POLICY STATEMENT TO REGULATION 93-101 RESPECTING DERIVATIVES: BUSINESS CONDUCT

PART 1
GENERAL COMMENTS

Introduction

This policy statement (the Policy) sets out the views of the Canadian Securities Administrators (the CSA or we) on various matters relating to *Regulation 93-101 respecting Derivatives: Business Conduct* (the Regulation) and related securities legislation.

Except for Part 1, the numbering and headings of Parts, sections and subsections in this Policy correspond to the numbering and headings in the Regulation. Any general guidance for a Part or section appears immediately after the Part or section name. Any specific guidance on a section or subsection follows any general guidance. If there is no guidance for a Part or section, the numbering in this Policy will skip to the next provision that does have guidance.

Unless otherwise stated, any reference to a Part, section, subsection, paragraph, subparagraph or definition in this Policy is a reference to the corresponding Part, section, subsection, paragraph, subparagraph or definition in the Regulation.

Definitions and interpretation

Unless defined in the Regulation or this Policy, terms used in the Regulation and in this Policy have the meaning given to them in securities legislation, including in *Regulation 14-101 respecting Definitions* (chapter V-1.1, r. 3). "Securities legislation" is defined in *Regulation 14-101 respecting Definitions*, and includes statutes and other instruments related to both securities and derivatives.

In this Policy, "Product Determination Rule" means,

- in Alberta, British Columbia, New Brunswick, Newfoundland and Labrador, the Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island, Saskatchewan and Yukon, Multilateral Instrument 91-101 *Derivatives: Product Determination*,

- in Manitoba, Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination*,

- in Ontario, Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination*, and

- in Québec, *Regulation 91-506 respecting Derivatives Determination* (chapter I-14.01, r. 01).

Interpretation of terms defined in the Regulation

Section 1 – Definition of Canadian financial institution

The definition of "Canadian financial institution" in the Regulation is consistent with the definition of this term in *Regulation 45-106 respecting Prospectus Exemptions* with one exception. The definition of this term in *Regulation 45-106 respecting Prospectus Exemptions* (chapter V-1.1, r. 21) does not include a Schedule III bank (due to the separate definition of the term "bank" in *Regulation 45-106 respecting Prospectus Exemptions*), with the result that *Regulation 45-106 respecting Prospectus Exemptions* contains certain references to "a Canadian financial institution or a Schedule III bank". The definition of this term in the Regulation includes a Schedule III bank.

Section 1 – Definition of derivatives adviser and derivatives dealer

A person that meets the definition of "derivatives adviser" or "derivatives dealer" in a local jurisdiction is subject to the Regulation in that jurisdiction, whether or not they are registered or exempted from the requirement to be registered in that jurisdiction.

A person will be subject to the requirements of the Regulation if they are

- in the business of trading derivatives or in the business of advising others in respect of derivatives, or

- otherwise required to register as a derivatives dealer or a derivatives adviser as a consequence of engaging in certain specified activities set out in Draft *Regulation 93-102 respecting Derivatives: Registration (insert here the reference).*

Factors in determining business purpose

In determining whether a person is in the business of trading or in the business of advising in derivatives, a number of factors should be considered. The factors are set out below.

This is not a complete list of factors and other factors may also be considered.

- *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.

- *Directly or indirectly carrying on the activity with repetition, regularity or continuity* – Frequent or regular transactions are a common indicator that a person may be engaged in trading or advising for a business purpose. The activity does not have to be their sole or even primary endeavour for them to be in the business. We consider regularly trading or advising in any way that produces, or is intended to produce, profits to be for a business purpose.

- *Facilitating or intermediating transactions* – The person provides services relating to the facilitation of trading or intermediation of transactions in derivatives between third-party counterparties to derivatives contracts. This typically takes the form of the business commonly referred to as a broker.

- *Transacting with the intention of being compensated* – The person receives, or expects to receive, any form of compensation for carrying on derivatives transaction activity. This would include any compensation that is transaction- or value-based including from spreads or built-in fees. It does not matter if the person actually receives compensation or what form the compensation takes. However, a person would not be considered to be a derivatives dealer solely by reason that it realizes a profit from changes in the market price for the derivative (or its underlying reference asset), regardless of whether the derivative is intended for the purpose of hedging or speculating.

- *Directly or indirectly soliciting in relation to derivatives transactions* – The person contacts others to solicit derivatives transactions. Solicitation includes contacting someone by any means, including communication that offers (i) transactions, (ii) participation in transactions or (iii) services relating to transactions. This includes advertising on the internet with the intention of encouraging transacting in derivatives by local persons. A person might not be considered to be soliciting solely because it contacts a potential counterparty, or a potential counterparty contacts them to enquire about a transaction in a derivative, unless it is the person's intention or expectation to be compensated from the transaction. For example, a person that wishes to hedge a specific risk might not be considered to be soliciting for the purpose of the Regulation if they contacted multiple potential counterparties to enquire about potential derivatives transactions to hedge the risk.

- *Engaging in activities similar to a derivatives adviser or derivatives dealer* – The person carries out any activities related to transactions involving derivatives that would reasonably appear, to a third party, to be similar to the activities discussed above. This would not include the operator of an exchange or a clearing agency.

- *Providing derivatives clearing services* – The person provides services to allow third parties, including counterparties to transactions involving the person, to clear derivatives through a clearing agency. These services are actions in furtherance of a trade conducted by a person that would typically play the role of an intermediary in the derivatives market.

In determining whether or not they are, for the purposes of the Regulation, a derivatives dealer or derivatives adviser, a person should consider their activities holistically. We do not consider that all of the factors discussed above necessarily carry the same weight or that any one factor will be determinative.

Generally, we would consider a person that engages in the activities discussed above in an organized and repetitive manner to be a derivatives dealer or, depending on the context, a derivatives adviser. Ad hoc or isolated instances of the activities discussed above may not necessarily result in a person being a derivatives dealer or, depending on the context, a derivatives adviser. For example, if a person makes an effort to take a long and short position at the same time to manage business risk, this does not necessarily mean that the person is making a market. Similarly, organized and repetitive proprietary trading, in and of itself, absent other factors described above, may not result in a person being considered to be a derivatives dealer for the purpose of the Regulation.

A derivatives dealer or a derivatives adviser in a local jurisdiction is a person that conducts the activities described in this section in that jurisdiction. For example, this would include a person that is located in a local jurisdiction and that conducts dealing or advising activity in that local jurisdiction or in a foreign jurisdiction. This would also include a person located in a foreign jurisdiction that conducts dealing or advising activity with a counterparty located in the local jurisdiction. A person does not need to have a physical location, staff or other presence in the local jurisdiction to be a derivatives dealer or derivatives adviser in that jurisdiction.

A person's primary business activity does not need to include the activities described above for the person to be a derivatives dealer or derivatives adviser for the purpose of the Regulation. The factors described above could represent only a small portion of the person's overall business activities. However, if these factors are present, it may be a derivatives dealer or derivatives adviser in the jurisdiction in which it engages in those activities.

Section 4 provides that a person is not a derivatives dealer or derivatives adviser for the purpose of the Regulation if they would be a dealer or adviser solely as a result of carrying out the activities described above in relation to one or more affiliated entities of the person.

Section 1 – Definition of derivatives party assets

"Derivatives party assets" includes all assets of a derivatives party that are received or held by a derivatives firm for or on behalf of the derivatives party for any purpose relating to derivatives transactions. This will include collateral delivered as initial or variation margin.

Section 1 – Definition of eligible derivatives party

Certain requirements of the Regulation do not apply where a derivatives firm is dealing with or advising a derivatives party that is an eligible derivatives party that is not an individual. If the derivatives firm is dealing with or advising a derivatives party who is an eligible derivatives party and is an individual, these requirements apply but may be waived in writing. Section 7 of this Policy provides additional guidance relating to this waiver.

