

Ontario Securities Commission

Companion Policy 91-506CP

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**COMPANION POLICY 91-506CP
*DERIVATIVES: PRODUCT DETERMINATION***

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PART 1 GENERAL COMMENTS

Introduction

This Companion Policy (the "Policy") sets out the views of the Commission ("our" or "we") on various matters relating to Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination* (the "Rule").

Except for Part 1, the numbering and headings in this Companion Policy correspond to the numbering and headings in the Rule. Any general guidance for a Section appears immediately after the Section name. Any specific guidance on sections in the Rule follows any general guidance.

The Rule applies only to the Ontario Securities Commission Rule 91-507 *Trade Repositories and Derivatives Data Reporting*.

Unless defined in the Rule or this Companion Policy, terms used in the Rule and in this Companion Policy have the meaning given to them in securities legislation, including, for greater certainty, in National Instrument 14-101 *Definitions* and Ontario Securities Commission Rule 14-501 *Definitions*.

In this Companion Policy, the term "contract" is interpreted to mean "contract or instrument".

PART 2 GUIDANCE

Excluded derivatives

2. (1) (a) Gaming contracts

Paragraph 2(1)(a) of the Rule prescribes certain domestic and foreign gaming contracts not to be "derivatives". While a gaming contract may come within the definition of "derivative", it is generally not recognized as being a financial derivative and typically does not pose the same potential risk to the financial system as other derivatives products. In addition, the Commission does not believe that the derivatives regulatory regime will be appropriate for this type of contract. Further, gaming control legislation of Canada (or a jurisdiction of Canada), or equivalent gaming control legislation of a foreign jurisdiction, generally has consumer protection as an objective and is therefore aligned with the objective of securities legislation to provide protection to investors from unfair, improper or fraudulent practices.

With respect to subparagraph 2(1)(a)(ii), a contract that is regulated by gaming control legislation of a foreign jurisdiction would only qualify for this exclusion if: (1) its execution does not violate legislation of Canada or Ontario, and (2) it would be considered a gaming contract under domestic legislation. If a contract would be treated as a derivative if entered into in Ontario, but would be considered a gaming contract in a foreign jurisdiction, the contract does not qualify for this exclusion, irrespective of its characterization in the foreign jurisdiction.

(b) Insurance and annuity contracts

Paragraph 2(1)(b) of the Rule prescribes qualifying insurance or annuity contracts not to be "derivatives". A reinsurance contract would be considered to be an insurance or annuity contract.

While an insurance contract may come within the definition of "derivative", it is generally not recognized as a financial derivative and typically does not pose the same potential risk to the financial system as other derivatives products. The Commission does not believe that the derivatives regulatory regime will be appropriate for this type of contract. Further, a comprehensive regime is already in place that regulates the insurance industry in Canada and the insurance legislation of Canada (or a jurisdiction of Canada), or equivalent insurance legislation of a foreign jurisdiction, has consumer protection as an objective and is therefore aligned with the objective of securities legislation to provide protection to investors from unfair, improper or fraudulent practices.

Certain derivatives that have characteristics similar to insurance contracts, including credit derivatives and climate-based derivatives, will be treated as derivatives and not insurance or annuity contracts.

Subparagraph 2(1)(b)(i) requires an insurance or annuity contract to be entered into with a domestically licensed insurer and that the contract be regulated as an insurance or annuity contract under Canadian insurance legislation. Therefore, for example, an interest rate derivative entered into by a licensed insurance company would not be an excluded derivative.

With respect to subparagraph 2(1)(b)(ii), an insurance or annuity contract that is made outside of Canada would only qualify for this exclusion if it would be regulated under insurance legislation of Canada or Ontario if made in Ontario. Where a contract would otherwise be treated as a derivative if entered into in Canada, but is considered an insurance contract in a foreign jurisdiction, the contract does not qualify for this exclusion, irrespective of its characterization in the foreign jurisdiction. Subparagraph 2(1)(b)(ii) is included to address the situation where a local counterparty purchases insurance for an interest that is located outside of Canada and the insurer is not required to be licensed in Canada.

