

Canada – Trading or advising in futures and security options

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Recent rulemaking across Canada and proposed rules in Quebec (if adopted) will have a significant impact on the cross-border trading activities of non-Canadian dealers, advisers, futures commission merchants (FCMs) and commodity-trading advisers (CTAs) with respect to commodity futures contracts and commodity futures options (futures) as well as security options.

On July 17, 2009, the Canadian Securities Administrators (CSA) published their final proposal for National Instrument 31-103 - *Registration Requirements and Exemptions* (31-103). Subject to governmental and other local approval requirements, 31-103 will come into force on September 28, 2009 (the Implementation Date). While the regulation of futures activities was not the focus of 31-103, the new securities registration rules will have some impact on the regulation of futures activities in Canada. For further information and a complete breakdown of the new regime, please refer to Stikeman Elliott's July 20, 2009 posting, "*Registration Reform in Canada: The Finish Line is Here*" available at www.canadiansecuritieslaw.com.

The pending adoption of 31-103 in Quebec can be expected to accelerate the implementation of rules under the Quebec *Derivatives Act* (QDA), which came into force in Quebec on February 1, 2009 and governs trading and advisory activities relating to all forms of derivatives. On July 31, 2009, as part of this implementation process, the *Autorité des marchés financiers* (AMF), Quebec's financial services regulator, published a proposed *Regulation to amend the Derivatives Regulation* (the Proposed Quebec Regulation). The Proposed Quebec Regulation incorporates by reference various registration-related instruments and material provisions of 31-103 and would (if adopted) introduce an important registration exemption for non-Quebec dealers and advisers in exchange-traded derivatives offered primarily outside Quebec, provided they limit their activities to "accredited counterparties" (as defined in the QDA).

Unfortunately, the regulation of futures and security options across all Canadian jurisdictions has not undergone a process of streamlining and harmonization similar to Canadian securities legislation, and remains very fragmented. Consequently, the rules regarding the futures and security options activities of non-Canadian FCMs and CTAs in Canada vary significantly by province and territory.

National Instrument 31-103

31-103 is intended to harmonize, streamline and modernize registration requirements and exemptions for dealers, advisers and investment fund managers across all Canadian provinces and territories (jurisdictions) with respect to *securities*. It regulates the registration of firms and individuals and consolidates requirements for registration, including proficiency, solvency and insurance requirements, as well as ongoing compliance requirements for registrants. These include requirements with respect to financial reporting, know-your-client, suitability, client disclosure, safekeeping of assets, recordkeeping, account activity reporting, complaint handling and other compliance procedures. The CSA note that, to create flexible regulation, 31-103 combines principles, supported by guidance in a Companion Policy, with prescriptive elements where considered appropriate.



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This newsletter was prepared by members of the Securities Group at Stikeman Elliott.

31-103 represents a major overhaul of the current securities registration regime and has significant implications for non-Canadian FCMs, dealers, CTAs, advisers and investment fund managers currently doing business on a registered or exempt basis in any jurisdiction of Canada.

However, 31-103 **does not** harmonize, streamline or modernize registration requirements and exemptions across Canada with respect to futures and security options. The CSA stated during the comment process that the regulation of futures was beyond the scope of 31-103. However, because futures and security options are regulated in some jurisdictions as securities, 31-103 will be relevant in those jurisdictions but not others.

A key development under 31-103 is the creation of an “international dealer exemption” and an “international adviser exemption” for trading with or advising “permitted clients” (including, specified institutional clients, entities with net assets of more than C\$25,000,000 and individuals with net financial assets before taxes of more than C\$5,000,000). The international dealer exemption is available for dealers *registered* in their home jurisdiction and is limited to dealing in non-Canadian securities and certain Canadian debt securities. The international adviser exemption is available to advisers that are *registered or exempt* in their home jurisdiction and is limited to advising on non-Canadian securities and to a very limited extent in Canadian securities where the advice on Canadian securities is incidental to the provision of advice on non-Canadian securities (for example, advising on a global portfolio with a small Canadian allocation). Reliance on these exemptions requires the prior filing of agent-for-service-of-process forms in each jurisdiction where the exemption is proposed to be relied on, along with the delivery of mandated client disclosure notices and compliance with annual filing requirements.