A derivatives firm should take reasonable steps to determine whether a derivatives party is an eligible derivatives party before transacting with or advising them. In determining whether the person that it transacts with or advises is an eligible derivatives party, the derivatives firm may rely on factual representations made in writing by the derivatives party, unless a reasonable person would have grounds to believe that such statements are false or it is otherwise unreasonable to rely on the representation. The criteria for determining whether a derivatives party is an eligible derivatives party are to be applied at the time a particular derivative is first entered into. A derivatives firm is not required to ensure that the derivatives party continues to be an eligible derivatives party during the life of the particular derivative but must consider the derivative party's eligible derivatives party status before entering into a new transaction with that derivatives party.

Section 1 – Definition of eligible derivatives party – subsections (m) and (n)

Under paragraphs (m) and (n) of the definition of "eligible derivatives party", a person will only be considered an eligible derivatives party if they have represented in writing to the

derivatives firm that they have the requisite knowledge and experience, and they have the minimum assets specified in the applicable paragraph.

If the derivatives firm has not received a written factual statement from a derivatives party, the derivatives firm should consider the derivatives party not to be an eligible derivatives party.

We expect that a derivatives firm would maintain a copy of each derivatives party's written representation about its status as an eligible derivatives party and would have policies and procedures reasonably designed to ensure that the information relating to each derivatives party is up to date.

Whether it is reasonable for a derivatives firm to rely on a derivative's party's written representation will depend on the particular facts and circumstances of the derivatives party and its relationship with the derivatives firm.

For example, in determining whether it is reasonable to rely on a derivative's party's representation that it has the requisite knowledge and experience, a derivatives firm may consider factors such as

- whether the derivatives party enters into transactions with frequency and regularity,

- whether the derivatives party has staff who have experience in derivatives and risk management,

- whether the derivatives party has retained independent advice in relation to its derivatives, and

- publically available financial information.

Taking the above factors into consideration, some people or companies may only have the requisite knowledge and experience pertaining to derivatives of a certain asset class or product type.

Section 1 – Definition of permitted depository

In recognition of the international nature of the derivatives market, paragraph (e) of the definition of "permitted depository" permits a foreign bank or trust company with a minimum amount of reported shareholders' equity to act as a permitted depository and hold derivatives party assets, provided its head office or principal place of business is located in a permitted jurisdiction and it is regulated as a bank or trust company in the permitted jurisdiction.

Section 1 – Definition of permitted investment

The term "permitted investment" sets out a principles-based approach to determining the types of instruments in which a derivatives firm may invest derivatives party assets, in accordance with the provisions of the Regulation. The term is intended to cover an investment in an instrument that is secured by, or is a claim on, high-quality debtors, and which allows for quick liquidation with little, if any, adverse price effect, for the purpose of mitigating market, credit and liquidity risk.

We expect that a derivatives firm that invests derivatives party assets in accordance with the Regulation would ensure such investment is:

- consistent with its overall risk-management strategy, and

- fully disclosed to its customers.

We are also of the view that it would be inconsistent with the principles-based approach to permitted investments for a derivatives firm to invest derivatives party assets in its own securities or those of its affiliated entities.

Examples of instruments that would be considered permitted investments by the local securities regulatory authority include the following:

- debt securities issued by or guaranteed by the Government of Canada or the government of a province or territory of Canada;

- debt securities that are issued or guaranteed by a municipal corporation in Canada;

- certificates of deposit, that are not securities, issued by a bank listed in Schedule I, II or III to the *Bank Act* of Canada (the "Bank Act");[1]

- commercial paper fully guaranteed as to principal and interest by the Government of Canada;

- interests in money market mutual funds.

We are also of the view that foreign investments in high-quality obligors exhibiting the same conservative characteristics as the instruments listed above would be acceptable.

Section 1 – Definition of permitted jurisdiction

Paragraph (a) of the definition of "permitted jurisdiction" captures jurisdictions where foreign banks authorized under the Bank Act to carry on business in Canada, subject to supervision by the Office of the Superintendent of Financial Institutions (OSFI), are located.[2] As of the time of the publication of this Regulation the following countries and their political subdivisions are included: Belgium, France, Germany, Ireland, Japan, Netherlands, Singapore, Switzerland, United Kingdom, and the United States of America.

For paragraph (b) of the definition of "permitted jurisdiction," in the case of the euro, where the currency does not have a single "country of origin", the provision will be read to include all countries in the euro area[3] and countries using the euro under a monetary agreement with the European Union.[4]

Section 1 – Definition of segregate

While the term "segregate" means to separately hold or separately account for derivatives party assets or positions, consistent with the PFMI Report and *Regulation 94-102 respecting Derivatives: Customer Clearing and Protection of Customer Collateral and Positions (insert here the reference)*, accounting segregation is acceptable.

For the purpose of this section "PFMI Report" means the April 2012 final report entitled *Principles for financial market infrastructures* published by the Bank for International Settlements' Committee on Payments and Market Infrastructure (formerly the Committee on Payment and Settlement Systems) and the Technical Committee of the International Organization of Securities Commissions, as amended from time to time.

Section 1 – Definition of valuation

We are of the view that the valuation can be calculated based upon the use of an industry-accepted methodology that is in accordance with accounting principles and that results in a reasonable valuation of the derivative[5] such as mark-to-market or mark-to-model. We expect that the methodology used to calculate the valuation that is reported with respect to a derivative would be consistent over the entire life of the derivative.

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[1] *Bank Act* (SC 1991, c 46).

[2] *Ibid.* at Part XII.1; For a list of authorized foreign banks regulated under the *Bank Act* and subject to OSFI supervision, see: Office of the Superintended of Financial Institutions, *Who We Regulate* (available: http://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx?sc=1&gc=1#WWRLink11).

[3] European Union, Economic and Financial Affairs, *What is the euro area?*, May 18, 2015, online: European Union (http://ec.europa.eu/economy_finance/euro/adoption/euro_area/index_en.htm).

[4] European Union, Economic and Financial Affairs, *The euro outside the euro area*, April 9, 2014, online: European Union (https://ec.europa.eu/info/business-economy-euro/euro-area/euro/use-euro/euro-outside-euro-area_en).

[5] For example, see International Financial Reporting Standard 13 *Fair Value Measurement*.

PART 2
APPLICATION

Section 2 – Application to registered and unregistered derivatives firms

The Regulation applies to "derivatives advisers" and "derivatives dealers" as defined in subsection 1(1) of the Regulation. These definitions include a person registered as a "derivatives dealer" or "derivatives adviser" under securities legislation. The Regulation applies even if the person is exempted or excluded from registration. Accordingly, derivatives firms that may be exempted from registration in a jurisdiction, such as Canadian financial institutions, will nevertheless be subject to a similar standard of conduct towards their derivatives parties as the standard of conduct applicable to registered derivatives firms and their representatives.

Section 3 – Scope of Regulation

This section ensures 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.

Section 7 – Requirements that apply when dealing with or advising an eligible derivatives party

The term "eligible derivatives party" is intended to refer to those derivatives parties that do not require the full set of protections afforded to derivatives parties that do not have the financial resources or expertise to meet the eligible derivatives party thresholds.

The obligations of a derivatives firm and individuals acting on its behalf towards a derivatives party differ depending on the nature of the derivatives party.

Section 7 – Requirements that apply when dealing with or advising a derivatives party that is not an eligible derivatives party

All of the requirements in Parts 3, 4 and 5 of the Regulation apply to a derivatives firm when dealing with or advising a derivatives party that is not an eligible derivatives party.

