REGISTRATION REFORM IN CANADA

Amendments to the Quebec Derivatives Regulation announced:
Proposed exemption for exchange-traded derivatives offered primarily outside Quebec

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On July 17, 2009, the Canadian Securities Administrators (the 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). The adoption of 31-103 in Quebec can be expected to accelerate the further implementation of 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 Regulation). The Proposed Regulation incorporates by reference various registration-related instruments and material provisions of 31-103 and sets out 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”.

The draft instrument is open for comment until August 31, 2009 and is scheduled to come into force on the Implementation Date, subject to ministerial approval following the end of the 30-day comment period.

Key requirements of the QDA
The QDA imposes a requirement to register as a derivatives dealer or adviser for any person that engages in those activities in Quebec. The QDA also sets out a recognition requirement for “regulated entities” (including exchanges, alternative trading systems not registered as derivatives dealers or other published markets, clearing houses, information processors and self-regulatory organizations) that carry on derivatives activities in Quebec. The QDA further requires that any person other than a “recognized regulated entity” that seeks to “create or market” a derivative must be qualified by the
AMF (the derivatives qualification requirement) and that the derivative must be approved by the AMF (the derivatives approval requirement). The QDA also contains rules for the purposes of determining whether so-called “hybrid products” are to be regulated as derivatives under the QDA or as securities under Quebec securities legislation.

**The OTC Derivatives Exemption** - By way of background, section 7 of the QDA sets out an important blanket exemption for OTC derivatives “involving accredited counterparties only or in any other cases specified by regulation” from the application of certain specified provisions, including the derivatives dealer and adviser registration requirements, the derivatives qualification and approval requirements, and certain limited procedural and enforcement-related provisions, except in the case of market manipulation and fraud (the OTC Derivatives Exemption). The list of “accredited counterparties” includes most of the leading Quebec institutional investors, as well as accredited persons meeting certain subjective (knowledge and experience) and objective (minimum financial assets) tests and qualified “hedgers”.

**Exchange-Traded Derivatives** - As noted in our previous updates, the QDA does not currently contain any exemption for exchange-traded derivatives activities that is equivalent to the OTC Derivatives Exemption. With the coming into force of the QDA on February 1, 2009, this marked a significant departure from the existing “accredited investor” exemptions under Quebec securities legislation on the basis of which many Canadian, U.S. and other foreign dealers had historically engaged in exchange-traded derivatives activities outside of Quebec for Quebec-resident institutional investors.

**The AMF Blanket Decision** – In the interim, the AMF had responded to the above concerns in part by issuing a blanket decision on January 22, 2009 (the AMF Blanket Decision) that sets out a temporary exemption from the derivatives dealer and adviser registration requirements and the derivatives qualification rules under the QDA for specified derivatives activities carried out solely with accredited investors as defined under the soon to be revised National Instrument 45-106 Prospectus and Registration Exemptions (45-106). The AMF has not indicated for how long the AMF Blanket Decision will remain in effect.

**The proposed exchange-traded derivatives exemption for non-Quebec derivatives dealers and advisers**

**Overview of the Proposed Exemption** - Under the Proposed Regulation, the AMF is proposing more general and permanent registration relief for activities in relation to exchange-traded derivatives offered primarily outside Quebec with “accredited counterparties” only. Specifically, the Proposed Regulation provides that “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” (the Proposed Exchange-Traded Derivatives Exemption). A “standardized derivative” is defined under the QDA as “a derivative that is traded on a published market, whose intrinsic characteristics are determined by that market and whose trade is cleared and settled by a clearing house.”1

The proposed exemption is essentially the exchange-traded derivatives equivalent of the OTC Derivatives Exemption but is significantly more limited in its scope. In particular, the exemption contemplates registration relief only. It does not provide any exemption from the derivatives qualification and approval requirements governing the creation and marketing of derivatives in Quebec, and 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.

**No Clear Exemption from Ongoing Requirements Applicable to Dealers and Advisers** - The OTC Derivatives Exemption provides a clear exemption from the application of the provisions of the QDA governing the business operations and client relationships of dealers and advisers under the QDA. In the absence of an equivalent carve-out, non-Quebec market participants relying on the Proposed Exchange-Traded Derivatives Exemption, on the other hand, will remain technically subject to these provisions. The relevant provisions, include, for example, the requirement to deliver to a client the risk information document prescribed by regulation
and the requirement to provide to the client, prior to recommending or executing any trade, “(1) information the client ordinarily needs for the purposes of their business relationship; (2) information required to make an informed decision and give clear trade instructions; and (3) information on the margin requirements to which the trade is subject and on the consequences of the client failing to meet those requirements when called to do so.” The QDA further requires that any document required to be communicated to a client under the QDA be provided in both English and French or in French only.

