

The New Quebec Derivatives Act – Key Transitional Measures Announced

First Policy Statements Published

ALIX D'ANGLEJAN-CHATILLON (adanglejan@stikeman.com)

As a follow-up to the recent announcement by the Quebec Government on the coming into force of the new *Derivatives Act* (the “QDA” or “Act”) on February 1, 2009, the *Autorité des marchés financiers* (the “AMF”, Quebec’s financial services regulator) issued a press release on January 26, 2009 to announce a series of important transitional measures. The coming-into-force documents published by the AMF also include three policy statements relating to the definition of “accredited counterparties”, the characterization of “hybrid instruments” and self-certification of rules made by “recognized regulated entities”.

The QDA is the first comprehensive standalone derivatives legislation to be adopted in Canada. The Act regulates both over-the-counter (OTC) and exchange-traded derivatives, subject to certain carve outs for OTC derivatives activities involving “accredited counterparties” (the “OTC Derivatives Exemption”) and in other cases to be specified by regulation. Please see Stikeman Elliott’s previous Structured Finance Updates regarding the QDA that are available at www.stikeman.com.

Noting that the QDA is principles-based legislation, the AMF commented in its press release that the legislation “*specifies obligations of results and transfers the responsibility for establishing the most effective means of assuming such obligations to market participants and other regulated entities*”. Exactly what standard is implied by this reference to “obligations of results” in the context of these principles-based rules is not yet clear.

Key transitional measures

The key transitional measures announced by the AMF in the coming-into-force package include the following:

- > **A blanket decision (the “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 National Instrument 45-106 Prospectus and Registration Exemptions (NI 45-106), subject to certain conditions, as more fully discussed below.
- > **A six-month window (to August 1, 2009) to enable financial sector participants to phase in the implementation of derivatives-related compliance measures** to address new requirements under the QDA. In particular, this window will enable participants in the OTC derivatives

industry to qualify current OTC counterparties as “accredited counterparties” for new transactions (and, depending on the terms, potentially for re-coupons), obtain appropriate counterparty representations and make the required amendments to ISDA and other documentation.

- > **The postponement of the coming into force of provisions dealing with derivatives dealer and adviser registration categories and procedures.** This measure will permit the QDA to incorporate the registration rules under proposed National Instrument 31-103 Registration Requirements (Proposed NI 31-103) expected to be adopted later this year. A complete analysis of Proposed NI 31-103 is available on the Registration Reform information page posted on www.canadiansecuritieslaw.com.
- > **The postponement of the coming into force of provisions dealing with the prior authorization of derivatives offered by persons other than “recognized regulated entities”** that are subject to the qualification procedure to “create or market” derivatives. The stated intention of this measure is to “*permit the [Canadian Securities Administrators] to complete harmonization initiatives with respect to derivatives offered to the public*”.

The Blanket Decision

Significantly, the QDA does not contain any exemption for exchange-traded derivatives activities equivalent to the OTC Derivatives Exemption or the “international dealer” and “international adviser” exemptions under Proposed NI 31-103. This is 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 have historically engaged in exchange-traded derivatives activities outside of Quebec for Quebec-resident institutional investors.

The AMF has responded to these concerns in part by issuing the Blanket Decision for an unspecified temporary period. The Blanket Decision provides an exemption from the derivatives dealer and adviser registration requirements and the derivatives qualification rules under the QDA for specified derivatives activities. The exemption is subject to the following conditions:

1. the derivatives activities must be carried out solely with “accredited investors” as defined under NI 45-106 and in accordance with the conditions set forth in that instrument (including the filing of a report under Part 6); and
2. the activities must relate only to the following categories of derivatives (the “Specified Categories”) currently regulated under the *Securities Act* (Quebec):
 - (i) An option or a negotiable futures contract pertaining to securities, or a Treasury bond futures contract;
 - (ii) An option on a commodity futures contract or financial instrument futures contract;
 - (iii) Commodities futures contracts, financial futures contracts, currencies futures contracts and stock indices futures contracts.

The coming-into-force package includes ancillary statements that would appear to imply that the relief under the Blanket Decision is restricted to OTC derivatives. There is in fact no such restriction in the decision and we understand that the decision is intended to cover both OTC and exchange-traded derivatives of a type covered by the Specified Categories. All other derivatives are subject to the QDA. Industry participants that engage in trading or advisory activities in Quebec not covered by the transitional relief described above will have to apply for specific exemptive relief.