Subsection 7(1) – Requirements that apply when dealing with or advising an eligible derivatives party that is not an individual

Only certain requirements in the Regulation apply to a derivatives firm when the derivatives firm is dealing with or advising a derivatives party that is an eligible derivatives party and that is not an individual:

In Part 3,

- all of Division 1, comprising section 8, section 9 and section 10, applies, and
- all other requirements in Part 3 do not apply.

In Part 4,

- in Division 2, section 24 and section 25 apply, and
- all other requirements in Part 4 do not apply.

In Part 5,

- all of Division 1 applies, and
- all of Division 2 applies.

Subsection 7(2) – Requirements that apply when dealing with or advising an eligible derivatives party that is an individual but that may be waived by the individual

If the derivatives firm is dealing with or advising a derivatives party that is an eligible derivatives party and an individual, the requirements of the Regulation apply to the derivatives firm in respect of such dealing or advice. However, the individual eligible derivatives party may agree to waive in writing any or all of the requirements of the Regulation, other than the requirements set out in subsection 7(1).

In the case of a waiver by an individual eligible derivatives party, the waiver may be included in account-opening documentation or other relationship disclosure and will be valid for up to 365 days. If the derivatives firm wishes to continue to be able to rely on a waiver from the individual eligible derivatives party more than 365 days after it has been given, the derivatives firm will need to obtain a new waiver in writing from the derivatives party.

There is no prescribed form for the waiver contemplated by subsection 7(2) of the Regulation. However, consistent with the derivatives firm's obligation to deal fairly, honestly and in good faith with derivatives parties, we expect the waiver to be presented to the derivatives party in a clear and meaningful manner in order to ensure the derivatives party understands the information presented and the significance of the protections being waived.

PART 3
DEALING WITH OR ADVISING DERIVATIVES PARTIES

DIVISION 1 – General obligations towards all derivatives parties

Section 8 – Fair dealing

The fair dealing obligation in section 8 is a principles-based obligation and is intended to be similar to the fair dealing obligation applicable to registered firms and registered individuals under Canadian securities legislation (the "registrant fair dealing obligation").[6]

The fair dealing obligation should be interpreted flexibly and in a manner sensitive to context

We recognize that there are important differences between derivatives markets and securities markets, with the result that the fair dealing obligation under the Regulation may not always apply to derivatives market participants in the same manner as the registrant fair dealing obligation would apply to securities market participants. Accordingly, we 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. For this reason, prior CSA guidance and case law on the registrant fair dealing obligation may not necessarily be relevant in interpreting the fair dealing obligation under the Regulation. Similarly, the guidance in this Policy is not necessarily applicable to registrants in their conduct with securities market participants.

We take the view that the concept of fairness when applied to derivatives market participants is context-specific. Conduct that may be considered unfair when dealing with a derivatives party that is not an eligible derivatives party may be considered fair and part of ordinary commercial practice when dealing with an eligible derivatives party. For example, the fair dealing obligation may be different if the derivative party is an individual or small business from what it would be if the derivative party were a sophisticated market participant such as a global financial institution. Similarly, conduct that may be considered to be unfair when acting as an agent to facilitate a derivatives transaction with a third-party may be considered fair when entering into a derivative as principal when it would be expected that each party negotiating the derivative is seeking to ensure favourable financial terms.

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[6] See 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 2.1 of OSC Rule 31-505 *Conditions of Registration* ; 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.

Section 9 – Conflicts of interest

We recognize that there are important differences between derivatives markets and securities markets, with the result that the conflict of interest provisions under the Regulation may not always apply to derivatives market participants in the same manner as they would for securities market participants. Accordingly, we believe that the conflict of interest provisions in section 9 should be interpreted flexibly and in a manner that is sensitive to context and to derivatives market participants' reasonable expectations. For this reason, prior CSA guidance and case law on conflicts of interest may not necessarily be relevant in interpreting the conflict of interest provisions under the Regulation. Similarly, the guidance in this Policy is not necessarily applicable to registrants in their conduct with securities market participants.

We take the view that the concept of conflict of interest when applied to derivatives market participants is context-specific. Circumstances that may be considered to give rise to a conflict of interest when dealing with a derivatives party that is not an eligible derivatives party may be considered fair and part of ordinary commercial practice when dealing with an eligible derivatives party. For example, conflicts of interests may be treated differently when dealing with a derivative party that is an individual or small business from how they would be treated if the derivative party were a sophisticated market participant such as a global financial institution.

In addition, the circumstances that may be considered to give rise to a conflict of interest when acting as an intermediary on behalf of an eligible derivatives party may not represent a conflict of interest when entering into a derivative as principal where the derivatives party is reasonably aware that derivatives firm is negotiating the derivative as a commercial arrangement.

Subsection 9(1) – Identifying conflicts of interest

Section 9 of the Regulation requires a derivatives firm to take reasonable steps to identify existing material conflicts of interest and material conflicts that the derivatives firm reasonably expects to arise between the derivatives firm and their derivatives parties.

We consider a conflict of interest to be any circumstance where the interests of a derivatives party and those of a derivatives firm or its representatives, are inconsistent or divergent.

Subsection 9(2) – Responding to conflicts of interest

We expect that a derivatives firm's policies and procedures for managing conflicts would allow the firm and its staff to

- identify conflicts of interest,
- determine the level of risk that a conflict of interest raises, and
- respond appropriately to conflicts of interest.

When responding to any conflict of interest, we expect a derivatives firm to consider the fair dealing obligation in Part 3 of the Regulation as well as any other standard of care that may apply when dealing with or advising a derivatives party.

In general, we view three methods as reasonable to respond to a conflict of interest, depending on the circumstances: avoidance, control and disclosure.

If a derivatives firm allows a serious conflict of interest to continue, there is a high risk of harm to derivatives parties or to the market. We expect that if there is a material risk of harm to a derivatives party or the integrity of the markets, the derivatives firm will take all reasonable steps to avoid the conflict of interest. If the derivatives firm does not avoid the conflict of interest, we expect that it will take steps to either control or disclose the conflict, or both. We would also expect the derivatives firm to consider what internal structures or policies and procedures it should implement to reasonably respond to such a conflict of interest.

Avoiding conflicts of interest

A derivatives firm must avoid all conflicts of interest that are prohibited by law. If a conflict of interest is not prohibited by law, we expect the derivatives firm to avoid the conflict if it is sufficiently contrary to the interests of a derivatives party that there can be no other reasonable response. Conflicts that have a lesser impact on the interests of a derivatives party can be managed through controls or disclosure.

Where conflicts of interest are so contrary to another person's interest that a derivatives party cannot use controls or disclosure to reasonably respond to them, we expect that the derivatives firm to avoid the conflict, stop providing the service or stop dealing with the derivatives party.

Controlling conflicts of interest

We would expect that a derivatives firm would design its organizational structures, lines of reporting and physical locations to control conflicts of interest effectively. For example, the following situations would likely raise a potential conflict of interest:

- advisory staff reporting to marketing staff,
- compliance or internal audit staff reporting to a business unit, and
- individuals acting on behalf of a derivatives firm and investment banking staff in the same physical location.

Depending on the conflict of interest, a derivative firm may control the conflict in an appropriate way, including by

- assigning a different individual to provide a service to the particular derivatives party,
- creating a group or committee to review, develop or approve responses,
- monitoring trading activity, or
- using information barriers for certain internal communication.

Subsection 9(3) – Disclosing conflicts of interest

When disclosure is appropriate

We expect a derivatives firm to inform its derivatives parties about any conflicts of interest that could affect the services the firm provides to them.