**Qualification of “Accredited Counterparties”** - Non-Quebec FCMs and CTMs seeking to rely on the proposed exemption will have to qualify their clients and prospects as “accredited counterparties” in much the same way as the OTC industry has done during the six-month phase-in period for compliance with the QDA. The proposal does not, however, provide an equivalent transition period to permit the qualification of existing clients for purposes of this exemption.

The AMF previously published a *Policy Statement Respecting Accredited Counterparties*. The policy statement was drafted in connection with the OTC Derivatives Exemption but may be helpful for purposes of relying on the Proposed Exchange-Traded Derivatives Exemption. Market participants seeking to rely on the proposed exemption should obtain representations from Quebec-resident clients and prospects as to their specific status as an “accredited counterparty” and consider appropriate amendments to their contractual documentation.

As certain categories of “accredited counterparties” involve factual determinations which, in certain cases, cannot be independently verified, detailed representations will be required in such cases. In addition, in certain cases, reliance on the exemption may require enhanced due diligence to back up a market participant’s reasonable reliance on a client or prospect’s status as an “accredited counterparty”.

**The Incorporation of the 31-103 and other registration-related provisions**

The QDA is formulated as principles-based legislation and its key provisions cross-reference regulations which (for the most part) have yet to be published. The current *Derivatives Regulation* covers a limited range of matters, including the minimum asset requirement for self-certified “accredited counterparties”, the rules for self-certification of operating rules of “recognized regulated entities”, and the prescribed risk disclosure document to be delivered by derivatives dealers.

The Proposed Regulation addresses a number of outstanding procedural and substantive matters by incorporating by reference the provisions of National Instrument 31-102 *National Registration Database* and National Instrument 33-109 *Registration Information* (as amended in conjunction with the adoption of 31-103), as well as most provisions of 31-103 governing the registration of individual representatives, and the business operations and client relationships of registered portfolio managers and dealers.

These provisions will generally apply only to persons and entities registered as derivatives dealers and advisers under the QDA and include initial and ongoing proficiency requirements for advising representatives, associate advising representatives and chief compliance officers of registered derivatives advisers, requirements governing internal control systems (including the implementation of compliance systems and the designation of an “ultimate designated person” and a “chief compliance officer”), restricted business practices, requirements governing the acquisition of a registrant’s securities or assets, working capital requirements, insurance and financial reporting requirements, provisions governing registrant relationships with clients (including with respect to the management and disclosure of conflicts of interest, referral arrangements, complaint handling and dispute resolution procedures), relationship disclosure, safekeeping of account assets, and the prohibition on registrants lending money, extending credit or providing margin to clients.

As noted above, in the absence of a clear exemption from these requirements under the Proposed Exchange-Traded Derivatives Exemption, a number of these requirements may technically apply to non-Quebec market participants seeking to rely on the exemption in connection with their activities with “accredited counterparties”.

The Proposed Regulation also cross references a very limited number of registration exemptions under 31-103, including the so-called “client mobility exemption” (which would allow a registered firm and representative to continue to deal with a small number of clients who move to another Canadian jurisdiction without the need to
register in that other jurisdiction) and the adviser registration exemption for "general advice" not purporting to be tailored to the needs of the particular recipient of the advice.

The Proposed Regulation also sets out the new registration categories for representatives of derivatives dealers and advisers registered under the QDA, the proficiency requirements for registered representatives of derivatives advisers, the registration requirements and responsibilities of the “ultimate designated person” and the “chief compliance officer” designated by QDA registrants and provisions governing the suspension and revocation of registration under the QDA.

Market participants who wish to comment on any aspect of the Proposed Regulation should submit their comments to the AMF no later than August 31, 2009.

For further information, please contact your Stikeman Elliott representative or any member of our Corporate Finance and Securities Group listed at www.stikeman.com

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1. The term “derivative” is defined under the QDA as “an option, a swap, a futures contract or any other contract or instrument whose market price, value, or delivery or payment obligations are derived from, referenced to or based on an underlying interest, or any other contract or instrument designated by regulation or considered equivalent to a derivative on the basis of criteria determined by regulation”. A “standardized derivative” would include listed futures, options on futures and equity options.

The AMF has not yet clarified that OTC derivatives such as Credit Default Swaps which, as a result of recent technological developments in the infrastructure for trading OTC derivatives and legislative proposals in the United States and in other jurisdictions, may be traded on automated trading platforms or become subject to mandatory clearing by a central counterparty, should not be re-characterized as “standardized derivatives”. The Alberta Securities Commission addressed this issue last year in restating Blanket Order 91-503 Over-The-Counter Derivatives Transactions and Commodity Contracts (April 11, 2008) to include an option, forward contract, contract for differences or other instrument of a type commonly considered to be a derivative, or any combination of any of them, if the agreement is cleared through an acceptable clearing corporation. See our April 2008 Structured Finance Update at www.stikeman.com