CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Notice and Request for Comment

Draft *Regulation 93-101 respecting Derivatives: Business Conduct*

Draft *Policy Statement to Regulation 93-101 respecting Derivatives: Business Conduct*

April 4, 2017

Introduction

We, the Canadian Securities Administrators (the **CSA** or **we**), are publishing the following for a 150-day comment period, expiring on September 1, 2017:

- Draft *Regulation 93-101 respecting Derivatives: Business Conduct* (the **Regulation**);

- Draft *Policy Statement to Regulation 93-101 respecting Derivatives: Business Conduct* (the **Policy Statement**).

Collectively, the Regulation and the Policy Statement are referred to as the **Proposed Regulation** in this Notice.

We are issuing this Notice to solicit comments on the Proposed Regulation. We welcome all comments on this publication and have also included specific questions in the Comments section.

The CSA intends to collaborate with the Bank of Canada, the Office of the Superintendent of Financial Institutions (Canada), and the Department of Finance (Canada) on the Proposed Regulation throughout its development.

We are also in the process of developing a proposed registration regime for derivatives dealers, derivatives advisers and potentially other derivatives market participants. We expect to publish Draft *Regulation 93-102 respecting Derivatives: Registration* and a related policy statement (collectively the **Proposed Registration Regulation**) for comment during the consultation period for the Proposed Regulation.

We have extended the comment period on the Proposed Regulation to 150 days in order to allow investors, derivatives market participants and other stakeholders an opportunity to consider both of the proposed regulations before the comment period for the Proposed Regulation expires.

Background

In April 2013, the CSA published for comment a consultation paper, CSA Consultation Paper 91-407 *Derivatives: Registration* (the **Consultation Paper**), that outlined a proposed registration and business conduct regime for derivatives market participants.

Based on our consideration of comments received on the Consultation Paper as well as our review of developments internationally, including the introduction of registration and market conduct regimes for swap dealers and major swap participants in the U.S.,[1] we have developed the Proposed Regulation and are in the process of developing the Proposed Registration Regulation for the purpose of adopting a harmonized derivatives registration and business conduct regime across Canada.

The CSA have chosen to split the proposed derivatives registration and business conduct regimes into two separate rules. This approach is intended to ensure that all derivatives firms remain subject to certain minimum standards in relation to their business conduct towards their customers and counterparties.

The Proposed Regulation applies to a person that meets the definition of "derivatives adviser" or "derivatives dealer" regardless of whether it is registered or exempted from the requirement to be registered in a jurisdiction.

Substance and Purpose of the Proposed Regulation

The CSA have developed the Proposed Regulation to help protect investors, reduce risk, improve transparency and accountability and promote responsible business conduct in the over-the-counter (**OTC**) derivatives markets.

During the financial crisis of 2008, the inappropriate sale of financial investments led to major losses for retail and institutional investors. The International Organization of Securities Commissions (**IOSCO**) noted in 2012 that "until recently, OTC derivatives markets have not been subject to the same level of regulation as securities markets. Insufficient regulation allowed certain participants to operate in a manner that created risks to the global economy that manifested during the financial crisis of 2008."[2] Since the financial crisis, there have been numerous cases of serious market misconduct in the global derivatives market including, for example, misconduct relating to the manipulation of benchmarks and alleged front-running of customer orders.

[1] In this Notice, we use the terms "swap dealer" and "major swap participant" to refer to both swap dealers and major swap participants regulated by the Commodity Futures Trading Commission (**CFTC**) and security-based swap dealers and major security-based swap participants regulated by the Securities and Exchange Commission (the **SEC**). In Canada, the distinction between security-based swaps and other swaps will generally not be relevant.

[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD381.pdf (DMI Report) at p 1.

The Proposed Regulation establishes a robust investor protection regime that meets IOSCO's international standards and takes into account CSA jurisdictions' commitments to create a derivatives dealer regime that is also consistent with the regulatory approach taken by most IOSCO jurisdictions with active derivatives markets.[3] The Proposed Regulation will help to protect participants in the OTC derivatives markets from unfair, improper or fraudulent practices.

