COMPANION POLICY 91-101
DERIVATIVES: PRODUCT DETERMINATION

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PART 1
GENERAL COMMENTS

Introduction

This companion policy (the "Policy") provides guidance on how those members ("participating jurisdictions" or "we") of the Canadian Securities Administrators participating in Multilateral Instrument 91-101 *Derivatives: Product Determination* (the "Instrument") interpret various matters in the Instrument.

Except for Part 1, the numbering and headings of sections and subsections in this Policy generally correspond to the numbering and headings in the Instrument. Any general guidance for a section appears immediately after the section name. Any specific guidance on a section in the Instrument follows any general guidance. If there is no guidance for a Part or section, the numbering in this Policy will skip to the next provision that does have guidance.

Unless defined in the Instrument or this Policy, terms used in the Instrument and in this Policy have the meaning given to them in securities legislation, including in National Instrument 14-101 *Definitions*.

Definitions and interpretation of terms in this Policy and in the Instrument

1(1) In this Policy, "contract" is interpreted to mean "contract or instrument".

(2) The Instrument includes a definition of the term "derivative" that will apply in local jurisdictions that do not have a definition of derivatives in their securities legislation that is consistent with the definitions in the securities legislation in Alberta, New Brunswick, Nova Scotia and Saskatchewan. In Alberta, the definition of "derivative" in the *Securities Act* (Alberta) includes a security or class of securities designated to be a derivative.

(3) The Instrument is drafted in the form of a definition of the term "specified derivative", to specify the scope of derivatives to which certain references and requirements relating to over-the-counter (**OTC**) derivatives apply. It is intended that the term "specified derivative" will capture the same contracts and instruments in each of the participating jurisdictions.

PART 2
GUIDANCE

Excluded contracts and instruments

Section 2(1) provides that "specified derivative", as defined in subsection 1(5), does not include certain categories of contracts that fall under the definition of derivative but, for a variety of reasons, should be excluded from certain requirements relating to OTC derivatives.

2. (1)(a) ***Gaming contracts***

Paragraph 2(1)(a) of the Instrument excludes certain domestic and foreign gaming contracts from the definition of "specified derivative".

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 do other derivatives products. The participating jurisdictions are of the view that certain requirements relating to OTC derivatives are not appropriate for a product that is subject to gaming control legislation of Canada (or a jurisdiction of Canada), or equivalent gaming control legislation of a foreign jurisdiction.

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: (A) it is entered into outside of Canada, and (B) it would be considered a gaming contract under domestic legislation. If a contract would be treated as a derivative if entered into in the local jurisdiction, 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 contracts and income or annuity contracts***

Paragraph 2(1)(b) of the Instrument excludes an insurance contract or income or annuity contract from the definition of "specified derivative" if the contract meets the criteria in subparagraphs 2(1)(b)(i) and (ii). A reinsurance contract would be considered to be an insurance contract or income or annuity contract.

While an insurance contract or income or annuity 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 do other derivatives products. The participating jurisdictions are of the view that certain requirements relating to OTC derivatives are not appropriate for contracts governed by the insurance legislation of Canada or a jurisdiction of Canada, or equivalent insurance legislation of a foreign jurisdiction.

Certain derivatives that have characteristics similar to insurance contracts or income or annuity contracts but that are not subject to regulation under insurance legislation, including credit derivatives and climate-based derivatives, will be treated as derivatives and are not excluded from the definition of "specified derivative" under paragraph 2(1)(b) as insurance contracts or income or annuity contracts.

In order to qualify for this exclusion, subparagraph 2(1)(b)(i) requires an insurance contract or income or annuity contract to be entered into with a domestically licensed insurer and to be regulated as an insurance contract or income or annuity contract under insurance legislation of Canada or a jurisdiction of Canada. 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 contract or income 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 the local jurisdiction if made in the local jurisdiction. Where a contract would otherwise be treated as a derivative if entered into in the local jurisdiction, 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 or any jurisdiction of Canada.

(c) *Currency exchange contracts*

Paragraph 2(1)(c) of the Instrument excludes a short-term contract for the purchase and sale of a currency from the definition of "specified derivative" if the contract 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 to apply.

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

Subparagraph 2(1)(c)(i) requires that, to qualify for the exclusion, 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 this exclusion would not apply.

The participating jurisdictions 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 definition of “specified derivative” 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 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 each contract was created and the netted settlement is physically settled in the currency prescribed by the contract;

- 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 one or both 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 the 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 exclusion in paragraph 2(1)(c), a currency exchange contract must not permit an extension of the settlement date or have the effect of extending the settlement date of a contract. This is commonly referred to as a rollover. 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), we 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.

We do not intend that the exclusion 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 contracts*

Paragraph 2(1)(d) of the Instrument excludes a contract for the delivery of a commodity from the definition of "specified derivative" if the contract 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. The participating jurisdictions are of the view 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 Instrument requires that the 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 are of the view that the contract must create an obligation on the counterparties to make or take delivery of the commodity. 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.

The participating jurisdictions 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;

- 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.

Embedded optionality with respect to the volume or quantity, or the timing or manner of delivery, of the commodity to be delivered may be consistent with the intention requirement in subparagraph 2(1)(d)(i) where the terms of the contract make it clear that the parties intend to settle the contract by physical delivery of the commodity and not by cash or any other means.

