

1.1.2 OSC Staff Notice 33-744 – Availability of registration exemptions to foreign dealers in connection with trades in options and futures contracts under the Commodity Futures Act (Ontario)

OSC STAFF NOTICE 33-744

AVAILABILITY OF REGISTRATION EXEMPTIONS TO FOREIGN DEALERS IN CONNECTION WITH TRADES IN OPTIONS AND FUTURES CONTRACTS UNDER THE COMMODITY FUTURES ACT (ONTARIO)

September 18, 2014

Purpose of this Notice

Staff of the Ontario Securities Commission (**staff** or **we**) have issued this notice (the **Notice**) to assist foreign dealers and other market participants in determining whether certain exemptions from the dealer registration requirement under the *Commodity Futures Act*, R.S.O. 1990, c. 20 (the **CFA**) are available to them.

Specifically, this Notice describes staff's view of the following:

- the circumstances in which the “unsolicited trade” exemption (as described below) is available, and activities that we consider inconsistent with the parameters of this exemption;
- the circumstances in which the “hedger” exemption (as described below) is available, and a market participant's obligations when relying on this exemption;
- the fee payment obligations of unregistered market participants that seek to trade with Ontario residents; and
- our expectations on foreign dealers and other unregistered market participants that intend to rely on exemptions from the registration requirement and actions that we may take where these expectations are not satisfied.

In this Notice, a reference to a “dealer” or “other market participant” includes both:

- a dealer or other market participant that is registered under the CFA, and
- an unregistered dealer or other market participant that is situate outside of Ontario but deals with customers in Ontario in reliance on an exemption from the registration requirement under the CFA.

We remind dealers and other market participants that there may be important differences in the regulatory treatment of exchange-traded futures and options across Canada and that market participants should review the specific requirements of securities, commodity futures and/or derivatives legislation in these jurisdictions prior to trading with customers in these jurisdictions.

Staff expect that this Notice will assist foreign dealers and other market participants in complying with the requirements of Ontario law until such time as the Canadian Securities Administrators (the CSA) develop a harmonized CSA approach to the regulation of exchange-traded options and futures contracts.

Background

Overview of regulatory regime in Ontario

In Ontario, exchange-traded futures and options are regulated as “commodity futures contracts” and “commodity futures options” under the CFA, and also, in some circumstances, as securities under the *Securities Act*, R.S.O. 1990, c. S.5 (the **OSA**).

Under the CFA, no person may trade¹ in a commodity futures contract or a commodity futures option (collectively, a **contract**) unless the person is registered as a dealer [*Futures Commission Merchant*], or as a representative of the dealer, or an exemption from the registration requirement is available.

Under the CFA, a “trade” is defined to include²

- (a) entering into contracts, whether as principal or agent,

¹ See s. 22 of the CFA.

² See s. 1(1) of the CFA.

- (b) acting as a floor trader,
- (c) any receipt by a registrant of an order to effect a transaction in a contract,
- (d) any assignment or other disposition of rights under a contract except a disposition arising from the death of an individual enjoying rights under a contract, and
- (e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of the foregoing.

Accordingly, under the CFA, a person who wishes to trade a contract is required to register as a dealer unless a registration exemption is available for the trade.

Registered dealers are required to be members of the Investment Industry Regulatory Organization of Canada (**IIROC**)³ and to comply with IIROC rules. The most commonly used registration exemptions are considered below.

The “unsolicited trade” exemption

The CFA includes an exemption⁴ from the registration requirement for a trade in a contract that is “unsolicited” and that meets certain other conditions (the **unsolicited trade exemption**). In order for a trade to meet the conditions of the unsolicited trade exemption, the trade must

- be executed on an exchange situated outside Ontario; and
- result from an order that
 - is placed with a dealer who does not carry on business in Ontario; and
 - did not involve any solicitation by or on behalf of the dealer.

Indicia of activities we consider to be “carrying on business” in Ontario

We consider each of the following to be indicia of a person “carrying on business” in Ontario:

- the establishment of an office or place of business in Ontario;
- the establishment of a relationship with an affiliated entity or third party in Ontario to conduct marketing or other activities that are in furtherance of a trade with a customer in Ontario;
- payment of commissions, fees or similar compensation to “introducing brokers”, “finders”, “referral agents” or other persons in connection with the trade with a customer in Ontario;
- trading with regularity with customers in Ontario, whether in reliance on the unsolicited trade exemption and/or in reliance on other exemptions, including exemptions contained in a discretionary exemptive relief order granted by the Commission under the CFA or the OSA.

Staff are of the view that the unsolicited trade exemption in the CFA was intended to apply to occasional, isolated trades by customers in Ontario that are not solicited by or on behalf of the foreign dealer. We do not believe that the exemption is available to permit the operation of unsolicited order-execution-only accounts by non-registered foreign dealers with customers in Ontario as we believe this would constitute trading with regularity with customers in Ontario and therefore carrying on business in Ontario.

Staff are generally prepared to recommend exemptive relief under the CFA to unregistered foreign dealers on terms and conditions that are similar to the terms and conditions contained in the international dealer exemption (the **international dealer exemption**) in section 8.18 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**).

However, if a foreign dealer has obtained an order under the CFA exempting the foreign dealer from the requirement to be registered under the CFA by analogy to the international dealer exemption in NI 31-103, and the foreign dealer relies on that order to trade with regularity with customers in Ontario, staff take the view that the foreign dealer is carrying on business in Ontario and is therefore unable to also rely on the unsolicited trade exemption in Ontario.