The Proposed Regulation is intended to create a uniform approach to derivatives market conduct regulation in Canada and will promote consistent protections for market participants regardless of the type of firms they deal with while also providing that persons that are subject to requirements under the Proposed Regulation are subject to consistent regulation that does not result in a competitive advantage.

A person is subject to the Proposed Regulation only if it is a "derivatives adviser" or a "derivatives dealer". As described below in the Summary of the Regulation, generally this is determined using a test to determine if the person is in the business of trading or advising in OTC derivatives.[4] Furthermore, a person that may be in the business of trading in OTC derivatives may nevertheless be exempt from the requirements of the Proposed Regulation if they qualify for the end-user exemption described further below. Finally, even if a person is subject to the requirements of the Proposed Regulation, those requirements are tailored depending on the nature of the dealer or adviser's derivatives party (refer to the description of the two-tiered structure of the Regulation, below).

The Proposed Regulation sets out a comprehensive regime regulating the conduct of derivatives market participants, including requirements relating to the following:

- Fair dealing
- Conflicts of interest
- Know your client (KYC)
- Suitability
- Pre-trade disclosure
- Reporting
- Compliance
- Senior management duties
- Recordkeeping
- Treatment of derivative party assets

Many of the requirements in the Proposed Regulation are similar to existing market conduct requirements applicable to registered dealers and advisers under *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**Regulation 31-103**) but have been modified to reflect the different nature of derivatives markets.

Much like Regulation 31-103, the Proposed Regulation takes a two-tiered approach to investor/customer protection, as follows:

- certain obligations apply in all cases when a derivatives firm is dealing with or advising a derivatives party, regardless of the level of sophistication or financial

[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD497.pdf (DMI Implementation Review) at p. 13.
[4] Only those OTC derivatives set out in the applicable Product Determination Rule are relevant.

resources of the derivatives party; and

- certain obligations:

    - do not apply if the derivatives firm is dealing with or advising a derivatives party that is an "eligible derivatives party" and that is not an individual, and

    - apply but may be waived if the derivatives firm is dealing with or advising a derivatives party who is an "eligible derivatives party" and is an individual.

The concept of "eligible derivatives party" and the extent to which obligations do not apply, or apply unless waived, when dealing with or advising an eligible derivatives party are explained in Part 1 of the summary of the Regulation below.

Summary of the Regulation

Part 1 – Definitions

Part 1 of the Regulation sets out relevant definitions and principles of interpretation.

Some of the most important definitions in the Regulation are as follows.

Derivatives adviser and derivatives dealer

The definitions of "derivatives adviser" and "derivatives dealer" incorporate a "business trigger" similar to the business trigger for registration in Canadian securities legislation.

As previously mentioned, it is important to note that the Regulation applies to a person that meets the definition of "derivatives adviser" or "derivatives dealer" regardless of whether they are registered or exempted from the requirement to be registered in a jurisdiction. This is intended to ensure that certain derivatives market participants that may benefit from an exemption from registration in certain jurisdictions nevertheless remain subject to certain minimum standards in relation to their business conduct towards their customers.

Clause (b) in the definitions of "derivatives adviser" and "derivatives dealer" has been included since the Proposed Registration Regulation may designate as or prescribe additional entities to be derivatives advisers or derivatives dealers based on specified activities (e.g., trading with non-eligible derivatives parties or engaging in certain market-making activities).

Derivatives party

In the Proposed Regulation, the term "derivatives party" refers to a derivatives firm's counterparties, customers, and other persons that the derivatives firm may deal with or advise (e.g., affiliates or other derivatives firms).

Eligible derivatives party

The term "eligible derivatives party" refers to those derivatives parties that do not require the full set of protections afforded to "retail" customers or investors, either because they may reasonably be considered sophisticated or because they have sufficient financial resources to purchase professional advice or otherwise protect themselves through contractual negotiation with the derivatives firm.

As currently drafted, the definition of "eligible derivatives party" is generally consistent with the current regulatory regimes in the U.S. and Canada in relation to OTC derivatives.[5] In addition, the eligible derivatives party concept should be familiar to market participants because it is similar to the definition of "permitted client" in Regulation 31-103, with a few modifications to reflect the different nature of derivatives markets and participants.

