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derivatives law bulletin

June 2010

over the counter, not under the radar: derivatives regulation in the proposed Canadian *Securities Act*

On Wednesday May 25, 2010, the Department of Finance released the proposed Canadian *Securities Act* (the National Act)[1] that aims to establish a national securities regulator. In a fact sheet released the same day, the Department stated that the National Act contains the "core fundamental provisions" that underpin the proposed regime. Further details and technical requirements will be set out in forthcoming regulations.

application of the *National Act* to derivatives transactions

Unlike the Draft Securities Act accompanying the Final Report and Recommendations of the Expert Panel on Securities Regulation (the Expert Panel Report), the National Act includes a definition of "derivative". This definition is sufficiently broad to include the entire range of exchange-traded and over-the-counter derivatives products, including a broad range of products which are not traditionally considered the subject of derivatives regulation (such as insurance contracts) or arguably are not best dealt with by a one size fits all regime (such as employee stock option or phantom stock plans).

For this reason, section 237 permits the Chief Regulator (the chief executive officer of the Regulatory Division) to make a designation that certain instruments or contracts be treated or not treated as derivatives, while section 227 allows selected derivatives to be exempted from whole portions of the National Act. This may be initiated by the Canadian Securities Regulatory Authority (CSRA) or by application.[2] This approach seeks to bring as many derivative instruments as possible within the authority of the National Act, then to allow exemptions where deemed appropriate. This is precisely the approach that was rejected by the Ontario Minister of Finance, when he returned Ontario Securities Commission Rule 91-504 *Over-the-Counter Derivatives* to the Ontario Securities Commission for further consideration[3].

1 The *Act* can be accessed on the Department of Finance's website at: http://www.fin.gc.ca/drleg-apl/csa-lvm-eng.asp

2 The *Act* does not specify who may make an application, or the procedural requirements.

3 The Notice specifically stated that the Rule was being returned for further consideration to determine "…whether the Commission's objectives in connection with the regulation of over-the-counter derivatives can be achieved by a rule that identifies the specific classes of transactions and related parties that will be regulated as opposed to having provisions of the [Ontario] *Securities Act* apply to all over-the-counter derivatives transactions and then providing exemptions from that application."

Also unlike the Draft Securities Act, the National Act adopts a narrow definition of "security" which only includes "prescribed derivatives" (those that are prescribed to be securities by regulation). Like the approach toward "hybrid products" in the Quebec *Derivatives Act* (the QDA), it is expected that only derivatives with the predominant characteristics of a security, such as structured notes, would be prescribed as securities. Such prescribed derivatives would be subject to the prospectus and dealer / adviser registration requirements of the National Act.

By contrast, both "exchange-traded derivatives" and "designated derivatives" are dealt with under Part 7 of the National Act. Trades in exchange-traded derivatives are required to be on an exchange that is "recognized" (already regulated in Canada) or "accepted" by the Chief Regulator. It is not clear from the language of the National Act what will constitute an "accepted" exchange, but it will likely include most of the foreign futures exchanges that are currently recognized or exempted from recognition in Canadian jurisdictions[4]. Persons are prohibited from trading "designated-derivatives" unless a "prescribed disclosure document" (risk statement) is filed with CSRA and delivered in accordance with the regulations.[5] It is expected that most OTC derivatives will be included in the designated derivative category.

It is also interesting to note that the definitions of "adviser" and "dealer" both explicitly refer to securities. Therefore an entity which advises solely with respect to or deals solely in derivatives which are not prescribed as securities would not be required to register under the National Act. This is likely because the registration requirements for derivatives dealers and advisers will be prescribed by regulation at a later date.

a welcome approach

In our Derivatives Law Bulletin dated February 2009 following the Expert Panel Report we noted that the Bank of Canada favoured a principled approach to derivatives regulation in order to keep pace with changing markets and business structures. The National Act reflects this advice.

Section 16 of the National Act identifies three principles that underpin the proposed regime: (i) openness, flexibility and responsiveness; (ii) accountability to the interests of all sectors of investors and businesses in Canada; and (iii) efficient administration of the regime. Despite regulating derivatives and traditional securities with a single piece of legislation (the approach taken in most provinces) the treatment of derivatives in the National Act resembles the Quebec model, where derivatives are separately regulated by the QDA (in contrast to the Draft Securities Act, which resembled the British Columbia / Alberta model). Both the QDA and the National Act take a functional approach to derivatives; dispensing with uniform prospectus requirements and rigid classification of instruments that do not reflect the reality of today's derivative markets. While it is too early to tell how durable and functional the QDA will be, treating derivatives differently from traditional securities is a step in the right direction.

