a derivatives dealer or adviser to treat a derivatives party as an eligible derivatives party (or not) for all purposes?

We believe that it is most practical for derivatives firms to determine whether a client qualifies as an EDP independently of any transactions, and then to manage their relationship accordingly. If a derivatives party is an EDP, the derivatives party should be an EDP for all purposes.

4. Two-tiered approach to requirements: eligible derivatives parties vs. all derivatives parties:

a) Do you agree with the two-tiered approach to investor/customer protection in the Instrument?

We agree with the two-tiered approach. However, as noted in our comment letter, it should be applied for managed accounts, not only dealer activities and non-discretionary advisory activities.

b) Are there additional requirements that a derivatives firm should be subject to even when dealing with or advising an eligible derivatives party? For example, should best execution or tied selling obligations, or other obligations in Division 2 of Part 3, also apply when a derivatives firm is dealing with or advising an eligible derivatives party?

We do not believe that there are any additional requirements that should be imposed.

c) Does the Proposed Instrument adequately account for current institutional OTC trading practices? Are there requirements that apply to a derivatives firm in respect of an eligible derivatives party that should not apply, or that impose unreasonable burdens that would unnecessarily discourage trading in OTC derivatives in Canada?

We are generally supportive of the Proposed Instrument, however we have suggested some ways to avoid unnecessarily discouraging trading in OTC derivatives in Canada in our comment letter.

d) Should the two-tiered approach apply to a derivatives adviser that is advising an eligible derivatives party?

Yes. We would ask the CSA to consider striking section 7(3) from the Proposed Instrument.

5. Business trigger guidance

Part 1 of the CP sets out factors that are considered relevant in determining whether a person or company is in the business of trading or advising in derivatives. One of those factors is as follows:

Quoting prices or acting as a market maker -- The person or company makes a two-way market in a derivative or routinely quotes prices at which they would be willing to transact in a derivative or offers to make a market in a derivative or derivatives.

Similarly, paragraph 39(c) of the Instrument provides that the exemption described therein is only available if "the person or company does not regularly quote prices at which they would be willing to transact in a derivative or otherwise make or offer to make a market in a derivative with a derivatives party"

Does the guidance in the CP, along with 39(c) of the Instrument, appropriately describe the situation in which a person or company should be considered to be a derivatives dealer because they are functioning in the role of a market maker?

We do not believe that the CP provides adequate guidance on this issue, and respectfully request that the language be amended. Please see our comment letter for further detail.

6. Fair Dealing

Is the proposed application of a flexible fair dealing model that is dependent on the relationship between the derivatives firm and its derivatives party appropriate?

Yes, we believe that there is a need for a flexible fair dealing model and we would welcome additional guidance on the application of these general requirements.

7. Fair terms and pricing

Are the proposed requirements in section 19 of the Instrument relating to fair terms and pricing appropriate?

Although we agree with the content of the obligations, we believe that section 19 would be better suited as a part of the CP guidance in respect of section 8 of NI 93-101.

8. Derivatives Party Assets

National Instrument 94-102 Derivatives: Customer Clearing and Protection of Customer Collateral and Positions imposes obligations on clearing intermediaries that hold collateral on behalf of customers relating to derivatives cleared through a clearing agency that is a central counterparty. These requirements apply regardless of the sophistication of the customer. Division 2 of Part 4 of the Instrument imposes comparable obligations but does not apply if the derivatives party is not an eligible derivatives party.

Should Division 2 of Part 4 apply if the derivatives party is an eligible derivatives party?

We do not believe that Division 2 of Part 4 should apply to EDPs.

9. Valuations for derivatives

a) Section 21, 22 and 30 require a derivatives firm to provide valuations for derivatives to their derivatives party. Should these valuations be accompanied by information on the inputs and assumptions that were used to create the valuation?

We are generally supportive of the disclosure requirements contemplated in these sections when the requirements have the effect of increasing transparency for derivatives end-users. In situations where valuations must be provided, we agree that the valuations should be accompanied by information on the inputs and assumptions used.

10. Senior derivatives managers

Section 33 of the Instrument imposes certain supervisory, management, and reporting obligations on "senior derivatives managers", and section 34 imposes related duties on the firm to respond to reports of non-compliance, and in certain circumstances to report non-compliance to the regulator or securities regulatory authority.

Please comment on the proposed senior management requirements including whether the proposed obligations are practical to comply with, and the extent to which they do or do not reflect existing best practices.

We have concerns with the senior derivatives manager concept, including who would be considered a senior derivatives manager, their reporting lines, proficiency and related issues. Also, we have significant concerns with the proposed self-reporting obligation. Please see section 4 of our letter for more detail.

11. Exemptions

Sections 40, 41, 42, and 44 of the Instrument contemplate exemptions for derivatives firms, conditional on being subject to and complying with equivalent domestic or foreign regulations. Please provide information on regulations that the CSA should consider for the equivalency analysis. Where possible, please provide specific references and information on relevant requirements and why they are equivalent, on an outcomes basis, to the requirements in the Instrument.

Osler is very supportive of the exemptions for derivatives firms, however we have concerns with the proposal to map equivalent domestic and foreign regulations, which may change over time. Therefore we urge the CSA to consider a broader, results-oriented approach to substituted compliance that allows for exemptions for foreign firms, so long as the home jurisdiction of the foreign firm has a sufficiently rigorous regulatory regime.