We are seeking comment on a number of elements of the definition of "eligible derivatives party" and have included specific questions about the definition in the Comments section, including a question related to the proposed definition of "institutional client" included in the CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients* (**CSA Consultation Paper 33-404**) published in April 2016.

As the CSA staff responsible for CSA Consultation Paper 33-404 continue to review comments received during the consultation period and engage in various stakeholder consultations, we propose to monitor the work on this project, and may recommend amendments to the Proposed Regulation at a later date based on this work.

Part 2 – Application of the Regulation

Part 2 of the Regulation sets out a number of provisions relating to the application and scope of the Regulation.

Section 3 is a scope provision intended to ensure that the Regulation applies to the same contracts and instruments in all jurisdictions of Canada. Each jurisdiction has adopted a Product Determination Rule that excludes certain types of contracts and instruments from being derivatives for the purpose of the Regulation.

[5] See, for example, the definition of "eligible contract participant" under the U.S. *Commodity Exchange Act* and the *Securities Exchange Act of 1934* applicable to CFTC and SEC swap dealers and major swap participants, the definition of "qualified party" in British Columbia Blanket Order 91-501 *Over-the-Counter Derivatives*, the definition of "qualified party" in Alberta Blanket Order 91-507 *Over-the-Counter Derivatives*, the definition of "accredited counterparty" in section 3 of the Quebec *Derivatives Act*, the definition of "qualified party" in New Brunswick Local Rule 91-501 *Derivatives*, the definition of "qualified party" in Nova Scotia Blanket Order 91-501 *Over The Counter Trades in Derivatives* and the definition of "qualified party" in Saskatchewan General Order 91-908 *Over-the-Counter Derivatives*.

Section 7 provides that the requirements of the Regulation, other than the specific requirements listed in subsection 7(1), do not apply to a derivatives firm if it is dealing with or advising an eligible derivatives party that is not an individual, or an eligible derivatives party that is an individual that has waived these protections in writing (collectively, a **specified eligible derivatives party**).

When a derivatives firm is dealing with or advising a specified eligible derivatives party, the derivatives firm will only be subject to the following requirements of the Regulation:

(a) Division 1 [*General obligations towards all derivatives parties*] of Part 3 [*Dealing with or advising derivatives parties*];

(b) Sections 24 [*Interaction with Regulation 94-102 respecting Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*] and 25 [*Segregating derivatives party assets*] of Part 4 [*Derivatives party accounts*];

(c) Subsection 29(1) [*Content and delivery of transaction confirmations*] of Part 4 [*Derivatives party accounts*]; and

(d) Part 5 [*Compliance and recordkeeping*].

A derivatives firm and a specified eligible derivatives party may choose to incorporate additional protections in the contracts that govern their relationship and their derivatives trading activities. However, the CSA are of the view that, in the case of a derivatives firm dealing with or advising a specified eligible derivatives party these protections should not be required but rather should be a matter of contract for the parties.

Despite the foregoing, section 7 does not limit the requirements that apply to a derivatives firm acting as an adviser in respect of a managed account of an eligible derivatives party.

We have included specific questions about the differential treatment of derivatives parties and specified eligible derivatives parties in the Comments section.

We have also included a table that compares the approach in the Regulation with the approach under Regulation 31-103 in Appendix B.

Part 3 – Dealing with or advising derivatives parties

DIVISION 1 – GENERAL OBLIGATIONS TOWARDS ALL DERIVATIVES PARTIES

Division 1 of Part 3 sets out the fundamental business conduct obligations that the CSA have recommended should apply to all derivatives firms when dealing with or advising derivatives parties, including eligible derivatives parties, namely

- fair dealing,
- responding to conflicts of interest, and
- general (or "gatekeeper") know-your-derivatives party obligations.

Fair dealing

The fair dealing obligation proposed in section 8 of this Regulation is consistent with international practice and is in line with the standards set by Regulation 31-103 while keeping in mind the differences between derivatives and securities markets. The CSA believe that the fair dealing obligation in section 8, as a principles-based obligation, should be interpreted flexibly and in a manner that is sensitive to context and to derivatives market participants' reasonable expectations; the expectation is that it will be applied differently depending on the sophistication of the market participant.

