MODEL EXPLANATORY GUIDANCE
TO
MODEL PROVINCIAL RULE – DERIVATIVES: PRODUCT DETERMINATION

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1. General comments

(1) This Model Explanatory Guidance sets out the views of the Canadian Securities Administrators OTC Derivatives Committee (the "Committee" or "we") on various matters relating to Model Provincial Rule – *Derivatives: Product Determination* (the "Scope Rule").

(2) Except for section 1, the numbering and headings of the sections in this Model Explanatory Guidance generally correspond to the numbering and headings in the Scope Rule. Any general guidance for a section appears immediately after the section heading. Any specific guidance on a section follows any general guidance.

(3) The Scope Rule only applies to Model Provincial Rule – *Trade Repositories and Derivatives Data Reportin*g (the "TR Rule"). The Committee expects that elements of the Scope Rule, subject to necessary amendments, will also be made applicable to certain provisions of securities legislation, and to additional derivatives rules that will be brought into force, including but not limited to rules relating to over-the-counter central counterparty clearing, end-user exemptions, trading platforms, capital and collateral, and registration. However, there may be variations in the application of the Scope Rule for these other rules. In particular, certain contracts or instruments that are prescribed to be securities or derivatives for the purposes of the TR Rule may be treated differently in other rules.

(4) Unless defined in the Scope Rule or this Model Explanatory Guidance, terms used in the Scope Rule and in this Explanatory Guidance have the meaning given to them in Ontario securities legislation, including, for greater certainty, in National Instrument 14-101 *Definitions* and OSC Rule 14-501 *Definitions*.[1]

2. Excluded derivatives

Subsections 2(a) and (b) of the Scope Rule prescribe a contract or instrument not to be a derivative if it is regulated by federal or provincial gaming control legislation, or is an insurance or annuity contract issued by an insurer licensed under federal or provincial insurance legislation. While these instruments may meet the technical definition of "derivative", they are generally not recognized as being financial derivatives and typically do not pose the same potential risks to the financial system as certain other derivatives products. In addition, the Committee does not believe that the derivatives regulation regime that it expects to implement will be appropriate for these types of contracts and instruments. Further, the federal and provincial legislation regulating these contracts and instruments often have consumer protection as an objective and are therefore aligned with the objective of the Act to provide protection to market participants from unfair, improper or fraudulent practices. It should be noted that the Committee's view is that credit derivatives are not insurance or annuity contracts.

Subsection 2(c) of the Scope Rule prescribes a short-term contract or instrument for the purchase and sale of currency not to be a derivative if it meets the requirements specified in paragraphs 2(c)(i), (ii) and (iii). Examples of these include a consumer currency exchange or a contract for immediate or near-immediate delivery of currency to support a commercial import or export transaction. Therefore, for transaction reporting purposes, forward foreign exchange contracts would need to be reported but spot foreign exchange contracts that meet the applicable requirements would not.

Paragraph 2(c)(ii) requires that the contract or instrument not allow for cash settlement in place of physical delivery of the foreign currency. This means that the specific foreign currency contracted for would have to be delivered and not an equivalent amount in a different currency. We consider physical delivery to refer to actual physical delivery of the specific foreign currency contracted for rather than a simple notation in a client account statement that is denominated in a foreign currency and may then be converted back into domestic currency at a later date.

[1] As explained in the accompanying Notice, the Scope Rule has been drafted based on the Securities Act (Ontario). Certain conforming amendments will be necessary in other jurisdictions.

The presence of provisions in the contract or instrument setting out the effect of breach or frustration of the contract or instrument, force majeure or similar events occurring outside of the control of the parties that render physical delivery of the agreed upon currency impossible do not make an otherwise firm obligation for physical delivery merely an option for physical delivery. We note that standard form contracts used in derivatives markets may include provisions that permit cash settlement in place of physical delivery in the context of termination rights, should a counterparty default on its obligation to physically deliver. To the extent that such standardized provisions relate exclusively to termination rights resulting from a breach of contract, we would not interpret them as allowing for cash settlement in place of physical delivery. This exclusion will not apply to contracts where the termination rights are used as a cash settlement option.