Timing of disclosure

Under subsection 9(3), a derivatives firm and individuals acting on its behalf must disclose the conflict in a timely manner. We expect a derivatives firm and its representatives to disclose a conflict of interest to a derivatives party before or at the time they recommend the transaction or provide the service that gives rise to the conflict.

Where this disclosure is provided to a derivatives party before the transaction takes place, we expect the disclosure to be provided shortly before the transaction takes place. For example, if it was initially provided with the derivative party's account-opening documentation months or years previously, we would expect that an individual acting on behalf of a derivatives firm to also disclose this conflict to the derivatives party shortly before the transaction or at the time the transaction is recommended.

When disclosure is not appropriate

Disclosure may not be appropriate if a conflict of interest involves confidential or commercially-sensitive information, or the information amounts to "inside information" under insider trading provisions in securities legislation. In these situations, a derivatives firm will need

to assess whether there are other methods to adequately respond to the conflict of interest. If not, the firm may have to decline to provide the service to avoid the conflict of interest. We would also expect a derivatives firm to have specific procedures for responding to conflicts of interest that involve inside information and for complying with insider trading provisions.

How to disclose a conflict of interest

Subsection 9(3) provides that a derivatives firm must provide disclosure about a material conflict of interest to a derivatives party. When a derivatives firm provides this disclosure, we expect that the disclosure would

- be prominent, specific, clear and meaningful to the derivatives party, and
- explain the conflict of interest and how it could affect the service the derivatives party is being offered.

We would expect that a derivatives firm would not

- provide only generic disclosure,
- provide only partial disclosure that could mislead the derivatives party, or
- obscure conflicts of interest in overly detailed disclosure.

Examples of conflicts of interest

Specific situations where a derivatives firm could be in a conflict of interest and how to manage the conflict are described below.

Acting as both dealer and counterparty

When a derivatives firm enters into a transaction with or recommends a transaction to a derivatives party, and the derivatives firm or an affiliated entity of the derivatives firm is the counterparty to the derivatives party in the transaction, we expect that the derivatives firm would respond to the resulting conflict of interest by disclosing it to the derivatives party.

Competing interests of derivatives parties

If a derivatives firm deals with or provides advice to multiple derivatives parties, we would expect the derivatives firm to make reasonable efforts to be fair to all such derivatives parties. We expect that a derivatives firm will have internal systems to evaluate the balance of these interests.

Compensation practices

We expect that a derivatives firm would consider whether any particular benefits, compensation or remuneration practices are inconsistent with their obligations to derivatives parties, especially if the firm relies heavily on commission-based remuneration. For example, if there is a complex product that carries a high commission but may not be appropriate for the derivatives firm's derivatives parties, the derivatives firm may decide that it is not appropriate to offer that product.

If such compensation practices are adopted, a derivatives firm might consider employing persons that do not receive compensation based on derivatives activity to conduct the supervision of staff receiving compensation based on derivatives activity.

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 an eligible derivatives party that is not an individual or an eligible derivatives party that is an individual that has waived these obligations.

Section 11 – Derivatives-party-specific needs and objectives

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

The derivatives-party-specific KYC information may also be relevant in complying with policies and procedures that are aimed at ensuring the most advantageous terms of a derivative for a derivatives party under subsection 19(1). Derivatives parties may have a variety of execution priorities. For example, a derivatives party may have as their primary objective the objective of having the transaction executed as quickly as possible rather than trying to obtain the best available price. Factors to consider when evaluating execution include price, certainty, timeliness, and minimizing impact cost of making a trading interest public.

Before transacting with a derivatives party, we expect a derivatives firm to have the appropriate information needed to assess the derivatives party's knowledge, experience and level of understanding of the relevant type of derivative, the derivative's party's objective in entering into the derivative and the risks involved in order to assess whether the derivative is suitable for the derivatives party. The derivatives-party-specific KYC information is obtained with this goal in mind.

If the derivatives party chooses not to provide the necessary information that would enable the derivatives firm to assess suitability, or if the derivatives party provides insufficient information, the firm should advise the derivatives party that it is required to request this information from them in order to determine whether the derivative is suitable for them or their priorities when transacting in the derivative. The derivatives firm should also indicate that without such information there is a strong risk that it will not be able to determine whether the derivatives party has the ability to understand the derivative and the risks involved with transacting the particular derivative.

Derivatives-party-specific KYC information for suitability depends on circumstances

The extent of derivatives-party-specific KYC information a derivatives firm needs to determine the suitability of a transaction or a derivatives party's priorities when transacting in the derivative will depend on factors that include

- the derivatives party's circumstances and objectives,
- the type of derivative,
- the derivatives party's relationship to the derivatives firm, and
- the derivatives firm's business model.

In some cases, a derivatives firm will need extensive KYC information, for example, where the derivatives party would like to enter into a derivatives strategy to hedge a commercial activity in a range of asset classes. In these cases, we would expect the derivatives firm to have a comprehensive understanding of the derivatives party's

- hedging needs and objectives, including the derivatives party's time horizon for their hedging strategy,
- overall financial circumstances, and
- risk tolerance for various types of derivatives, taking into account the derivative party's investment knowledge.

In other cases, a derivatives firm may need to obtain less KYC information, for example, if the derivatives firm enters into a single derivative with a derivatives party who needs to hedge a loan that the derivatives firm extended to the derivatives party.

Section 12 – Suitability

Subsection 12(1) 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.

Suitability obligation

To meet the suitability obligation, the derivatives firm should have in-depth knowledge of all derivatives that it transacts in with or for, or is recommending to, its derivatives party. This is often referred to as the "know your product" or KYP obligation.

We expect a derivatives firm to know each derivative well enough to understand and explain to the derivatives party the derivative's risks, key features, and initial and ongoing obligations. The decision by a derivatives firm to include a type of derivative on its product shelf or approved list of products does not necessarily mean that the derivative will be suitable for each derivatives party. Individuals acting on behalf of a derivatives firm must still determine the suitability of each transaction for every derivatives party.

When assessing suitability, we expect a derivatives firm to take all reasonable steps to determine whether the derivatives party has the capability to understand the particular type of derivative and the risks involved.

In all cases, we expect derivatives firms to be able to demonstrate a process for making suitability determinations that are appropriate under the circumstances.

Suitability obligations cannot be delegated

A derivatives firm is not permitted to

- delegate its suitability obligations to anyone else, or
- satisfy the suitability obligation by simply disclosing the risks involved with a transaction.

Section 11 and 12 - Use of online services to determine derivatives party needs and objectives and suitability

The conduct obligations set out in the Regulation, including the KYC and suitability obligations in sections 11 and 12 of the Regulation, are "technology neutral". This means that these obligations are the same for derivatives firms that interact with derivatives parties on a face-to-face basis or through an online platform.

Where the information necessary to fulfill derivatives firms' obligations pursuant to sections 11 and 12 of the Regulation is solicited through an online service or questionnaire, the CSA expects that this process would amount to a meaningful discussion with the derivatives party.

An online service or questionnaire will achieve this objective if it

- uses a series of behavioural questions to establish risk tolerance and elicit other KYC information,
- prevents a derivatives party from progressing further until all questions have been answered,
- tests for inconsistencies or conflicts in the answers and will not let the derivatives party complete the questionnaire until the conflict is resolved,
- offers information about the terms and concepts involved, and
- reminds the derivatives party that an individual from the derivatives firm is available to help them throughout the process.

Section 13 – Permitted referral arrangements

Subsection 1(1) defines a "referral arrangement" in broad terms. Referral arrangement means an arrangement in which a derivatives firm agrees to pay or receive a referral fee. The definition is not limited to referrals for providing derivatives, financial services or services requiring registration. It also includes receiving a referral fee for providing a derivatives party name and contact information to an individual or firm. "Referral fee" is also broadly defined. It includes sharing or splitting any commission resulting from a transaction.