Identifying and responding to conflicts of interest

Section 9 of the Regulation contains obligations to identify and respond to conflicts of interest. This obligation applies when dealing with or advising market participants of all levels of sophistication. It is a principles-based obligation, which should be interpreted flexibly and in a manner that is sensitive to context and to derivatives market participants' reasonable expectations. Furthermore, it is expected that in responding to any conflict of interest, the derivatives party will consider the fair dealing obligation in Part 3 as well as any other standard of care that may apply when dealing with or advising a derivatives party.

General (or "gatekeeper") know-your-derivatives party obligations

Section 10 of the Regulation sets out the general "gatekeeper" know-your-derivatives party (**KYDP**) obligations. These obligations include requirements to: verify the identity of a derivatives party, verify that the derivatives party is an eligible derivatives party, determine if the derivatives party is an insider of a reporting issuer, and comply with anti-money-laundering and terrorist financing obligations.

We would anticipate that many derivatives firms, including Canadian financial institutions, will already have policies and procedures in place to address these obligations and that section 10 should not result in any significant new obligations for these entities.

DIVISION 2 – ADDITIONAL OBLIGATIONS WHEN DEALING WITH OR ADVISING CERTAIN DERIVATIVES PARTIES

The obligations in Division 2 of Part 3 do not apply if a derivatives firm is dealing with or advising a specified eligible derivatives party.

These obligations are intended to protect less sophisticated market participants. These include but are not limited to:

Derivatives-party-specific needs and objectives

Section 11 sets out the obligation on a derivatives firm to obtain information about a derivatives party's specific investment needs and objectives in order for the derivatives firm to meet its suitability obligations under section 12 and to assess a transaction under subsection 19(1).

Information on a derivatives party's specific needs and objectives (sometimes referred to as "client-specific KYC information") forms the basis for determining whether transactions in derivatives are suitable for a derivatives party or the terms of the transaction are the most advantageous. The obligations in section 11 require a derivatives firm to take reasonable steps to obtain and periodically update information about its derivatives parties.

Suitability

Section 12 requires a derivatives firm to take reasonable steps to ensure that a proposed transaction is suitable for a derivatives party before making a recommendation or accepting instructions from the derivatives party to transact in a derivative.

Disclosure regarding the use of borrowed money or leverage

Section 16 requires a derivatives firm to provide a risk disclosure to a derivatives party before a transaction takes place, which explains that the leverage inherent in derivatives may require the derivatives party to deposit additional funds if the value of the derivative declines and that borrowing money or using leverage to fund a derivatives transaction carries additional risk.

DIVISION 3 – RESTRICTIONS ON CERTAIN BUSINESS PRACTICES WHEN DEALING WITH CERTAIN DERIVATIVES PARTIES

The obligations in Division 3 focus on restricting certain business activities when dealing with less sophisticated derivatives parties. These obligations relate to tied selling and fair terms and pricing. The obligations in this Division do not apply if a derivatives firm is dealing with or advising a specified eligible derivatives party.

Tied selling

Section 18 prohibits a derivatives firm from engaging in certain sales practices that would pressure or require a derivatives party to obtain a product or service as a condition of obtaining other products or services from the derivatives firm. An example of tied selling would be offering a loan on the condition that the derivatives party purchase another product or service, such as a swap to hedge the loan from the derivatives firm or one of its affiliates.

As explained in the Policy Statement, section 18 is not intended to prohibit relationship pricing or other beneficial selling arrangements similar to relationship pricing. Relationship pricing refers to the practice of industry participants offering financial incentives or advantages to certain derivatives parties.

Fair terms and pricing

Subsection 19(1) imposes an obligation on derivatives firms to implement policies and procedures that are reasonably designed to obtain the most advantageous terms reasonably available when acting as agent for a derivatives party. Subsection 19(2) requires derivatives dealers, when transacting with a derivatives party as principal to make a reasonable effort to provide a price that is fair and reasonable taking into account all relevant factors.

Part 4 – Derivatives Party Accounts

DIVISION 1 - DISCLOSURE TO DERIVATIVES PARTIES

The CSA believe that less sophisticated derivatives parties, or those individuals who would like a higher level of protection, need more detailed information concerning their transactions and their accounts. Below are some of the requirements designed to keep derivatives parties informed. The obligations in this Division do not apply if a derivatives firm is dealing with or advising a specified eligible derivatives party.