We note that the intention requirement in paragraph 2(c)(iii) of the Scope Rule is not limited to the point in time at which the contract is entered into, but applies for the duration of the contract. If a contract is intended to be physically settled at the time it is entered but this intention changes, the contract would become subject to all applicable derivatives rules. The intention requirement is designed to address situations where contractual provisions that do not permit cash settlement are not observed. The exclusion would therefore not be available if, for example, the counterparties set out an obligation for physical settlement of the contract or instrument but actually intend to rely on breach or frustration provisions in the contract or instrument in order to achieve an economic outcome akin to cash settlement. Additionally, in situations where a market participant settles contracts in cash on a repeated basis, we take the position that irrespective of contractual requirements for physical settlement, this may be evidence of a party's intention not to physically settle.

Subsection 2(d) of the Scope Rule prescribes a contract or instrument for delivery of a physical commodity not to be a derivative if it meets the requirements specified in paragraphs 2(d)(i), (ii) and (iii). In order to be a physical contract or instrument, its terms must provide for immediate or deferred delivery of a physical commodity. The phrase "immediate or deferred delivery" is intended to convey that the exclusion is available for contracts or instruments that meet the criteria in subparagraphs 2(d)(i) to (iii) regardless of whether they are entered into for spot delivery or forward settlement. Physical commodities include, but are not limited to, agricultural products, forest products, products of the sea, minerals, metals, hydrocarbon fuel, precious stone or other gem, electricity, energy and fuel products (including gas, oil, and any by-products), and water. For the purposes of the Scope Rule, we are of the view that physical commodities do not include financial commodities such as currencies, interest rates, securities and indexes, so as to limit the exemption to commercial transactions in physical goods.

We take the position that the obligation for physical delivery in paragraph 2(d)(i) of the Scope Rule means a firm obligation of a party to the contract or instrument and not merely an option to make or take physical delivery. A contract or instrument that has an option relating to some aspect of the physical delivery such as the volume of physical commodity to be delivered or the location of delivery would not, as a result of such an option, be a derivative.

We take the view that the presence of provisions in the contract or instrument setting out obligations in the case of breach or frustration of the contract or instrument, force majeure, or similar events occurring outside of the control of the parties that render physical delivery impossible do not make an otherwise firm obligation for physical delivery merely an option for physical delivery. In addition, an option to vary delivery obligations (e.g., volume) based on factors beyond the control of the parties will not on its own make a contract ineligible for the reporting exclusion in subsection 2(d) of the Scope Rule. We note that standard form contracts used in derivatives markets may include provisions that permit cash settlement in place of physical delivery in the context of termination rights, should a counterparty default on its obligation to deliver. To the extent that such standardized provisions relate exclusively to termination rights arising as a result of the breach of the terms of the contract or instrument, we would not interpret them as allowing for cash settlement in place of physical delivery. This exclusion will not apply to contracts where the termination rights are used as a cash settlement option.

Paragraph 2(d)(iii) of the Scope Rule requires that counterparties intend to physically settle the contract or instrument. The exclusion would therefore not be available if, for example, the counterparties set out an obligation for physical settlement of the contract or instrument but actually intend to rely on breach or frustration provisions in the contract or instrument in order to achieve an economic outcome akin to cash settlement. In addition, the exclusion would not be available if the counterparties intend to enter into collateral agreements which, together with the original contract or instrument, achieve an economic outcome that is, or is akin to, cash settlement of the original contract or instrument.

Paragraph 2(f) of the Scope Rule refers to "similar statutes from a province or territory of Canada". As explained, the Scope Rule is based on the *Securities Act* (Ontario) therefore the provincial acts explicitly mentioned in the provision are from Ontario. The intention is that all province-specific statutes will receive the same treatment in every province or territory. For example, if a credit union to which the Ontario *Credit Unions and Caisses Populaires Act, 1994* applies issues an evidence of deposit to a market participant located in a different province, that province would apply the treatment under their legislation equivalent to paragraph 2(f) of the Scope Rule.

Apart from the contracts and instruments expressly prescribed not to be derivatives in section 2 of the Scope Rule, there are other contracts or instruments which we would not be considered to be "derivatives" for the purposes of the Act. A feature common to these contracts and instruments is that they are entered into for consumer, business or non-profit purposes that do not involve investment, speculation or hedging. Typically, they provide for the transfer of ownership of a good or the provision of a service. In most cases they are not traded on a market.