Three different regimes for the regulation of futures

After the implementation of 31-103, there will continue to be three regimes governing the regulation of futures and security options in Canada and the applicable regime will depend on the Canadian jurisdiction in which an FCM or CTA is doing business. The rules vary significantly depending on the applicable regime. In the first regime, futures and security options fall within the definition of a “security” and thus are regulated in the same manner as securities. In the second regime, futures are governed by separate futures or derivatives legislation while security options are regulated under securities legislation. In the third regime, futures and options are governed by securities legislation but subject to separate treatment under the definition of “exchange contracts” in the securities legislation. Each of these regimes and where they are applicable is discussed below.

Securities-only regime

In Nova Scotia, Prince Edward Island, Newfoundland, Yukon Territory, Northwest Territories and Nunavut, futures and security options fall within the definition of “security” under applicable securities legislation. Consequently, under 31-103 FCMs that are registered and CTAs that are registered or exempt in their home jurisdiction may rely on the “international dealer exemption” and “international adviser exemption” provided that the conditions of those exemptions are met (see above).

This represents a significant change, since prior to 31-103 FCMs that were not registered in these jurisdictions could deal on an exempt basis with “accredited investors” in Canadian or non-Canadian futures, security options and securities. Under the 31-103 international dealer exemption, FCMs are limited to dealing with “permitted clients” in non-Canadian futures, security options and securities. Because of the transition rules, FCMs should review their current client base and determine the appropriate time to make the required filings in order to rely on the international dealer exemption.

For CTAs, the new 31-103 international adviser exemption is an improvement, as previously there was no exemption for CTAs for advising on non-Canadian futures, security options and securities in these provinces and territories. The required international adviser exemption filings would need to be made prior to relying on this new exemption.

Separate futures or derivatives statutes

In Ontario, Manitoba and Quebec, trading in and advising with respect to investing in futures are regulated under the *Commodity Futures Acts* in Ontario and Manitoba and the QDA in Quebec. These statutes include FCM and CTA registration requirements and exemptions from such requirements, which are not affected by the new securities registration regime established under 31-103.

In Ontario, FCMs may continue to rely upon statutory exemptions under the *Commodity Futures Act* (Ontario) (Ontario *CFA*) such as the “hedger” exemption and the “unsolicited” trade exemption to trade with, or on behalf of, Ontario resident clients. Under the Ontario *CFA*, there are no exemptions from the adviser registration requirement and thus CTAs would be required to be registered. However, the Ontario Securities Commission (OSC) has recently granted discretionary relief to several firms that are registered to trade securities as “international dealers” in Ontario, allowing them to also trade futures with “designated institutions.” We would expect that the OSC will continue to be willing to grant similar exemptions to firms based on the requirements of the 31-103 international dealer exemption; however, this remains to be determined. Firms that have previously received this type of exemption may continue to rely upon such relief. In Ontario, security options fall within the definition of “security” and therefore, after the Implementation Date, non-Canadian firms may rely on the “international dealer exemption” and the “international adviser exemption” to trade or advise “permitted clients” in Ontario with respect to security options. Transition issues under 31-103 will need to be considered prior to making the filings to rely on these exemptions.

In Manitoba, there are no available statutory exemptions for trading or advising with respect to futures. A firm that wishes to trade in or advise on futures with clients residing in Manitoba would have to seek discretionary relief. Security options will continue to be covered by the definition of “security” under Manitoba securities legislation and thus, after the Implementation Date, non-Canadian firms may rely on the international dealer exemption and the international adviser exemption to trade and advise “permitted clients” in Manitoba with respect to security options. Again, transition issues under 31-103 will need to be considered.