Section 20 requires a derivatives firm to provide a derivatives party with all information that the derivatives party needs to understand not only their relationship with the derivatives firm but also the products and services that the derivatives firm will or may provide and the fees or other charges that the derivatives party may be required to pay.

Subsection 21(1) sets out the obligation for a derivatives firm to provide a derivatives party with disclosure relating to the type of derivative that is reasonably designed to allow the derivatives party to assess the material risks of transacting in the derivative. This includes the derivatives party's potential exposure and the material characteristics of the derivative which include the material economic terms and the rights and obligations of the counterparties to the type of derivative.

In addition, subsection 21(2) establishes obligations, before transacting a specific derivative, to advise the derivatives party about material risks in relation to the specific derivative that are materially different than the risks disclosed under subsection 21(1) and, if applicable, the price of the derivative to be transacted and the most recent valuation.

Further to these obligations, section 22 requires a derivatives firm to provide a derivatives party with daily valuation of the derivatives that it has transacted with or on behalf of that derivatives party.

DIVISION 2 - DERIVATIVES PARTY ASSETS

Division 2 sets out certain requirements related to segregation and holding of derivatives party assets held by a derivatives firm, as well as restrictions on the use and investment of those assets.

The obligations in this Division, other than section 24 and section 25, do not apply if a derivatives firm is dealing with or advising a specified eligible derivatives party.

DIVISION 3 - REPORTING TO DERIVATIVES PARTIES

Division 3 sets out obligations of derivatives firms to provide certain reports to derivatives parties.

Section 29 provides that a derivatives firm must provide a confirmation of the key elements of a derivatives transaction. The contents of this confirmation are set out in subsection 29(2).

Section 30 sets out the obligations of a derivatives firm to provide monthly statements to derivatives parties. Subsection 30(2) describes the information that must be provided in the monthly statement.

The obligations in this Division, other than the fundamental transaction confirmation requirement in subsection 29(1), do not apply if a derivatives firm is dealing with or advising a specified eligible derivatives party.

Part 5 – Compliance and recordkeeping

DIVISION 1 - COMPLIANCE

Section 32 provides that a derivatives firm must have policies and procedures that establish a system of controls to assure that, with respect to transacting or advising on derivatives, the firms and individuals acting on its behalf comply with applicable laws, to manage risk and to ensure that individuals have the necessary training and expertise.

Section 33 imposes certain supervisory, management, and reporting obligations on

"senior derivatives managers". These requirements are intended to create accountability at the senior management level. The CSA are monitoring international regulatory initiatives[6] designed to ensure that senior managers bear responsibility for the effective and efficient management of their business units. A senior derivatives manager is an individual that is responsible for the derivatives activities of a particular business unit (e.g., the individual responsible for, or head of, interest rate trading or the "rates desk" at a derivatives firm). Senior derivatives managers must supervise compliance activities, promote compliance, and take steps to prevent and respond to non-compliance. At least annually, senior derivatives managers must also report to the firm's board of directors, either to certify that the business unit is in material compliance with all applicable securities legislation, or to specify circumstances of material non-compliance.

Section 34 sets out the requirement of a derivatives firm to respond to material non-compliance, and in certain circumstances to report material non-compliance to the regulator, except in Québec, or securities regulatory authority.

Part 6 – Exemptions

DIVISION 1 - EXEMPTIONS FROM THE REGULATION

Section 38 provides that persons that are registered under securities legislation, in Canada or a foreign jurisdiction, do not qualify for the exemption in section 39.

Section 39 provides that derivatives end-users (e.g., entities that trade derivatives for their own account for commercial purposes) are exempt from the Regulation provided they do not do any of the following:

- solicit or otherwise transact in a derivative with, for or on behalf of a person that is not an eligible derivatives party;

- advise persons in respect of transactions in derivatives, if the person is not an eligible derivatives party, other than general advice that is provided in accordance with the conditions of section 43;

- 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;

- regularly facilitate or otherwise intermediate transactions in derivatives for another person;

- facilitate the clearing of a transaction in a derivative through the facilities of a clearing agency for a third-party, other than an affiliated entity.