These contracts or instruments include, but are not limited to:

- a consumer or commercial contract or instrument to acquire, or lease real or personal property, to provide personal services, to sell or assign rights, equipment, receivables or inventory, or to obtain a loan or mortgage, including a loan or mortgage with a variable rate of interest, interest rate cap, interest rate lock or embedded interest rate option;

- a consumer contract or instrument to purchase products or services at a fixed, capped or collared price;

- an employment contract or retirement benefit arrangement;

- a guarantee;

- a performance bond;

- a commercial sale, servicing, or distribution arrangement;

- a contract or instrument for the purpose of effecting a business purchase and sale or combination transaction;

- a contract or instrument representing a lending arrangement in connection with building an inventory of assets in anticipation of a securitization of such assets; and

- a commercial contract or instrument containing mechanisms indexing the purchase price or payment terms for inflation such as via reference to an interest rate or consumer price index.

3. Investment contracts and over-the-counter options

Section 3 of the Scope Rule prescribes a contract or instrument (to which section 2 of the Scope Rule does not apply), that is a derivative and a security solely by reason of being an investment contract[2], not to be a security. Some types of contracts traded over-the-counter, such as foreign exchange contracts and contracts for difference meet the definition of "derivative" (because their market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest) but also meet the definition of "security" (because they are investment contracts). This provision prescribes that such instruments will be treated as derivatives and therefore be required to be reported to a designated trade repository.

Similarly, options are covered by both the definition of "derivative" and the definition of "security"[3]. Section 3 of the Scope Rule prescribes options that are only securities by virtue of provision (d) of the definition of "security" (and not described in section 5 of the Scope Rule), not to be securities. Therefore, derivatives treatment will apply to these instruments which will be required to be reported to a designated trade repository. It should be noted that this treatment will only apply to options traded over-the-counter. Exchange-traded options will not be required to be reported to a designated trade repository. In Ontario, these types of options are commodity futures options and therefore regulated under the *Commodity Futures Act* and excluded from definition of "derivative". This reporting exclusion will also be implemented in other jurisdictions although the form of the exclusion may differ.[4]

4. Derivatives that are securities

Section 4 of the Scope Rule prescribes a contract or instrument (to which sections 2 and 3 of the Scope Rule do not apply) that is a security and a derivative, not to be a derivative. Derivatives that are securities and are contemplated by this provision include structured notes, asset-backed securities, exchange-traded notes, capital trust units, exchangeable securities, income trust units, securities of investment funds and warrants. This provision ensures that such instruments will continue to be subject to applicable prospectus disclosure and continuous disclosure requirements as well as applicable registration requirements for dealers and advisers. The Committee anticipates that it will review the categorization of instruments as securities and derivatives once the comprehensive derivatives regime has been implemented.

5. Derivatives prescribed to be securities

Section 5 of the Scope Rule prescribes a security-based derivative that is used by an issuer or its affiliate to compensate an officer, director, employee or service provider, or as a financing instrument, not to be a derivative. Examples of the compensation instruments contemplated by section 5 include stock options, phantom stock units, restricted share units, deferred share units, restricted share awards, performance share units, stock appreciation rights and compensation instruments provided to service providers such as broker options. Securities treatment would also apply to the above described instruments when used as financing instruments, for example, rights, warrants and special warrants, or subscription rights/receipts or convertible instruments issued to raise capital for any purpose. It is the Committee's view that an instrument would only be considered a financing instrument if it is used for capital raising purposes. An equity swap, for example, would generally not be considered a financing instrument. The classes of derivatives referred to in section 5 can have similar or the same economic effect as a

[2] See paragraph (n) of the definition of security in the *Securities Act* (Ontario).

[3] See paragraph (d) of the definition of security in the *Securities Act* (Ontario).

[4] Please see Section 7 – *Local Aspect of Model Rules* of the accompanying *CSA Notice and Request for Comments* for further details.

securities issuance and are therefore subject to requirements generally applicable to securities. As they are prescribed not to be derivatives they are not subject to the transaction reporting requirements under the TR Rule.