(c) *Currency exchange contracts*

Paragraph 2(1)(c) of the Rule prescribes a short-term contract for the purchase and sale of a currency not to be a "derivative" if it is settled within the time limits set out in subparagraph 2(1)(c)(i). This provision is intended to apply exclusively to contracts that facilitate the conversion of one currency into another currency specified in the contract. These currency exchange services are often provided by financial institutions or other businesses that exchange one currency for another for clients' personal or business use (e.g., for purposes of travel or to make payment of an obligation denominated in a foreign currency).

Timing of delivery (subparagraph 2(1)(c)(i))

To qualify for this exclusion the contract must require physical delivery of the currency referenced in the contract within the time periods prescribed in subparagraph 2(1)(c)(i). If a contract does not have a fixed settlement date or otherwise allows for settlement beyond the prescribed periods or permits settlement by delivery of a currency other than the currency referenced in the contract, it will not qualify for this exclusion.

Clause 2(1)(c)(i)(A) applies to a transaction that settles by delivery of the referenced currency within two business days – being the industry standard maximum settlement period for a spot foreign exchange transaction.

Clause 2(1)(c)(i)(B) allows for a longer settlement period if the foreign exchange transaction is entered into contemporaneously with a related securities trade. This exclusion reflects the fact that the settlement period for certain securities trades can be three or more days. In order for the provision to apply, the securities trade and foreign exchange transaction must be related, meaning that the currency to which the foreign exchange transaction pertains was used to facilitate the settlement of the related security purchase.

Where a contract for the purchase or sale of a currency provides for multiple exchanges of cash flows, all such exchanges must occur within the timelines prescribed in subparagraph 2(1)(c)(i) in order for the exclusion in paragraph 2(1)(c) to apply.

Settlement by delivery except where impossible or commercially unreasonable (subparagraph 2(1)(c)(i))

Subparagraph 2(1)(c)(i) requires that a contract must not permit settlement in a currency other than what is referenced in the contract unless delivery is rendered impossible or commercially unreasonable as a result of events not reasonably within the control of the counterparties.

Settlement by delivery of the currency referenced in the contract requires the currency contracted for to be delivered and not an equivalent amount in a different currency. For example, where a contract references Japanese Yen, such currency must be delivered in order for this exclusion to apply. We consider delivery to mean actual delivery of the original currency contracted for either in cash or through electronic funds transfer. In situations where settlement takes place through the delivery of an alternate currency or account notation without actual currency transfer, there is no settlement by delivery and therefore the exclusion in paragraph 2(1)(c) would not apply.

We consider events that are not reasonably within the control of the counterparties to include events that cannot be reasonably anticipated, avoided or remedied. An example of an intervening event that would render delivery to be commercially unreasonable would include a situation where a government in a foreign jurisdiction imposes capital controls that restrict the flow of the currency required to be delivered. A change in the market value of the currency itself will not render delivery commercially unreasonable.

Intention requirement (subparagraph 2(1)(c)(ii))

Subparagraph 2(1)(c)(ii) excludes from the reporting requirement a contract for the purchase and sale of a currency that is intended to be settled through the delivery of the currency referenced in such contract. The intention to settle a contract by delivery may be inferred from the terms of the relevant contract as well as from the surrounding facts and circumstances.

When examining the specific terms of a contract for evidence of intention to deliver, we take the position that the contract must create an obligation on the counterparties to make or take delivery of the currency and not merely an option to make or take delivery. Any agreement, arrangement or understanding between the parties, including a side agreement, standard account terms or operational procedures that allow for the settlement in a currency other than the referenced currency or on a date after the time period specified in subparagraph 2(1)(c)(i) is an indication that the parties do not intend to settle the transaction by delivery of the prescribed currency within the specified time periods.

We are generally of the view that certain provisions, including standard industry provisions, the effect of which may result in a transaction not being physically settled, will not necessarily negate the intention to deliver. The contract as a whole needs to be reviewed in order to determine whether the counterparties' intention was to actually deliver the contracted currency. Examples of provisions that may be consistent with the intention requirement under subparagraph 2(1)(c)(ii) include:

- a netting provision that allows two counterparties who are party to multiple contracts that require delivery of a currency to net offsetting obligations, provided that the counterparties intended to settle through delivery at the time the contract was created and the netted settlement is physically settled in the currency prescribed by the contract, and

- a provision where cash settlement is triggered by a termination right that arises as a result of a breach of the terms of the contract.

Although these types of provisions permit settlement by means other than the delivery of the relevant currency, they are included in the contract for practical and efficiency reasons.