Under section 13, parties to a referral arrangement are required to set out the terms of the arrangement in a written agreement. This is intended to ensure that each party's roles and responsibilities are made clear. This includes obligations for a derivatives firm involved in referral arrangements to keep records of referral fees. Payments do not necessarily have to go through a derivatives firm, but a record of all payments related to a referral arrangement must be kept.

We expect referral agreements to include

- the roles and responsibilities of each party,
- limitations on any party that is not a derivatives firm,
- the disclosure to be provided to referred derivatives parties, and
- who provides the disclosure to referred derivatives parties.

If the individual or the derivatives firm receiving the referral is a derivatives firm or an individual acting on its behalf, they are responsible for carrying out all obligations of a derivatives firm towards a derivatives party and communicating with referred derivatives parties.

A derivatives firm is required to be a party to referral agreements. This ensures that it is aware of these arrangements so it can adequately supervise the individuals acting on its behalf and monitor compliance with the agreements. This does not preclude the individual acting on behalf of the derivatives firm from also being a party to the agreement.

A party to a referral arrangement may need to be registered depending on the activities that the party carries out. A derivatives firm cannot use a referral arrangement to assign, contract out of or otherwise avoid its regulatory obligations.

In making referrals, a derivatives firm should ensure that the referral does not itself constitute an activity that the derivatives firm is not authorized to engage in.

Section 14 – Verifying the qualifications of the person receiving the referral

Section 14 requires the derivatives firm making a referral to satisfy itself that the party receiving the referral is appropriately qualified to perform the services, and, if applicable, is appropriately registered. The derivatives firm is responsible for determining the steps that are appropriate in the particular circumstances. For example, this may include an assessment of the types of derivatives parties that the referred services would be appropriate for.

Section 15 – Disclosing referral arrangements to a derivatives party

The disclosure of information to a derivatives party required under section 15 is intended to help a derivatives party make an informed decision about the referral arrangement and to assess any conflicts of interest. We expect the disclosure to be provided to a derivatives party before or at the time the referred services are provided. We would also expect a derivatives firm, and any individuals acting on behalf of the derivatives firm who are directly participating in the referral arrangement, to take reasonable steps to ensure that a derivatives party understands

- which entity they are dealing with,
- what they can expect that entity to provide to them,
- the derivatives firm's key responsibilities to them,

- if applicable, the limitations of the derivatives firm's registration category,

- if applicable, any relevant terms and conditions imposed on the derivatives firm's registration,

- the extent of the referrer's financial interest in the referral arrangement, and

- the nature of any potential or actual conflict of interest that may arise from the referral arrangement.

Section 17 – Handling complaints

General duty to document and respond to complaints

Section 17 requires a derivatives firm to document complaints and to effectively and fairly respond to them. We expect that a derivatives firm would document and respond to all complaints received from a derivatives party who has dealt with the derivatives firm (in this section, a "complainant").

Complaint handling policies

We are of the view that an effective complaint system would deal with all formal and informal complaints or disputes in a timely and fair manner. To achieve the objective of handling complaints fairly, we would expect the derivatives firm's compliance system to include standards allowing for objective factual investigation and analysis of the matters specific to the complaint.

We expect a derivatives firm to take a balanced approach to the gathering of facts that objectively considers the interests of

- the complainant,

- the individual or individuals acting on behalf of the derivatives firm, and

- the derivatives firm.

We would also expect a derivatives firm to not limit its consideration and handling of complaints to those relating to possible violations of securities legislation.

Complaint monitoring

We would expect a derivatives firm's complaint handling policy to provide for specific procedures for reporting the complaints to superiors, in order to allow the detection of frequent and repetitive complaints made with respect to the same matter which may, on a cumulative basis, indicate a serious problem. We would also expect the derivatives firm to take appropriate measures to promptly address the cause of a problem, particularly a serious problem.

Responding to complaints

Types of complaints

We expect that all complaints relating to one of the following matters would be responded to by the derivatives firm by providing an initial and substantive response, both in writing and within a reasonable time:

- a trading or advising activity,

- a breach of the derivatives party's confidentiality,

- theft, fraud, misappropriation or forgery,

- misrepresentation,

- an undisclosed or prohibited conflict of interest, or

- personal financial dealings with a derivatives party.

A derivatives firm may determine that a complaint relating to matters other than the matters listed above is nevertheless of a sufficiently serious nature to be responded to in the manner described below. This determination should be made, in all cases, by considering if a derivatives party, acting reasonably, would expect a written response to their complaint.

When complaints are not made in writing

We would not expect that complaints relating to matters other than those listed above, when made orally and when not otherwise considered serious based on a derivatives party's reasonable expectation, would need to be responded to in writing. However, we do expect that oral complaints be given as much attention as written complaints. If a complaint is made orally and is not clearly expressed, the derivatives firm may request the complainant to put the complaint in writing and we would expect a derivatives firm to offer reasonable assistance to do so.

A derivatives firm is entitled to expect the complainant to put unclear oral issues into written format in order to try to resolve confusion about the nature of the issue. If the oral complaint is clearly frivolous, we do not expect a derivatives firm to offer assistance to put the complaint in writing. The derivatives firm may nonetheless ask the complainant to put the complaint in writing on his or her own.

Timeline for responding to complaints

We expect that a derivatives firm would

- promptly send an initial written response to a complainant – we consider that an initial response should be provided to the complainant within 5 business days of receipt of the complaint, and

- provide a substantive response to all complaints relating to the matters listed under "Types of complaints" above, indicating the derivatives firm's decision on the complaint.

A derivatives firm may also wish to use its initial response to seek clarification or additional information from the derivatives party.

We encourage derivatives firms to resolve complaints relating to the matters listed above within 90 days.

DIVISION 3 – Restrictions on certain business practices when dealing with non-eligible derivatives parties

The obligations in Division 3 of Part 3 do not apply if a derivatives firm 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 obligations.

Section 18 – Tied selling

Section 18 prohibits a derivatives firm from imposing undue pressure on or coercing a person to obtain a product or service from a particular person, including the derivatives firm or any of its affiliates, as a condition of obtaining another product or service from the derivatives firm. These types of practices are known as "tied selling". In our view, this section would be contravened if, for example, a financial institution agreed to lend money to a derivatives party on the condition that the derivatives party hedged their loan through the same financial institution. In this example, we would take the view that a derivatives firm would not contravene section 18 if it required the derivatives party to enter into an interest rate derivative in connection with a loan agreement as long as the derivatives party were permitted to transact in this derivative with the counterparty of their choice.

However, 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.

Subsection 19(1) – Fair terms and pricing when acting as agent

What constitutes "most advantageous terms" will vary depending on the particular circumstances and a derivatives firm may not be able to achieve the most advantageous terms for every single transaction that it executes on behalf of a derivatives party. The derivatives firm should be able to demonstrate that it has set and follows policies and procedures that are reasonably designed to achieve the most advantageous terms for the derivatives firm's derivatives parties and that these policies and procedures are reviewed regularly and amended as required.

The policies and procedures required under this subsection should consider the following broad factors for the purpose of achieving the most advantageous terms for all derivatives party orders:

- price;
- the speed of execution;
- the certainty of execution;
- the overall cost of the transaction, when costs are passed on to derivatives parties.

These factors are not intended to be exhaustive and a derivatives firm should consider all other facts and circumstances that may be applicable to their derivatives parties.