[6] See for example https://www.fca.org.uk/firms/senior-managers-certification-regime and http://www.sfc.hk/web/EN/faqs/intermediaries/licensing/manager-in-charge-regime.html

DIVISION 2 AND DIVISION 3 - EXEMPTIONS FROM SPECIFIC REQUIREMENTS OF THE REGULATION

Foreign derivatives dealers and foreign derivatives advisers

These Divisions provide, under certain conditions, an exemption from requirements in the Regulation for foreign derivatives dealers and foreign derivatives advisers that are regulated under the laws of a foreign jurisdiction that achieve substantially the same objectives, on an outcomes basis, as the Proposed Regulation.

These exemptions apply to the provisions of the Regulation where the derivatives dealer or derivatives adviser is subject to and in compliance with the laws of a foreign jurisdiction set out in Appendix A and Appendix D of the Regulation opposite the name of the foreign jurisdiction. The jurisdictions specified in Appendices A and D will be determined on a jurisdiction-by-jurisdiction basis, and based on a review of the laws and regulatory framework of the jurisdiction.

Note that as of the time of this publication for comment, the equivalence analysis required to populate Appendices A and D of the Regulation has not been completed.

DIVISION 3 – EXEMPTIONS FOR DERIVATIVES ADVISERS

Advising generally

Division 3 provides an exemption for persons that provide general advice in relation to derivatives, where the advice is not tailored to the needs of the person receiving the advice (e.g., analysis published in mass media), and the person discloses all financial or other interests in relation to the advice.

Anticipated Costs and Benefits

The CSA have developed the Proposed Regulation to help protect investors and counterparties, reduce risk, improve transparency and accountability and promote responsible business conduct in the OTC derivatives markets.

We are proposing an investor protection regime for Canadian OTC derivatives parties that is equivalent to the protections offered in major international markets and also targets misconduct that could impact the Canadian market.

There will be compliance costs for derivatives firms that may increase the cost of trading or receiving advice for market participants. In the CSA's view, the compliance costs to market participants are proportionate to the benefits to the Canadian market of implementing the Proposed Regulation. The major benefits and costs of the Proposed Regulation are described below.

(a) Benefits

The Proposed Regulation will protect participants in the Canadian OTC derivatives market by reducing the likelihood of suffering loss through inappropriate transactions, inappropriate sale of derivatives and market misconduct. The Proposed Regulation offers protections not only to retail market participants but also large market participants whose derivatives losses could impact their business operations and potentially the Canadian economy more broadly. The Proposed Regulation fills a regulatory gap in the Canadian OTC derivatives market for certain derivatives firms that are not subject to business conduct regulation and oversight. It is intended to foster confidence in the Canadian derivatives market by creating a regime that meets international standards and is equivalent to the regimes in major trading jurisdictions. Currently, OTC derivatives are regulated differently across Canadian jurisdictions, and there is inconsistency in regulation of business conduct in OTC derivatives markets. The Proposed Regulation aims to reduce compliance costs for derivatives firms by harmonizing the rules across Canadian jurisdictions and establishing a regime that is tailored for the derivatives market.

(b) Costs

Generally, any increased costs resulting from compliance with the Proposed Regulation are expected to arise from analysing the requirements put forth and establishing policies and procedures for compliance. Any costs associated with complying with the Proposed Regulation are expected to be borne by derivatives firms and in certain circumstances may be passed on to derivatives parties. There is also a possibility that foreign derivatives firms may be dissuaded from entering or remaining in the Canadian market due to the costs of complying with the Proposed Regulation, which would reduce Canadian derivatives parties' options for derivatives services. However the Proposed Regulation contemplates an exemption for derivatives firms located in foreign jurisdictions, which are subject to and in compliance with equivalent exemptions under foreign laws. This exemption could significantly reduce compliance costs associated with the Proposed Regulation for derivatives firms located in and complying with the laws of approved foreign jurisdictions.

(c) Conclusion

Protection of derivatives parties and the integrity of the Canadian derivatives market are the fundamental principles of the Proposed Regulation. The CSA are of the view that the impact of the Proposed Regulation, tailored for the OTC derivatives market, including anticipated compliance costs for derivatives firms, is proportional to the benefits sought. The Proposed Regulation aims to provide a level of protection similar to that offered to derivatives parties in other jurisdictions with significant OTC derivatives markets. To achieve a balance of interests, the Proposed Regulation is designed to promote a safer environment in the Canadian derivatives market by delivering a high level of protection to customers transacting in OTC derivatives and also facilitate a flexible and competitive market for derivatives firms to operate in.