In addition to the contract itself, intention may also be inferred from the conduct of the counterparties. Where a counterparty's conduct indicates an intention not to settle by delivery, the contract will not qualify for the exclusion in paragraph 2(1)(c). For example, where it could be inferred from the conduct that counterparties intend to rely on breach or frustration provisions in the contract in order to achieve an economic outcome that is, or is akin to, settlement by means other than delivery of the relevant currency, the contract will not qualify for this exclusion. Similarly, a contract would not qualify for this exclusion where it can be inferred from their conduct that the counterparties intend to enter into collateral or amending agreements which, together with the original contract, achieve an economic outcome that is, or is akin to, settlement by means other than delivery of the relevant currency.

Rolling over (subparagraph 2(1)(c)(iii))

Subparagraph 2(1)(c)(iii) provides that, in order to qualify for the reporting exclusion in paragraph 2(1)(c), a currency exchange contract must not permit a rollover of the contract. Therefore, physical delivery of the relevant currencies must occur in the time periods prescribed in subparagraph 2(1)(c)(i). To the extent that a contract does not have a fixed settlement date or otherwise allows for the settlement date to be extended beyond the periods prescribed in subparagraph 2(1)(c)(i), the Commission would consider it to permit a rollover of the contract. Similarly, any terms or practice that permits the settlement date of the contract to be extended by simultaneously closing the contract and entering into a new contract without delivery of the relevant currencies would also not qualify for the exclusion in paragraph 2(1)(c).

The Commission does not intend that the exclusion in paragraph 2(1)(c) will apply to contracts entered into through platforms that facilitate investment or speculation based on the relative value of currencies. These platforms typically do not provide for physical delivery of the currency referenced in the contract, but instead close out the positions by crediting client accounts held by the person operating the platform, often applying the credit using a standard currency.

(d) *Commodities*

Paragraph 2(1)(d) of the Rule prescribes a contract for the delivery of a commodity not to be a "derivative" if it meets the criteria in subparagraphs 2(1)(d)(i) and (ii).

Commodity

The exclusion available under paragraph 2(1)(d) is limited to commercial transactions in goods that can be delivered either in a physical form or by delivery of the instrument evidencing ownership of the commodity. We take the position that commodities include goods such as agricultural products, forest products, products of the sea, minerals, metals, hydrocarbon fuel, precious stones or other gems, electricity, oil and natural gas (and by-products, and associated refined products, thereof), and water. We also consider certain intangible commodities, such as carbon credits and emission allowances, to be commodities. In contrast, this exclusion will not apply to financial commodities such as currencies, interest rates, securities and indexes.

Intention requirement (subparagraph 2(1)(d)(i))

Subparagraph 2(1)(d)(i) of the Rule requires that counterparties *intend* to settle the contract by delivering the commodity. Intention can be inferred from the terms of the relevant contract as well as from the surrounding facts and circumstances.

When examining the specific terms of a contract for evidence of an intention to deliver, we take the position that the contract must create an obligation on the counterparties to make or take delivery of the commodity and not merely an option to make or take delivery. Subject to the comments below on subparagraph 2(1)(d)(ii), we are of the view that a contract containing a provision that permits the contract to be settled by means other than delivery of the commodity, or that includes an option or has the effect of creating an option to settle the contract by a method other than through the delivery of the commodity, would not satisfy the intention requirement and therefore does not qualify for this exclusion.

We are generally of the view that certain provisions, including standard industry provisions, the effect of which may result in a transaction not being physically settled, may not necessarily negate the intention to deliver. The contract as a whole needs to be reviewed in order to determine whether the counterparties' intention was to actually deliver the commodity. Examples of provisions that may be consistent with the intention requirement under subparagraph 2(1)(d)(i) include:

- an option to change the volume or quantity, or the timing or manner of delivery, of the commodity to be delivered;
- a netting provision that allows two counterparties who are party to multiple contracts that require delivery of a commodity to net offsetting obligations provided that the counterparties intended to settle each contract through delivery at the time the contract was created,
- an option that allows the counterparty that is to accept delivery of a commodity to assign the obligation to accept delivery of the commodity to a third-party; and
- a provision where cash settlement is triggered by a termination right arising as a result of the breach of the terms of the contract or an event of default thereunder.

Although these types of provisions permit some form of cash settlement, they are included in the contract for practical and efficiency reasons.