A contract that is an option for the delivery of a commodity which, if exercised, results in an obligation to make or take delivery of the commodity referenced in the contract may be consistent with the intention requirement in subparagraph 2(1)(d)(i) where the terms of the contract make it clear that the parties intend to settle the contract by physical delivery of the commodity and not by cash or any other means.

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 their conduct that the 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 generally 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. A book-out will generally be considered to qualify for this exclusion provided that, at the time of execution of the original contract, the counterparties intended that the commodity would be delivered.

The participating jurisdictions are of the view that, in the context of a commodity that is marketed or distributed through a regulated pool arrangement, such as electricity or natural gas, and taking into account the intention of the counterparties at the time of the transaction, a transaction in a contract for the delivery of the commodity through the pool would constitute “physical delivery” of the commodity for the purposes of paragraph 2(1)(d) in the Instrument and the guidance in this section.

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

Subparagraph 2(1)(d)(ii) requires that, to be excluded from the definition of "specified derivative", a contract must 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 to 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;
- 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) *Evidences of deposit*

Paragraphs 2(1)(e) and (f) of the Instrument exclude certain evidences of deposit from the definition of "specified derivative". Paragraph 2(1)(f) references deposits issued by any credit union, league, caisse populaire, loan corporation or trust company that is operating under the legislation of the federal government (in addition to the specific legislation referenced in paragraph 2(1)(e)) or under the legislation of any province or territory of Canada.

(g) *Exchange-traded derivatives*

Paragraph 2(1)(g) of the Instrument excludes a contract from the definition of "specified derivative" if it is traded on one or more prescribed exchanges. Exchange-trading of derivatives provides certain benefits to the derivatives market and the financial system in general, including a measure of transparency to regulators and to the public with respect to trading activity, as well as processing through an accepted clearing and settlement system. For this reason, exchange-traded derivatives are not subject to certain requirements relating to OTC derivatives. A transaction that is cleared through a clearing agency, but not traded on an exchange, is not considered to be exchange-traded and is a specified derivative and subject to certain requirements relating to OTC derivatives, as applicable. The participating jurisdictions interpret a contract "traded on an exchange" to include a contract that is made pursuant to the rules of an exchange and reported to the exchange after execution.

(h) ***Securities in New Brunswick, Nova Scotia and Saskatchewan***

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) in the securities legislation of the local jurisdiction, but also meet the definition of "security" (because they are investment contracts) in the securities legislation of the local jurisdiction. In New Brunswick, Nova Scotia and Saskatchewan, these contracts would meet the definition of "security" but for the exclusion of derivatives from the definition of "security". This paragraph provides that such contracts are excluded from the definition of "specified derivative".

(i) ***Stock options, warrants and similar instruments in British Columbia, Newfoundland and Labrador, Northwest Territories, Nunavut, Prince Edward Island and Yukon***

Some types of contracts that meet the definition of derivative but that also meet the definition of "security" can have a similar or identical economic effect as a security. We are of the view that the requirements generally applicable to securities are more appropriate for these types of contracts. As a result, in certain jurisdictions, paragraph 2(1)(i) provides that such contracts are excluded from the definition of "specified derivative".

Examples of the types of contracts contemplated as being more appropriately subject to the requirements generally applicable to securities include the following: compensation or incentive instruments such as 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; and contracts issued for the purpose of raising capital, including any of the aforementioned instruments as well as rights, warrants and special warrants, or subscription rights/receipts or convertible instruments issued to raise capital for any purpose. A contract that is issued with a profit motive would not generally be considered to be a financing instrument issued in connection with the raising of capital. An equity swap, for example, would generally not be considered a financing instrument issued in connection with the raising of capital.

In New Brunswick, Nova Scotia and Saskatchewan, these types of contracts or instruments are securities and do not fall within the definition of "derivative" and, as a result, these contracts are excluded from the definition of "specified derivative".

Investment contracts and options, and stock options, warrants and similar instruments in Alberta

In Alberta, the definition of "derivative" in the securities legislation excludes a contract or instrument that is a security. Options and certain investment contracts fall within the definition of a "security". They also fall within the first prong of the definition of "derivative" but are excluded by the second prong because they are securities. However, in Alberta, the Alberta Securities Commission has authority to designate a security or class of securities to be a derivative. In Alberta, certain options and certain investment contracts are designated pursuant to an order of the Alberta Securities Commission to be derivatives and not to be securities, but only for the purpose of the Instrument.

As a result of the designation order, in Alberta, the following are derivatives and are therefore included in the definition of "specified derivative" unless otherwise excluded under section 2 of the Instrument:

- a contract that meets the first prong of the definition of "derivative" and is a security solely by reason of being an investment contract under the definition of "security";

- an option that is only a security because the definition of "security" includes an option.

In Alberta, options, such as stock options, that are also securities under other prongs of the definition of "security", for example, because they are commonly known as a security, remain securities. Where applicable, certain requirements relating to OTC derivatives apply to those options that do not meet other prongs of the definition of security. This treatment applies only to options that are traded over-the-counter; under paragraph 2(1)(g), transactions involving exchange-traded options are excluded from the definition of "specified derivative".

Additional contracts not considered to be derivatives

Apart from the contracts expressly excluded from the definition of "specified derivative" by section 2 of the Instrument, there are other contracts that are not considered 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;

- 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.