In Quebec, the recently enacted QDA regulates futures and security options, as well as other types of derivatives. Under the Proposed Quebec Regulation, the AMF is proposing registration relief for persons “authorized to act as a dealer or adviser or authorized to exercise similar functions in a jurisdiction outside Quebec where its head office or principal place of business is located” in relation to activities involving exchange-traded derivatives (futures and security options) offered primarily outside Quebec with “accredited counterparties” only. However, the exemption contemplates registration relief only, and does not provide any exemption from the derivatives qualification and approval requirements governing the creation and marketing of derivatives in Quebec. It does not specifically exempt non-Quebec market participants from other ongoing compliance requirements applicable to “dealers” and “advisers” under the QDA, as does the OTC derivatives exemption. Consequently, the precise scope of this exemption is not yet entirely clear. Additional information is available at www.canadiansecuritieslaw.com under the August 6, 2009 posting, “*Amendments to the Quebec Derivatives Regulation Announced.*”

Securities statutes with definition of “exchange contracts”

In Alberta, British Columbia, New Brunswick (after the Implementation Date) and Saskatchewan, trading and advising in “exchange contracts” (standardized exchange-traded futures and security options) are regulated under the *Securities Acts* in those provinces. However, in these provinces, the registration requirements and exemptions applicable to exchange contracts are different from those applicable to securities. Exchange contracts are expressly excluded in these four jurisdictions from the international dealer exemption and the international adviser registration exemption under 31-103, with the result that dealers or advisers relying on those exemptions for their securities-related activities in any of these jurisdictions could not rely on the exemptions for trading or advising activity in respect of exchange contracts. In Alberta, British Columbia and New Brunswick but not Saskatchewan, 31-103 provides two limited dealer-registration exemptions for trading in exchange contracts. The first exemption is for a trade made solely through an agent who is a registered dealer, if the dealer is registered in a category that permits the trade. The second is an exemption for an unsolicited order placed with an individual who is not a resident of, and does not carry on business in, the local jurisdiction. However, the scope and practical application of the latter exemption is very limited due to the definition of “individual” (*i.e.* natural person) and existing commentary from the regulators, which suggests that this exemption may only be relied upon for one trade.

Some non-Canadian firms have applied for and received discretionary relief in both British Columbia and Alberta in order to trade exchange contracts with certain investors. In British Columbia, the discretionary relief permits non-Canadian firms to trade in non-Canadian exchange contracts with “accredited investors.” In Alberta, the discretionary relief permits non-Canadian firms to trade in non-Canadian exchange contracts with “qualified parties.” This relief will continue to apply in British Columbia and Alberta after the Implementation Date.

Montreal Exchange and ICE Futures Canada

The Montreal Exchange (MX) permits non-Canadian firms to apply for foreign approved-participant (FAP) status, which provides these firms with direct access to the MX, including the Montreal Climate Exchange (MCEX). In addition, many non-Canadian firms have access to ICE Futures Canada (ICE Canada). Firms that are FAPs or have access to ICE Canada should review their current status and trading activities to determine the impact of these new rules on such activities.

Canadian activities chart

For a summary of the basic permitted activities and exemptions in the Canadian provinces and territories for non-Canadian firms trading in or advising on futures and security options, please refer to our Canadian Securities/Futures Activities Chart on the following page.

For further information, please contact your Stikeman Elliott representative or any of the authors listed above.

Canada - Applicable Exemptions for Trading or Advising in Listed Futures and Security Options

Assumes implementation of National Instrument 31-103 and the proposed Regulations to amend the Derivative Regulation (Proposed Derivatives Regulation) made under the Derivatives Act (Quebec) and clarification of the scope of the proposed exemption.