Publication

The Regulation and the Policy Statement are published together with this Notice.

Comments

In addition to your comments on all aspects of the Proposed Regulation, the CSA also seek specific feedback on the following questions:

1) Definition of "eligible derivatives party"

As currently drafted, the definition of "eligible derivatives party" is generally similar to the definition of "permitted client" in Regulation 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?

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?

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.[7]

The CSA Consultation Paper 33-404 proposed a definition of "institutional client"[8] which is generally similar to the definition of a "permitted client" in section 1.1 of Regulation 31-103. However, in comparison to the definition of "permitted client" in Regulation 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, 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

[7] See the Bulletin de l'Autorité des marchés financiers, Vol. 13, No. 17, published on April 28, 2016, at page 145.

[8] For the proposed definition of "institutional client", see the Bulletin de l'Autorité des marchés financiers, Vol. 13, No. 17, published on April 28, 2016, at page 194.

higher financial threshold for non-individual entities:

> (x) *any other person, other than an individual, with financial assets, as defined in section 1.1 of Regulation 45-106 respecting 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 Regulation.

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

Clauses (m) and (n) of the definition of "eligible derivatives party" provide that a person 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 Policy statement notes that "some people may only have the requisite knowledge and experience pertaining to derivatives of a certain asset class or product type".

If a person 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?

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?

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

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

Does the Proposed Regulation 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?

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

derivatives party?

5) Business trigger guidance

Part 1 of the Policy Statement sets out factors that are considered relevant in determining whether a person 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 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 Regulation provides that the exemption described therein is only available if "the person 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 Policy Statement, along with 39(c) of the Regulation, appropriately describe the situation in which a person should be considered to be a derivatives dealer because they are functioning in the role of a market maker?

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?

7) Fair terms and pricing

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

8) Derivatives Party Assets

Regulation 94-102 respecting 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 Regulation 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?

9) Valuations for derivatives

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?

10) Senior derivatives managers

Section 33 of the Regulation 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, except in Québec, 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.

11) Exemptions

Sections 40, 41, 42, and 44 of the Regulation 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 Regulation.

Please provide your comments in writing by **September 1, 2017.**

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. In addition, all comments received will be posted on the websites of each of the Alberta Securities Commission at www.albertasecurities.com, the Autorité des marchés financiers at www.lautorite.qc.ca and the Ontario Securities Commission at www.osc.gov.on.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Thank you in advance for your comments.

Please address your comments to each of the following:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission

Office of the Superintendent of Securities, Newfoundland and Labrador
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

Please send your comments **only** to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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Appendix A

Comparison of protections that do not apply to, or may be waived by, "eligible derivatives parties" under Draft *Regulation 93-101 respecting Derivatives: Business Conduct* and "permitted clients" under *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*

Certain requirements in the Proposed Regulation are similar to existing market conduct requirements applicable to registered dealers and advisers under *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**Regulation 31-103**) but have been modified to reflect the different nature of derivatives markets.

The extent to which obligations do not apply, or apply unless waived, when dealing with or advising an eligible derivatives party is set out in the following chart:

Obligation	**Approach under Regulation 31-103**	**Approach under Regulation 93-101**
Fair dealing[9]	Applies in respect of all clients	Applies in respect of all derivatives parties (s. 8)
Identifying and responding to conflicts of interest	Applies in respect of all clients (s. 13.4) However, client relationship disclosure obligations in relation to conflicts of interest do not apply in respect of a permitted client that is not an individual (s. 14.2(6))	Applies in respect of all derivatives parties (s. 9) However, relationship disclosure obligations in Part 4 in relation to conflicts of interest do not apply in respect of • an EDP that is not an individual • an EDP that is an individual that has waived this disclosure