Subsection 19(2) – Fair terms and pricing when acting as principal

Both the compensation component and the market value or price component of the derivative is relevant in determining whether the price for a derivatives party is fair and reasonable. A derivatives firm's policies and procedures must address both the market value of the derivative as well as the reasonableness of compensation.

In assessing the fairness and reasonableness of compensation, the derivatives firm should take into consideration all relevant factors, including the availability of the derivatives involved in the transaction, the expense of executing transaction to the derivatives firm including, when applicable, the costs to hedge the derivative firm's exposure, the value of the services rendered by the derivatives firm, the risks incurred by the derivatives firm and the amount of any other compensation received or to be received by the derivatives firm in connection with the transaction.

PART 4
DERIVATIVES PARTY ACCOUNTS

DIVISION 1 – Disclosure to derivatives parties

The obligations in this Division do not apply if a derivatives firm 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 obligations.

Section 20 – Relationship disclosure information

Content of relationship disclosure information

There is no prescribed form for the relationship disclosure information required under section 20. A derivatives firm may provide this information in a single document, or in separate documents, which together give the derivatives party the prescribed information.

We would expect that relationship disclosure information would contain accurate, complete, and up-to-date information. We suggest that derivatives firms review their disclosures annually or more frequently, as necessary. A derivatives firm must take reasonable steps to

notify a derivatives party, in a timely manner, of significant changes in respect of the relationship disclosure information that has been provided.

To satisfy their obligations under subsection 20(1), individuals acting on behalf of a derivatives firm must spend sufficient time with derivatives parties in a manner consistent with their operations to adequately explain the relationship disclosure information that is delivered to them. We expect a derivatives firm to have policies and procedures that reflect the derivatives firm's practices when preparing, reviewing, delivering and revising relationship disclosure documents.

Disclosure should occur before entering into an initial derivatives transaction, prior to advising a derivatives party in respect of a derivative and when there is a significant change in respect of the information delivered to a derivatives party. We expect that the derivatives firm will maintain evidence of compliance with their disclosure requirements.

Subsection 20(2) – Required relationship disclosure information

Description of the nature or type of the derivative party's account

Under paragraph 20(2)(a), a derivatives firm must provide derivatives parties with a description of the nature or type of account that the derivatives party holds with the derivatives firm. In particular, we would expect that a derivatives firm would provide sufficient information to enable the derivatives party to understand the manner in which transactions will be executed and any applicable contractual obligations. We would also expect a derivatives firm to provide information regarding margin and collateral requirements, if applicable, and disclose how the derivatives party assets will be held, used and invested. We would expect that the relationship disclosure information would also describe any related services that may be provided by the derivatives firm. If the firm is advising in derivatives, and the adviser has discretion over the derivatives party's account, we would also expect this to be disclosed

Identify the products or services the derivatives firm offers

Under paragraph 20(2)(b) a derivatives firm must provide a general description of the products and services the derivatives firm offers to a derivatives party. We would expect the relationship disclosure information to explain which asset classes the derivatives firm deals in and explain the different types of derivative products that the derivatives firm can transact with the derivatives party.

Describe the types of risks that a derivatives party should consider

We would expect a derivatives firm to provide an explanation of the risks associated with the derivatives products being transacted, including any specific risks relevant to the derivatives offered and strategies recommended to the derivatives party. While not exhaustive, transactions will involve one or more of the following risks: market, credit, liquidity, operational, legal and currency risk.

Describe the risks to a derivatives party of using leverage to finance a derivative

In addition to the disclosure prescribed by section 16, paragraph 20(2)(d) contemplates that a derivatives firm will disclose the risk of leverage to all derivatives parties, regardless of whether or not the derivatives party uses leverage or the derivatives firm recommends the use of borrowed money to finance any part of a transaction. Using leverage means that investors are only required to deposit a percentage of the total value of the investment when entering into a transaction. This effectively amounts to a loan by the derivatives firm to the derivatives party. However, the derivatives party's profits or losses are based on changes in value of the total investment. This means leverage magnifies a derivatives party's profit or loss on a transaction, and losses can exceed the amount of funds deposited.

Describe the conflicts of interest

Under paragraph 20(2)(e) a derivatives firm must provide a description of the conflicts of interest that the derivatives firm is required to disclose under securities legislation. One such requirement is in section 9 of the Regulation, which provides that a firm must take reasonable steps to identify and then respond to existing and potential material conflicts of interest between

the derivatives firm and the derivatives party. This includes disclosing the conflict, where appropriate.

Disclosure of charges and other compensation

Paragraphs 20(2)(f), (g) and (h) require a derivatives firm to provide a derivatives party information on fees and costs they might be charged when entering into a transaction in a derivative. These requirements ensure that a derivatives party receives all relevant information to evaluate the costs associated with the products and services they receive from the derivatives firm. We expect this disclosure to include information related to compensation or other incentives that the derivatives party may pay relating to a transaction.

At the outset of their relationship, a derivatives firm must provide the derivatives party with general information on any transaction and other charges that a derivatives party may be required to pay, as well as other compensation the derivatives firms may receive as a result of their business relationship. We recognize that a derivatives firm may not be able to provide all cost information regarding a particular transaction until the terms of the contract have been agreed upon. However, before entering into an initial transaction, a derivatives firm must meet the applicable pre-trade disclosure requirements in section 21 of the Regulation.

Description of content and frequency of reporting

Under paragraph 20(2)(i) a derivatives firm is required to provide a description of the content and frequency of reporting to the derivatives party. Reporting to derivatives parties includes, as applicable

- daily reporting under section 22,
- transaction confirmations under section 29, and
- derivatives party statements under section 30.

Further guidance about a derivatives firm's reporting obligations to a derivatives party is provided in Division 3 of this Part.

Know your derivatives party information

Paragraph 20(2)(l) requires a derivatives firm to disclose the type of information that it must collect from the derivatives party and explain how this information will be used in assessing and determining the suitability of a derivatives party transaction.

Section 21 – Pre-transaction disclosure

There is no prescribed form for the pre-trade disclosure that must be provided to a derivatives party under section 21. The derivatives firm may provide this information in a single document, or in separate documents which together give the derivatives party the prescribed information.

The disclosure document required under subsection 21(1) must be delivered to the derivatives party at a reasonably sufficient time prior to entering into the first transaction with the derivatives firm to allow the derivatives party to assess the material risks and material characteristics of the type of derivative transacted.

We consider a material risk that a derivatives firm is required under paragraph 21(1)(a) to disclose to a derivatives party to include market, credit, liquidity, foreign currency, legal, operational and any other applicable risks.

In addition to the requirement to provide a general disclosure document under subsection (1), we understand that the use of the term "price" is not always appropriate in relation to a transaction in a derivative. In paragraph 21(2)(b), we also expect disclosure with respect to spreads, premiums, costs, etc.

DIVISION 2 – Derivatives party 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 an eligible derivatives party that is not an individual or an eligible derivatives party that is an individual that has waived these obligations.

Section 25 – Segregating derivatives party assets

A derivatives firm is required to segregate derivatives party assets from its own property either by separately holding or accounting for derivatives party assets. Records maintained by a derivatives firm must make it clear that accounts holding derivative party assets are for the benefit of derivatives parties only.

Section 26 – Holding derivatives party assets

We expect that a derivatives firm would take reasonable efforts to confirm that the permitted depository holding the derivatives party assets

- qualifies as a permitted depository under the Regulation,

- has appropriate rules, policies and procedures, including robust accounting practices, to help ensure the integrity of the derivatives party assets and minimize and manage the risks associated with the safekeeping and transfer of the derivatives party assets,

- maintains securities in an immobilised or dematerialised form for their transfer by book entry,

- protects derivatives party assets against custody risk through appropriate rules and procedures consistent with its legal framework,

- employs a robust system that ensures segregation between the permitted depository's own property and the property of its participants and segregation among the property of participants, and where supported by the legal framework, supports operationally the segregation of property belonging to a derivative party on the participant's books and facilitates the transfer of derivatives party assets,

- identifies, measures, monitors, and manages its risks from other activities that it may perform, and

- facilitates prompt access to derivatives party assets, when required.