JURISDICTION	TRADING		ADVISING	
	FUTURES	SECURITY OPTIONS	FUTURES	SECURITY OPTIONS
British Columbia	UE ^{1 2}	UE ^{1 2}	None	None
Alberta	UE ²	UE ²	None	None
Saskatchewan	None	None	None	None
Manitoba ³	None	IDE ⁷	None	IAE ⁸
Ontario ⁴	UE ⁵ , Hedger ⁶	IDE ⁷	None	IAE ⁸
Quebec ⁹	AC ¹⁰	AC ¹⁰	AC ¹⁰	AC ¹⁰
New Brunswick	UE ²	UE ²	None	None
Nova Scotia	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸
Prince Edward Island	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸
Newfoundland and Labrador	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸
Yukon Territory	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸
Northwest Territories	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸
Nunavut	IDE ⁷	IDE ⁷	IAE ⁸	IAE ⁸

UE – Unsolicited trade exemption Hedger – Hedging exemption AC – Accredited Counterparty – proposed
 IDE – International dealer exemption (NI 31-103) – new IAE – International adviser exemption (NI 31-103) – new

¹ Section 47(b) of the *Securities Act* (British Columbia) (“BCSA”) provides that the dealer registration requirement under subclause 34(1)(a) of the BCSA does not apply to “a trade [in exchange contracts] resulting from an unsolicited order placed with an individual who is not a resident of and does not carry on business in British Columbia.” “Individual” means a natural person.

² Section 8.20(1)(a) of National Instrument 31-103 *Registration Requirements and Exemptions* (NI 31-103) provides that in British Columbia, Alberta and New Brunswick, the dealer registration requirement does not apply in respect of a trade made “solely through an agent who is a registered dealer, if the dealer is registered in a category that permits the trade.” Section 8.20(b) of NI 31-103 provides that in British Columbia, Alberta and New Brunswick, the dealer registration requirement does not apply in respect of “a trade [in exchange contracts] resulting from an unsolicited order placed with an individual who is not a resident of, and does not carry on business in, the local jurisdiction.” “Individual” means a natural person. Section 4.9 of Companion Policy 45-106CP states that while an unsolicited trade does not require registration, if the individual conducts further trades in the future, that individual will be deemed to be carrying on business in the jurisdiction and will not be able to rely on this exemption.

³ Trading in and advising on futures is governed by the *Commodity Futures Act* (Manitoba). Trading in and advising on security options is governed by the *Securities Act* (Manitoba).

⁴ Trading in and advising on futures is governed by the *Commodity Futures Act* (Ontario) (CFA). Trading in and advising on security options is governed by the *Securities Act* (Ontario).

⁵ Section 32(c) of the CFA provides that “registration is not required in respect of a trade in a contract to be executed on an exchange situated outside Ontario resulting from an order placed with a dealer who does not carry on business in Ontario, not involving any solicitation by or on behalf of the dealer.”

⁶ Section 32(a) of the CFA provides that registration is not required in respect of “a trade in a contract by a hedger through a dealer”.

⁷ The IDE permits non-Canadian dealers to trade with “permitted clients” (including individuals who beneficially own financial assets having an aggregate realizable value that, before taxes, but net of any related liabilities, exceeds C\$5 million) in “foreign securities” (which excludes inter-listed securities of Canadian issuers) and certain Canadian debt securities.

⁸ The IAE permits non-Canadian advisers to advise “permitted clients” on “foreign securities”, and to a very limited extent on Canadian securities where the advice is “incidental” to advising on foreign securities.

⁹ Trading in and advising on futures and security options is governed by the *Derivatives Act* (Quebec) (QDA).

¹⁰ The Proposed Quebec Regulation to the QDA provides an exemption for trades in exchange-traded derivatives with “accredited counterparties.” Specifically, section 11.14 of the Proposed Quebec Regulation states: “11.14. A person authorized to act as a dealer or adviser or authorized to exercise similar functions under legislation applicable in a jurisdiction outside Québec where its head office or principal place of business is located is exempt from the registration requirement to the extent it carries on business solely for an accredited counterparty and its activity involves a standardized derivative that is offered primarily outside Québec.”