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Structured Finance Update

STIKEMAN ELLIOTT

Quebec *Derivatives Act* proclaimed in force

No transitional relief issued to date

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The Quebec Government has proclaimed the *Derivatives Act* (QDA) in force as of February 1, 2009. The Act had received royal assent on June 20, 2008.

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" and in other cases to be specified by regulation. An earlier article regarding the adoption of the QDA appears in the July 2008 issue of Stikeman Elliott's Structured Finance Update, which is available at www.stikeman.com

Highlights of the QDA

Some of the highlights of the new legislation are noted below:

The QDA will regulate trading and advisory activities with respect to all forms of "derivatives" (broadly defined), including both "standardized derivatives" and OTC derivatives.

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 dealer and adviser registration requirements, the derivatives qualification procedure and certain limited procedural and enforcement-related provisions, except with respect to market manipulation and fraud (the OTC Derivatives Exemption).

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 *Registration Requirements*. 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.

Since 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 enactment of the legislation will raise a number of significant compliance issues, particularly given the absence of any transitional relief.

The situation will be particularly problematic for U.S. and other foreign FCMs and CTMs which have longstanding business with institutional clients in

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Quebec and have historically relied on the "accredited investor" exemption from the dealer and adviser registration requirement. The QDA sets out a fast-track registration mechanism for dealers and advisers registered under the *Securities Act* (Quebec). There are, however, no rules which would permit registration of foreign market participants or even Ontario limited market dealers.

Selected Key Issues

Key issues to consider include the following:

General Issues

> The need for Canadian, U.S. and other market participants with derivatives activities in Quebec to review their product and service offerings into Quebec for compliance issues under the QDA;
> The possible need to make consequential amendments to existing client agreements;

Exchange-traded Derivatives Activities

> The need for Quebec registered dealers and advisers to transition their registrations under the QDA to cover exchange-traded derivatives activities;
> In the case of previously exempt trading and advisory activity with qualified Quebec clients involving exchange traded futures and options, the urgent need to apply for discretionary relief under the QDA, failing which such activities may have to be discontinued;
> The possible need for exemptive relief to cover proprietary trading activities in exchange-traded derivatives, including proprietary activities of Quebec institutional investors on foreign derivatives exchanges and automated-trading systems;
> The possible need for exemptive relief for fully registered Quebec dealers with discount brokerage activities;

OTC Derivatives Activities

> The need for parties to OTC derivatives transactions between or including Quebec counterparties, to amend their representations under applicable ISDA Master Agreements to include reciprocal representations as to their status as "accredited counterparties" under the QDA in order to rely on the OTC Derivatives Exemption;
> The need to obtain more detailed representations from certain types of counterparties recognized as "accredited counterparties" based on certain factual requirements of that definition (e.g., hedgers);
> The need for enhanced KYC (Know Your Client) and suitability verifications for certain categories of "accredited counterparties" (e.g., parties who can establish in a "conclusive and verifiable manner" that they meet the specified knowledge and experience test, the minimum asset test and a net asset test with respect to repayment and delivery obligations (the minimum threshold for this third test has not been specified under the Derivatives Regulation (discussed below));

The *Autorité des marchés financiers* (the "AMF", Quebec's financial services regulator) had published a draft Derivatives Regulation (the Derivatives Regulation) for comment on October 3, 2008. The final form of the Derivatives Regulation was adopted on January 15, 2009.

The Derivatives Regulation covers a limited range of matters, including the minimum asset requirement for self-certified "accredited counterparties" (discussed above), the rules for self-certification of operating rules of "recognized regulated entities", and the prescribed information document to be delivered by derivatives dealers to their clients. The AMF is expected to publish companion policies on certain specific interpretation issues.

The QDA does not include any material transitional provisions, although the AMF is expected to issue guidance on the transitional application of the legislation. Canadian and foreign market participants should immediately consider the impact of the QDA to identify potential jurisdictional, legal and operational issues that may be raised by this legislation with respect to their activities in Quebec.

For further information, 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