In addition to the contract itself, intention may also be inferred from the conduct of the counterparties. For example, where it could be inferred from the conduct that counterparties intend to rely on breach or frustration provisions in the contract in order to achieve an economic outcome that is, or is akin to, cash settlement, the contract will not qualify for this exclusion. Similarly, a contract will not qualify for this exclusion where it can be inferred from their conduct that the counterparties intend to enter into collateral or amending agreements which, together with the original contract, achieve an economic outcome that is, or is akin to, cash settlement of the original contract.

When determining the intention of the counterparties, we will examine their conduct at execution and throughout the duration of the contract. Factors that we will consider include whether a counterparty is in the business of producing, delivering or using the commodity in question and whether the counterparties regularly make or take delivery of the commodity relative to the frequency with which they enter into such contracts in relation to the commodity.

Situations may exist where, after entering into the contract for delivery of the commodity, the counterparties enter into an agreement that terminates their obligation to deliver or accept delivery of the commodity (often referred to as a "book-out" agreement). Book-out agreements are typically separately negotiated, new agreements where the counterparties have no obligation to enter into such agreements and such book-out agreements are not provided for by the terms of the contract as initially entered into. We will generally not consider a book-out to be a "derivative" provided that, at the time of execution of the original contract, the counterparties intended that the commodity would be delivered.

Settlement by delivery except where impossible or commercially unreasonable (subparagraph 2(1)(d)(ii))

Subparagraph 2(1)(d)(ii) requires that a contract not permit cash settlement in place of delivery unless physical settlement is rendered impossible or commercially unreasonable as a result of an intervening event or occurrence not reasonably within the control of the counterparties, their affiliates or their agents. A change in the market value of the commodity itself will not render delivery commercially unreasonable. In general, we consider examples of events not reasonably within the control of the counterparties would include:

- events to which typical *force majeure* clauses would apply,
- problems in delivery systems such as the unavailability of transmission lines for electricity or a pipeline for oil or gas where an alternative method of delivery is not reasonably available, and
- problems incurred by a counterparty in producing the commodity that they are obliged to deliver such as a fire at an oil refinery or a drought preventing crops from growing where an alternative source for the commodity is not reasonably available.

In our view, cash settlement in these circumstances would not preclude the requisite intention under subparagraph 2(1)(d)(i) from being satisfied.

(e) and (f) *Evidence of a deposit*

Paragraphs 2(1)(e) and (f) of the Rule prescribe certain evidence of deposits not to be a "derivative".

Paragraph 2(1)(f) refers to "similar statutes of Canada or a jurisdiction of Canada". While the *Credit Unions and Caisses Populaires Act, 1994* (Ontario) is Ontario legislation, it is intended that all federal or province-specific statutes will receive the same treatment in every province or territory. For example, if a credit union to which the Ontario *Credit Unions and Caisses Populaires Act, 1994* (Ontario) applies issues an evidence of deposit to a market participant that is located in a different province, that province would apply the same treatment under its equivalent legislation.

(g) *Exchange-traded derivatives*

Paragraph 2(1)(g) of the Rule prescribes a contract not to be a derivative if it is traded on certain prescribed exchanges. Exchange-traded derivatives provide a measure of transparency to regulators and to the public, and for this reason are not required to be reported. We note that where a transaction is cleared through a clearing agency, but not traded on an exchange, it will not be considered to be exchange-traded and will be required to be reported.

Subsection 2(2) of the Rule excludes derivatives trading facilities from the meaning of exchange as it is used in paragraph 2(1)(g). A derivatives trading facility means a person or company that constitutes, maintains, or provides a facility or market that brings together buyers and sellers of over-the-counter derivatives, brings together the orders of multiple buyers and multiple sellers, and uses methods under which the orders interact with each other and the buyers and sellers agree to the terms of trades.

For example, the following would not be considered an exchange for purposes of paragraph 2(1)(g): a "swap execution facility" as defined in the Commodity Exchange Act 7 U.S.C. §(1a)(50); a "security-based swap execution facility" as defined in the Securities Exchange Act of 1934 15 U.S.C. §78c(a)(77); a "multilateral trading facility" as defined in Directive 2014/65/EU Article 4(1)(22) of the European Parliament; and an "organized trading facility" as defined in Directive 2014/65/EU Article 4(1)(23) of the European Parliament. Therefore derivatives traded

on the foregoing facilities that would otherwise be considered derivatives for the purposes of this Rule are required to be reported.