[9] See section 2.1 of OSC Rule 31-505 *Conditions of Registration*; section 14 of the Securities Rules, B.C. Reg. 194/97 under the *Securities Act* (British Columbia), R.S.B.C. 1996, c. 418; section 75.2 of the *Securities Act* (Alberta) R.S.A. 2000, c.S-4; section 33.1 of *The Securities Act, 1988* (Saskatchewan), S.S. 1988-89, c. S-42.2; subsection 154.2(3) of *The Securities Act* (Manitoba) C.C.S.M. c. S50; section 65 of the *Derivatives Act* (Québec), R.S.Q., c. 14.01; section 39A of the *Securities Act* (Nova Scotia), R.S.N.S. 1989, c. 418; subsection 54(1) of the *Securities Act* (New Brunswick) S.N.B. 2004, c. S-5.5; section 90 of the *Securities Act* (Prince Edward Island), R.S.P.E.I. 1988, c. S-3.1; subsection 26.2(1) of the *Securities Act* (Newfoundland and Labrador), R.S.N.L.1990, c. S-13; section 90 of the *Securities Act* (Nunavut), S.Nu. 2008, c. 12; section 90 of the *Securities Act* (Northwest Territories), S.N.W.T. 2008, c. 10; and section 90 of the *Securities Act* (Yukon), S.Y. 2007, c. 16.

Gatekeeper KYC (AML, etc.)	Applies in respect of all clients (s. 13.2) However, this does not apply if the client is a registered firm, Canadian financial institution or Schedule III bank (s. 13.2(5))	Applies in respect of all derivatives parties (s. 10) However, this does not apply if the derivatives party is a registered firm or a Canadian financial institution (including a Schedule III bank)
Client-specific KYC (investment needs and objectives, etc.) Suitability	Applies in respect of all clients (ss. 13.2(2)(c) and 13.3) May be waived in writing by a permitted client (including an individual permitted client) if registrant does not act as an adviser in respect of a managed account for the client (ss. 13.2(6) and 13.3(4))	Applies in respect of all derivatives parties other than • an EDP that is not an individual • an EDP that is an individual that has waived in writing this obligation (ss. 7, 11 and 12)
Miscellaneous other obligations	Do not apply to a permitted client • Disclosure when recommending the use of borrowed money – s. 13.13(2) • When the firm has a relationship with a financial institution – s. 14.4(3)	Apply in respect of all derivatives parties other than • an EDP that is not an individual • an EDP that is an individual that has waived in writing this obligation (ss. 7 and 16)
Miscellaneous other obligations	Do not apply to a permitted client that is not an individual • Dispute resolution service – s. 13.16(8) • Relationship disclosure information – s. 14.2(6) • Pre-trade disclosure of charges – s. 14.2.1(2), • Restriction on self-custody and qualified custodian requirement – s. 14.5.2 • Additional statements – s. 14.14.1 • Security position cost information – s. 14.14.2 • Report on charges and other compensation – s. 14.17 • Investment performance report – s. 14.18	Apply in respect of all derivatives parties other than • an EDP that is not an individual • an EDP that is an individual that has waived in writing this obligation (See s. 7 and Part 4)

Appendix B

Application of business conduct requirements

Regulatory Requirement	Derivatives firms dealing only with EDPs	Derivatives firms dealing with non-EDPs	Derivatives advisers acting for managed account
General obligations toward all (Part 3 Div 1) • Fair dealing • Conflict of interest management • General/gatekeeper know-your-derivatives party	●	●	●
Additional obligations and restrictions (Part 3 Div 2–3) • Derivatives-party-specific know-your-derivatives party • Product suitability • Permitted referral arrangements • Leverage/borrowing disclosure • Complaint handling • Prohibition on tied selling • Fair terms and pricing		●	●
Client and counterparty accounts (Part 4) • Relationship disclosure • Pre-trade disclosures re. risk, product, price, and compensation • Report daily valuations • Notice by non-resident registrants • Holding of assets[10] • Use and investment of assets • Transaction confirmations[11] • Monthly statements		●	●
Compliance and recordkeeping (Part 5) • Compliance and risk management systems • Senior manager certification • Client/counterparty agreement • Recordkeeping	●	●	●

[10] A basic segregation requirement applies in all circumstances, but most of the asset requirements only apply in the non-EDP context.

[11] A basic transaction confirmation requirement applies in all circumstances, but the more detailed requirement applies only in the non-EDP context.