If a derivatives firm is a permitted depository, as defined in the Regulation, it may hold derivatives party assets itself and is not required to hold derivatives party assets at a third party depository. For example, a Canadian financial institution that acts as a derivatives firm would be permitted to hold derivatives party assets provided it did so in accordance with the requirements of the Regulation. Where a derivatives firm deposits derivatives party assets with a permitted depository, the derivatives firm is responsible for ensuring the permitted depository maintains appropriate books and records to ensure the derivatives party assets can be attributed to the derivatives party.

Section 27 – Use of derivatives party assets

The use of derivatives party assets attributable to a derivatives party to satisfy the obligations of any other party is not permitted.

Subsection 27(3) allows a derivatives firm to place a lien on derivatives party assets where the lien arises in connection with an obligation of the derivatives party. This exception recognizes that certain arrangements involve the granting of security interests in derivatives party assets. A derivatives firm is prohibited from imposing or permitting a lien that is not expressly permitted by the Regulation on derivatives party assets and should such an improper lien be placed on derivatives party assets, the derivatives firm must take all reasonable steps to promptly address the improper lien.

Section 28 – Investment of derivatives party assets

Although losses in the value of invested derivatives party assets are not to be allocated to a derivatives party, we are of the view that parties should be free to contract for the allocation of gains resulting from a derivatives firm's investment activities in accordance with the Regulation.

DIVISION 3 – Reporting to derivatives parties

The obligations in this Division, other than subsection 29(1), do not apply if a derivatives firm 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 obligations.

Section 29 – Content and delivery of transaction confirmations

We are of the view that the description of the derivative transacted required by paragraph 29(2)(a) would be fulfilled by providing a plain language description of the asset class of the derivative and the features of the derivative (e.g., fixed for floating interest swap with CDOR as reference rate, single name credit default swap).

Section 30 – Derivatives party statements

We are of the view that the description of the derivative transacted required by paragraphs 30(2)(b) and 30(3)(a) would be fulfilled by providing a plain language description of the asset class of the derivative and the features of the derivative (e.g., fixed for floating interest swap with CDOR as reference rate, single name credit default swap).

PART 5
COMPLIANCE AND RECORDKEEPING

DIVISION 1 – Compliance

Section 31 – Definitions

For the purposes of this Division 1 of Part 5, a "derivative business unit" refers to an organizational unit or division of a derivatives firm that conducts derivatives activities. A derivatives firm may have one or more organizational divisions that conduct derivatives activities. For example, a firm may divide its derivatives activities based on asset class or geographic location of trading. A derivatives business unit may conduct activities in addition to over-the-counter (OTC) derivatives trading such as exchange-traded derivatives or securities activities.

For the purposes of this Division, "senior derivatives manager" refers to each individual who is principally responsible for managing one or more derivatives business units at a derivatives firm. For example, an individual responsible for, or head of, interest rate trading or the "rates desk" at a derivatives firm would be considered a senior derivatives manager. Depending on its size, level of derivatives activity and structure, a derivatives firm may have a number of different derivatives business units. A derivatives firm would be required to have a senior derivatives manager who fulfills the requirements of this Division in respect of each derivatives business unit. A senior manager may be responsible for multiple business units.

The definition of "senior derivatives manager" is intended to capture individuals who are directly responsible for specific lines of derivatives activity and therefore this would not necessarily be the Chief Executive Officer or Chief Compliance Officer of a derivatives firm.

Section 32 – Policies and procedures

Section 32 requires a derivatives firm to establish, maintain and apply policies and procedures that establish a system of controls and supervision (i.e., a "compliance system") that provides assurance that the derivatives firm and those acting for it, as applicable, comply with applicable securities legislation, manage risks prudently, and possess the requisite education and training to perform these activities in a competent manner.

We would expect that a compliance system that is sufficient to meet the requirements of this section would include internal controls and monitoring systems that are reasonably likely to

identify non-compliance at an early stage and supervisory systems that allow the firm to correct non-compliant conduct in a timely manner. As more requirements apply to a derivatives firm when transacting with or advising a person that is not an eligible derivatives party, the monitoring and compliance systems that are appropriate when transacting with or advising such person would be commensurately more comprehensive.

"Securities legislation" is defined in *Regulation 14-101 respecting Definitions*, and includes statutes and other instruments related to both securities and derivatives. We do not expect that the compliance system established in accordance with the Regulation would be applicable to activities other than a derivatives firm's derivatives activities. For example, a derivatives dealer may also be a reporting issuer. The compliance system established to monitor compliance with the Regulation would not necessarily be concerned with matters related only to the derivatives firm's status as a reporting issuer, though it would be acceptable to have a single compliance system related to the derivatives firm's compliance with all applicable securities laws.

The risks referred to in paragraph 32(b) include the risks inherent in derivatives trading (including credit risk, counterparty risk, and market risk), which relate to the derivatives firm's overall financial viability.

The proficiency requirement in paragraph 32(c) imposes on a derivatives firm a duty to ensure that individuals acting for the derivatives firm in relation to its derivatives activities possess the required education and training to ensure competency. The Regulation establishes a reasonableness standard rather than setting out specific courses or other training requirements. However, a derivatives firm may also be required to be registered in accordance with securities legislation; more specific training and experience requirements apply to such a derivatives firm and its representatives under that regulation.

While a certain amount of industry experience could substitute for formal education and training, we would expect that all individuals connected with trading in or advising on derivatives receive appropriate recurring training, at least annually.

Section 33 – Responsibilities of senior derivatives managers

A senior derivative manager's responsibilities under this Division apply to the senior derivative manager even in situations where that individual has delegated his or her responsibilities.

The requirement on a senior derivative manager in paragraph 33(1)(c) to take reasonable steps to prevent material non-compliance with respect to derivatives activities conducted in his or her business unit includes both preventative steps and reactive steps where a senior derivatives manager has discovered material non-compliance. Where a senior manager becomes aware of material non-compliance in his or her business unit but does not take reasonable steps to address it, that senior derivatives manager would be in breach of the Regulation. A senior manager would also be in breach of the Regulation in terms of identifying and reporting non-compliance even if the senior manager has delegated responsibilities and has not been properly advised of the non-compliance.

Under section 33 of the Regulation, each senior derivatives manager of a derivatives firm must, at least once per calendar year, submit a report to the derivatives firm's board of directors

- certifying that the derivatives business unit is in material compliance with the Regulation, applicable securities legislation, and the policies and procedures of the derivatives firm under section 32, or

- specifying all circumstances where the derivatives business unit is not in material compliance with the Regulation, applicable securities legislation, or the policies and procedures of the derivatives firm under section 32.

We would expect that in complying with this requirement the senior derivatives manager will exercise reasonable care in determining when and how often material non-compliance should be reported to the board. For example, in a case of serious misconduct we would expect the board to be made aware promptly.

We consider non-compliance with the Regulation, applicable securities legislation and the policies and procedures of the derivatives firm required under section 32 to be material if the non-compliance

- has, or could have, a negative impact on the interest of a derivatives party,
- results, or could result, in a material harm to the derivatives firm, including causing the derivatives firm to incur
    - a material financial loss, or
    - a material increase in their business or financial risk,
- was part of a pattern on non-compliance, or
- would constitute bad faith or fraud or would be an offence under applicable securities legislation.