3 See s. 10 of the General Regulation under the CFA, R.R.O. 1990, Reg. 90 (the **CFA Regulation**).

4 See s. 32 of the CFA.

Indicia of activities we consider to be a “solicitation” in a jurisdiction

We consider each of the following to be indicia of activities that may be considered a “solicitation” in Ontario:

- any advertising or promotional activities that are directed to persons in Canada during the six months preceding the trade, including attendance at industry group conferences in Canada to promote the foreign dealer’s products and services to Canadians;
- website disclosure that is addressed to Canadians or that provides information, including tax information, which is tailored to Canadians; and
- payment of commissions, fees or similar compensation to “introducing brokers”, “finders”, “referral agents” or other persons, whether situate in Ontario or not, in connection with a trade with a customer in Ontario.

If an unregistered foreign dealer undertakes any of these activities, staff take the view that the foreign dealer has solicited the trade, and is therefore unable to rely on the unsolicited trade exemption for that trade.

The “hedger” exemption

In Ontario, if a customer meets the definition of a “hedger” for the purposes of a trade, the customer may trade in a contract without registration if the trade is made through a dealer,⁵ including an unregistered foreign dealer.

The term “hedger” is defined in the CFA as follows:

“hedger” means a person or company who carries on agricultural, mining, forestry, processing, manufacturing or other commercial activities and, as a necessary part of these activities, becomes exposed from time to time to a risk attendant upon fluctuations in the price of a commodity and offsets that risk through trading in contracts for the commodity or related commodities whether or not any particular trade is effected for that purpose, but a person or company is a hedger only as to trades in contracts for such commodity or related commodities;

The hedger exemption in subsection 32(a) of the CFA is an exemption for “a trade ... by a hedger through a dealer”. By its terms, the hedger exemption is only available to a customer who meets the definition of hedger for the purposes of that trade.

Staff are of the view that the hedger exemption is not available to an unregistered foreign dealer that wishes to trade with the hedger. An unregistered foreign dealer may trade with a customer in reliance on another exemption, such as the unsolicited trade exemption, the exemption for a trade made through a registered dealer⁶ or an exemption in an exemptive relief order, provided the foreign dealer complies with the terms of such exemption.

Obligation to determine that a customer is a bona fide hedger for the trade

Where a dealer seeks to trade with a customer on the basis that the customer is a hedger, we expect the dealer to take reasonable steps to confirm that the customer is a *bona fide* hedger for such trading activities.

We generally would not consider it sufficient for a dealer to simply rely on the customer’s self-certification in account-opening documentation. Collecting and documenting this information is more than just a “tick the box” exercise. Instead, we would expect the dealer to review with the customer the nature and extent of the risk that is sought to be hedged through trading in contracts, and to confirm that the trading is primarily for hedging purposes and not also for speculative or investment purposes.

We would also recommend that the dealer include in customer documentation appropriate representations that the customer:

- (a) is a hedger;
- (b) acknowledges that this representation is deemed to be repeated by the customer each time it enters an order for a contract and that the customer must be a hedger for the purposes of each trade resulting from such an order;
- (c) agrees to notify the dealer if it ceases to be a hedger;
- (d) represents that it will only enter orders for its own account.

5 See section 32(a) of the CFA.

6 See section 32(b) of the CFA.

We expect the dealer to periodically verify that the customer's trading activities are consistent with the terms of the hedger exemption and the above recommended representations.

Books and records obligations of an unregistered foreign dealer

We consider a foreign dealer or other market participant that seeks to trade with customers in Ontario in reliance on a registration exemption to be a "market participant" for the purposes of the CFA and OSA. Accordingly, we expect these entities

- to provide appropriate risk disclosure to a customer that explains, among other things, the structure, features and risks of the products being offered and the regulatory protections that are provided, or not provided, to the client, including whether client assets are protected under the Canadian Investor Protection Fund (**CIPF**), the U.S. Securities Investor Protection Corporation, or equivalent protections, or if there are no equivalent protections, a clear statement in plain language to this effect;
- to keep such books, records and other documents as are necessary for the proper recording of their business transactions and financial affairs, and the transactions that they execute on behalf of others; and
- to keep such books, records and documents as may otherwise be required by the laws of their home jurisdiction in connection with the trade.

We expect these books and records to include books and records that demonstrate the extent of the firms' compliance with applicable requirements of all applicable legislation and identify all transactions conducted on behalf of the entity and each of their clients, including the name and address of all parties to the transaction and its terms. For example, if a foreign dealer seeks to trade with a customer on the basis that the customer is a "hedger", we expect the entity to keep books and records that demonstrate how the entity determined the customer was a hedger for the purposes of that transaction.

Staff may, from time to time, conduct a compliance review of a foreign dealer or other unregistered entity to determine whether the firm is in compliance with the terms of any exemptions being relied upon and/or may contact the firm's home jurisdiction regulator for assistance.

Forms and Fees

A foreign dealer or other unregistered market participant that applies for exemptive relief in Ontario in order to trade with a customer in Ontario will generally be required, as a condition of the relief, to file a completed Form 31-103F2 *Submission to Jurisdiction and Appointment of Agent for Service* and to pay a participation fee under OSC Rule 13-502 *Fees*.

The participation fees under OSC Rule 13-502 *Fees* are for "capital market activities" which includes "activities for which registration under the *Commodity Futures Act*, or an exemption from registration under the *Commodity Futures Act*, is required". Accordingly, a firm is required to pay participation fees in respect of activities under both the OSA and the CFA.

Questions

If you have questions regarding this Notice, please refer them to any of the following:

Compliance and Registrant Regulation

Paul Hayward
Senior Legal Counsel
416-593-3657
phayward@osc.gov.on.ca

Derivatives

Aaron Unterman
Legal Counsel
416-593-8090
aunterman@osc.gov.on.ca

General Counsel's Office

Victoria Carrier
Senior Legal Counsel
416-593-8329
vcarrier@osc.gov.on.ca