(h) *Additional contracts not considered to be derivatives*

Apart from the contracts expressly prescribed not to be derivatives in section 2 of the Rule, there are other contracts that we do not consider to be "derivatives" for the purposes of securities or derivatives legislation. A feature common to these contracts is that they are entered into for consumer, business or non-profit purposes that do not involve investment, speculation or hedging. Typically, they provide for the transfer of ownership of a good or the provision of a service. In most cases, they are not traded on a market.

These contracts include, but are not limited to:

- a consumer or commercial contract to acquire, or lease real or personal property, to provide personal services, to sell or assign rights, equipment, receivables or inventory, or to obtain a loan or mortgage, including a loan or mortgage with a variable rate of interest, interest rate cap, interest rate lock or embedded interest rate option;
- a consumer contract to purchase non-financial products or services at a fixed, capped or collared price;
- an employment contract or retirement benefit arrangement;
- a guarantee;
- a performance bond;
- a commercial sale, servicing, or distribution arrangement;
- a contract for the purpose of effecting a business purchase and sale or combination transaction;
- a contract representing a lending arrangement in connection with building an inventory of assets in anticipation of a securitization of such assets; and
- a commercial contract containing mechanisms indexing the purchase price or payment terms for inflation such as via reference to an interest rate or consumer price index.

Investment contracts and over-the-counter options

3. Section 3 of the Rule prescribes a contract (to which section 2 of the Rule does not apply) that is a derivative and a security solely by reason of being an investment contract under paragraph (n) of the definition of "security" in subsection 1(1) of the Act, not to be a security. Some types of contracts traded over-the-counter, such as foreign exchange contracts and contracts for difference meet the definition of "derivative" (because their market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest) but also meet the definition of "security" (because they are investment contracts). This section prescribes that such instruments will be treated as derivatives and therefore be required to be reported to a designated trade repository.

Similarly, options fall within both the definition of "derivative" and the definition of "security". Section 3 of the Rule prescribes an option that is only a security by virtue of paragraph (d) of the definition of "security" in subsection 1(1) of the Act (and not described in section 5 of the Rule), not to be a security. This section prescribes that such instruments will be treated as derivatives

and therefore will be required to be reported to a designated trade repository. This treatment will only apply to options that are traded over-the-counter. Under paragraph 2(g), exchange-traded options will not be required to be reported to a designated trade repository. Further, options that are entered into on a commodity futures exchange pursuant to standardized terms and conditions are commodity futures options and therefore regulated under the *Commodity Futures Act* (Ontario) and excluded from the definition of "derivative".

Derivatives that are securities

4. Section 4 of the Rule prescribes a contract (to which sections 2 and 3 of the Rule do not apply) that is a security and a derivative, not to be a derivative. Derivatives that are securities and which are contemplated as falling within this section include structured notes, asset-backed securities, exchange-traded notes, capital trust units, exchangeable securities, income trust units, securities of investment funds and warrants. This section ensures that such instruments will continue to be subject to applicable prospectus disclosure and continuous disclosure requirements in securities legislation as well as applicable registration requirements for dealers and advisers. The Commission anticipates that it will again review the categorization of instruments as securities and derivatives once the comprehensive derivatives regime has been implemented.

Derivatives prescribed to be securities

5. Section 5 of the Rule prescribes a security-based derivative that is used by an issuer or its affiliate to compensate an officer, director, employee or service provider, or as a financing instrument, not to be a derivative. Examples of the compensation instruments that are contemplated as falling within section 5 include stock options, phantom stock units, restricted share units, deferred share units, restricted share awards, performance share units, stock appreciation rights and compensation instruments provided to service providers, such as broker options. Securities treatment would also apply to the aforementioned instruments when used as a financing instrument, for example, rights, warrants and special warrants, or subscription rights/receipts or convertible instruments issued to raise capital for any purpose. The Commission takes the view that an instrument would only be considered a financing instrument if it is used for capital-raising purposes. An equity swap, for example, would generally not be considered a financing instrument. The classes of derivatives referred to in section 5 can have similar or the same economic effect as a securities issuance and are therefore subject to requirements generally applicable to securities. As they are prescribed not to be derivatives they are not subject to the derivatives reporting requirements.