Section 34 – Responsibility of a derivatives firm to respond to material non-compliance

If a senior derivatives manager notifies the board of directors of a derivatives firm that his or her derivatives business unit is not in material compliance with the Regulation, applicable securities legislation, or the policies and procedures of the derivatives firm under section 32, the derivatives firm must,

- respond to the specified non-compliance in a timely manner, and document its response, and
- report to the regulator, except in Québec, or securities regulatory authority in a timely manner 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 the Regulation, applicable securities legislation, or the policies and procedures of the derivatives firm required under section 32.

The obligation on the derivatives firm to make a report to the regulator under subsection 34(b) will depend on whether the specified non-compliance would reasonably be considered material non-compliance by the derivatives firm, with the Regulation, applicable securities legislation, or the policies and procedures required under section 32.

DIVISION 2 – Recordkeeping

Section 35 – Derivatives party agreement

Appropriate subject matter for the derivatives party agreement includes terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution. We would expect that the agreement would also cover other areas as appropriate in the context of the transactions into which the parties will enter. For example, where transactions will be subject to margin, we would expect the agreement to cover margin requirements, assets that may be used, asset valuation methods, investment and rehypothecation terms, and custodial arrangements.

Section 36 – Records

Section 36 imposes a general obligation on a derivatives firm to keep full and complete records relating to the derivatives firm's derivatives, transactions in derivatives, and all of its business activities relating to derivatives, trading in derivatives or advising in derivatives. This list of records is not intended to be exhaustive but rather includes the records that must be kept, at a minimum. We would expect a derivatives firm to consider the nature of its derivatives-related activity when determining the records that it must keep and the form of those records.

The general principle underlying section 36 is that a derivatives firm must document, through its records,

- compliance with all applicable securities legislation (including the Regulation),

- the details and evidence of the derivatives to which it has been a party or in respect of which it has been an agent,

- the circumstances surrounding the entry into and termination of those derivatives, and

- related post-trade matters.

We would, for example, expect a derivatives firm to be able to demonstrate, for each derivatives party, the details of compliance with the obligations in section 10 and, if applicable, the obligations in section 11 and section 12 (and if sections 11 and 12 are not applicable, the reason as to why it is not).

If a derivatives firm wishes to rely on any exemption or exclusion in the Regulation or other related securities laws, it should be able to demonstrate that it is entitled to rely on the exemption or exclusion.

With respect to records demonstrating the existence and nature of the derivatives firm's derivatives that are required to be kept pursuant to paragraph 36(b) and records documenting the transactions relating to the derivatives required to be kept pursuant to paragraph 36(c), we expect a derivatives firm to accurately and fully document every transaction it enters into. We expect a derivatives firm to maintain notes of communications that could have an impact on a derivatives party's account or its relationship with the derivatives firm. These communications may include oral communications and all e-mail, regular mail, fax and other written communications.

While a derivatives firm may not need to save every voicemail or e-mail, or to record all telephone conversations with every derivatives party, we do expect a derivatives firm to maintain records of all communications with a derivatives party relating to derivatives transacted with, for or on behalf of the derivatives party.

Section 37 – Form, accessibility and retention of records

Paragraph 37(1)(b) requires derivatives firms to keep their records in a safe location. This includes ensuring that no one has unauthorized access to information, particularly confidential derivatives party and counterparty information. We would expect a derivatives firm to be particularly vigilant if it maintains books and records in a location that may be accessible by a third party. In this case, we would expect the derivatives firm to have a confidentiality agreement with the third party.

PART 6
EXEMPTIONS

The Regulation provides several exemptions from the requirements in the Regulation. If a person is exempt from a requirement in the Regulation, the individuals acting on its behalf are also exempt from the requirement on the same terms.

DIVISION 1 – Exemptions from this Regulation

Section 39 – Exemption for certain derivatives end-users

Section 39 provides an exemption from the requirements of the Regulation for a person that transacts in derivatives but does not engage in the activities set out in paragraphs (a) – (e). The intention of this exemption is to exclude from the application of the Regulation a person that uses derivatives in the course of their business but does not deal with or advise other derivatives parties. For example, a person that frequently and regularly transacts in derivatives to hedge business risk may qualify for this exemption. Typically, such a person would transact with a derivatives dealer who would be subject to the requirements of the Regulation. It would not be

reasonable for a person who regularly quotes prices on derivatives to other derivatives parties to claim that they are an end-user hedging business activities.

Under paragraph 39(c), a person who regularly quotes prices at which they would be willing to transact in a derivative would not qualify for this exemption. This ineligibility applies even if the person does not make a two-way market in a derivative by publishing quotes to buy and quotes to sell a derivatives position at the same time. For example, a person who is only willing to take a long position in a derivative but regularly quotes prices to prospective counterparties would not qualify for this exemption.

DIVISION 2 – Exemptions from specific requirements in this Regulation

Section 40 – Foreign derivatives dealers

General principle

Section 40 contemplates an exemption from the Regulation for foreign derivatives dealers that are regulated under the laws of a foreign jurisdiction that achieve substantially the same objectives, on an outcomes basis, as the Regulation. This exemption applies to the provisions of the Regulation where the derivatives dealer is subject to and in compliance with the laws of a foreign jurisdiction set out in Appendix A opposite the name of the foreign jurisdiction. The foreign jurisdictions specified in Appendix A are determined on a jurisdiction-by-jurisdiction basis, and depend on a review of the laws and regulatory framework of the jurisdiction.

This exemption is only available where a foreign derivatives dealer is in compliance with the requirements of the laws of the applicable foreign jurisdiction specified in Appendix A and does not incorporate any exemption or discretionary relief granted to a foreign derivatives dealer in connection with the laws of the foreign jurisdiction. Where a foreign derivatives dealer relies on an exemption or discretionary relief from the laws of a foreign jurisdiction set out in Appendix A, it will need to apply to the relevant securities regulatory authorities for consideration of similar exemptive or discretionary relief from the Regulation.

Conditions

This exemption is only available where the foreign derivative dealer is dealing with persons that are eligible derivatives parties. The foreign derivatives dealer must also comply with each of the requirements under section 40. Furthermore, there may be “residual” provisions of the Regulation listed in Appendix A which must be complied with even if a foreign derivatives dealer is in compliance with the laws of a foreign jurisdiction set out in Appendix A.

DIVISION 3 – Exemptions for derivatives advisers

Section 44 – Foreign derivatives advisers

General principle

Section 44 contemplates an exemption from the Regulation for 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 Regulation. This exemption applies to the provisions of the Regulation where the derivatives adviser is subject to and in compliance with the laws of a foreign jurisdiction set out in Appendix D opposite the name of the foreign jurisdiction. The foreign jurisdictions specified in Appendix D are determined on a jurisdiction-by-jurisdiction basis, and depend on a review of the laws and regulatory framework of the jurisdiction.

This exemption is only available where a foreign derivatives adviser is in compliance with the requirements of the laws of the applicable foreign jurisdiction specified in Appendix D and does not incorporate any exemption or discretionary relief granted to a foreign derivatives adviser in connection with the laws of the foreign jurisdiction. Where a foreign derivatives adviser relies on an exemption or discretionary relief from the laws of a foreign jurisdiction set out in Appendix D, it will need to apply to the relevant securities regulatory authorities for consideration of similar exemptive or discretionary relief from the Regulation.

Conditions

This exemption is only available where the foreign derivative adviser is dealing with persons that are eligible derivatives parties. The foreign derivatives adviser must also comply with each of the requirements under section 44. Furthermore, there may be "residual" provisions of the Regulation listed in Appendix D which must be complied with even if a foreign derivatives adviser is in compliance with the laws of a foreign jurisdiction set out in Appendix D.