Recognition of “regulated entities”

The QDA also governs the activities of so-called “regulated entities”, which are defined under the Act to include exchanges, alternative trading systems (not registered as derivatives dealers) or other published markets, clearing houses, information processors and self-regulatory organizations (SROs). The QDA provides that “*no regulated entity may carry on derivatives activities in Québec*” unless it is recognized by the AMF. Under the QDA, recognized regulated entities are subject to various requirements covering their operating rules, activities, governance practices, information disclosure and the filing with the AMF of annual audited financial information. Certain types of regulated entities previously recognized by the AMF under securities legislation are partially grandfathered under the QDA. The AMF has not issued any guidance on what will constitute derivatives-related “activities in Québec” for purposes of these rules. This is an important jurisdictional issue for U.S. and international exchanges, ATSS, clearing organizations, information processors and SROs, etc.

Three policy statements published

The coming-into-force package also includes three policy statements issued by the AMF:

- > **The Policy Statement respecting Accredited Counterparties** provides certain guidance on the definition of “accredited counterparties” as applied to financial institutions and the accreditation of certain counterparties.

The statement specifies that the status of a counterparty as an “accredited counterparty” is to be determined “at the time a derivative is entered into” and that “a counterparty is not required to ensure that the other counterparty continues to be accredited during the life of the derivative”. Since the availability of the OTC Derivatives Exemption is conditioned on the requirement that the OTC derivative involve “accredited counterparties only”, the statement notes that an accredited counterparty is “responsible for determining whether the other party is also accredited”. In doing so, “a counterparty may rely on the factual statements made by the other party provided that it does not have reasonable grounds to believe that such statements are false. However, the counterparty is nonetheless responsible for determining whether, on the basis of the facts, the exemption is applicable.” The statement further requires that counterparties keep a documentary record sufficient to establish that they properly relied on the exemption.

Counterparties to OTC derivatives involving at least one Quebec-resident counterparty should, therefore, give and obtain reciprocal representations as to their respective status as “accredited counterparties” 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, a counterparty will have to perform enhanced due diligence to back up its reasonable reliance on the other counterparty’s status as an “accredited counterparty”.

- > **The Policy Statement respecting Hybrid Products** explains the characterization test under the QDA for “hybrid products” based on the basis of which an instrument that combines elements of both derivatives and securities may be presumed to be predominantly a security and not subject to the QDA. The statement also provides examples of hybrid products presumed to be securities, including certain types of principal protected notes and other structured notes.
- > **The Policy Statement respecting Self-Certification** covers self-certification of operating rules made by recognized regulated entities.

Canadian and foreign market participants should consider the impact of the QDA to identify potential jurisdictional, legal, documentary, due diligence and operational issues that may be raised by this legislation with respect to their activities in Quebec. Certain of the key issues to consider were noted in our previous update referenced above.

For assistance with any of these issues, please contact your Stikeman Elliott representative, the author, Alix d'Anglejan-Chatillon (adanglejan@stikeman.com), or any member of our Structured Finance Group listed at www.stikeman.com

MONTRÉAL

1155 René-Lévesque Blvd. West, 40th Floor, Montréal, QC, Canada H3B 3V2
Tel: (514) 397-3000 Fax: (514) 397-3222

TORONTO

5300 Commerce Court West, 199 Bay Street, Toronto, ON, Canada M5L 1B9
Tel: (416) 869-5500 Fax: (416) 947-0866

OTTAWA

Suite 1600, 50 O'Connor Street, Ottawa, ON, Canada K1P 6L2
Tel: (613) 234-4555 Fax: (613) 230-8877

CALGARY

4300 Bankers Hall West, 888 - 3rd Street S.W., Calgary, AB, Canada T2P 5C5
Tel: (403) 266-9000 Fax: (403) 266-9034

VANCOUVER

Suite 1700, Park Place, 666 Burrard Street, Vancouver, BC, Canada V6C 2X8
Tel: (604) 631-1300 Fax: (604) 681-1825

NEW YORK

Tower 56, 14th Floor, 126 East 56th Street, New York, USA 10022
Tel: (212) 371-8855 Fax: (212) 371-7087

LONDON

Dauntsey House, 4B Frederick's Place, London EC2R 8AB England
Tel: 44 20 7367 0150 Fax: 44 20 7367 0160

SYDNEY

Level 12, The Chifley Tower, 2 Chifley Square, Sydney N.S.W. 2000 Australia
Tel: (61-2) 9232 7199 Fax: (61-2) 9232 6908

www.stikeman.com

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