[4] British Columbia Instrument 21-501 *Recognition of exchanges, self regulatory bodies, and jurisdictions* includes a comprehensive list of the various futures exchanges that would likely be accepted under the National Act.

[5] Derivatives can be exempted from this requirement under s.90(2).

One question that remains to be answered is whether this degree of flexibility is too much of a good thing. Responsiveness often comes at the price of certainty. There is a risk that in framing the National Act to be adaptable to a changing market, it will be too loose and unable to deliver predictability or establish any true 'rules' for market players that will prevent excessive risk. At some point, flexibility must yield to the stated objective of the National Act: protecting the stability and integrity of Canada's financial system.

the international context

The National Act raises questions as to Canada's likely response to international calls for greater regulation of derivative markets. Throughout the ongoing financial crisis, the topic of derivatives regulation has received much attention in the United States and Europe. The G20 has called for "development of standards for central clearing and trading on exchanges or electronic platforms of all standardized over-the-counter derivative contracts, where appropriate, and reporting to trade repositories of all over-the-counter derivative contracts."[6] The United States Congress is in the process of refining measures to improve transparency and reduce risk exposure in derivative markets[7]. Canada is the only G7 state that does not have a national securities regulator. In 2009 the Expert Panel cautioned that it would be a mistake for Canada to adopt a regulatory stance towards derivatives that would be out of step with larger global trends. The current fragmented and inconsistent treatment of derivatives across Canada appears out of step.

The broad regulation-making power given to the CSRA by the National Act would allow Canada to move toward greater transparency in OTC derivatives trading by, for example, allowing for regulations requiring disclosure of trades and greater monitoring and scrutiny of positions, or perhaps a move toward central clearing of private derivative contracts. The Canadian Derivatives Clearing Corporation (CDCC), a self-regulated organization in Quebec under the oversight of the Autorité des marchés financiers (AMF), is working on a central OTC derivatives clearing platform with six domestic banks. As part of this project, the CDCC is in discussion with major international clearing organizations to enable domestic execution alongside cross-border margining and settlement (interoperability). Canadian banks have expressed a preference for domestic clearing of OTC derivatives.[8]

A central clearing platform for OTC derivatives supervised by the Canadian government could be the solution the banks are looking for. The debate on the desirability of these options, and the balance that must be achieved between greater regulation and market freedom, is ongoing and will likely raise more questions in the future. What is clear from the National Act is that the Canadian government is taking derivative regulation seriously and is open to adopting a regime that differs significantly from the status quo.

[6] Quoted from the Communiqué released following the April 23, 2010, Meeting of Finance Ministers and Central Bank Governors, available online at: http://www.g20.org/Documents/201004_communique_WashingtonDC.pdf.

[7] *The Restoring American Financial Stability Act* was passed in the Senate on May 20, 2010, and must now be reconciled with the version passed by the House of Representatives.

[8] "Canadian Clearing, Interoperability Take Shape" *Derivatives Week* (5 April 2010) 5.

in perspective

Change may be in the air, but it is far from upon us. The National Act, despite being optional for the provinces (which obviously reduces the effectiveness of a national derivatives regulatory regime), raises serious constitutional questions; the federal government's ability to legislate securities regulation has been referred to the Supreme Court of Canada and an answer is expected in 2012. The Backgrounder on the National Act released by the Department of Finance[9] projects the new regime to be launched in 2012 to 2013. Clearly there is time to prepare.

Sometime in the coming weeks the Canadian Securities Transition Office (CSTO) will release a technical commentary on the National Act and deliver its Transition Plan to the Minister of Finance on July 12, 2010. We expect to receive greater insight into the new regime and Canada's stance on the movement toward greater international regulation of financial instruments. Our analysis of the commentary will form the subject of a future Derivatives Law Bulletin.

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[9] The Backgrounder can be accessed on the Department of Finance's website at: http://www.fin.gc.ca/n10/data/10-051_1-eng.asp

[10] Thanks to Stephen Eddy, Summer Student for his assistance with this bulletin.

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