

13.1.2 IDA Amendments to Regulations 100.4C and 1004K - Offset Positions in Canadian Debt Securities and Related Futures Contracts

INVESTMENT DEALERS ASSOCIATION OF CANADA - AMENDMENTS TO REGULATIONS 100.4C AND 100.4K - OFFSET POSITIONS IN CANADIAN DEBT SECURITIES AND RELATED FUTURES CONTRACTS

I OVERVIEW

A Current Rules

IDA Regulations 100.4A through 100.4C and 100.4K set out the capital and margin requirements for offsets involving Canadian debt securities and Government of Canada bond future contracts.

B The Issue

The current offset rules for Canadian debt securities are out of date and are overly conservative. The current rules:

- do not provide relief for capital purposes for offset positions in Government of Canada, provincial or municipal bonds of different maturity bands, even though correlation studies indicate that the market risk associated with these combined positions is less than that of an unhedged debt position; and
- set margin requirements for offset positions that are significantly more than necessary to cover the market risk of these positions.

C Objective

The objective of the amendments to Regulation 100.4C is to recognize for regulatory purposes the market risk reduction of Member firm offset positions in debt securities of different issuers and of different maturity bands by expanding the number of permissible offsets. The objective of the accompanying amendments to Regulation 100.4K is to keep the offsets available to Government of Canada bond futures positions consistent with those available to Government of Canada bonds.

D Effect of Proposed Rules

It is believed that the proposed amendments will not have any significant impacts on market structure, or competitiveness between members and non-members nor increase the cost of compliance or conflict with the other rules. It is believed that the amendments will align the capital and margin requirements for debt offset positions more closely with their market risk and reduce the conservatism that exists in the current offset rules. The cost of any system changes associated with the proposed amendments is considered to be immaterial.

II DETAILED ANALYSIS

A Present Rules, Relevant History and Proposed Policy

As mentioned previously the current offset rules are out of date and overly conservative. Analysis done by the IDA staff indicates that the market risk associated with certain offset positions involving Government of Canada, provincial and municipal bonds of different maturity bands is significantly lower than current margin requirements would indicate. Specifically, the current requirements for offset positions involving debt securities of different maturity bands is overly conservative as it is greater than the requirement for an equivalent unhedged position.

The proposed amendments to Regulation 100.4C (included as Attachment #1) recognize for regulatory purposes the risk reduction associated with offset positions in debt securities of different issuers and of different maturity bands by expanding the number of permissible offsets and allowing reduced margin requirements as follows:

- the margin requirement for Member firm positions in Government of Canada bonds or provincial bonds, which are offset by other positions in Government of Canada bonds or provincial bonds of different maturity bands, will be 50% of the greater of the margin on the long and short positions; and
- the margin requirement for Member firm positions in municipal bonds, which are offset by Government of Canada or provincial bonds of same maturity bands will be 50% of the greater of the margin on the long and short positions, provided the municipal bonds have a long-term issuer credit rating of a single A or higher by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service, or Standard & Poor's Bond Record.

Offset positions involving Canadian debt securities

Table I below summarizes the current requirements set out in and the proposed amendments to Regulation 100.4C for offset positions in involving debt securities:

Offset Strategy	Current Requirement	Proposed Requirement
Government of Canada bonds offset with same of same maturity band OR Provincial bonds offset with same of same maturity band	Maturity greater than 1 year Positions may be offset on a net market value basis and margin is computed on the net long or net short position. [Reg.100.4A] Maturity less than 1 year Margin calculated in both positions may be netted [Reg.100.4B]	Same
Government of Canada bonds offset with provincial bonds of same maturity band	Greater of the margin required on the long and short position [Reg.100.4C(a)]	50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(j)]
Government of Canada bonds offset with municipal bonds of same maturity band	Greater of the margin required on the long and short position [Reg.100.4C(b)]	Greater of the margin required on the long and short position [Reg.100.4C(b)] Where municipal has credit rating of single A or higher 50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(l)]
Provincial bonds offset by municipal bonds of same maturity band .	Greater of the margin required on the long and short position [Reg.100.4C(e)]	Greater of the margin required on the long and short position [Reg.100.4C(e)] Where municipal has credit rating of single A or higher 50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(m)]
Government of Canada bonds of different maturity bands	Sum of the normal margin requirement on the long and short positions	50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(i)]
Government of Canada bonds offset with provincial bonds of different maturity Bands	Sum of the normal margin requirement on the long and short positions	50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(j)]
Provincial bonds of different maturity bands	Sum of the normal margin requirement on the long and short positions	50% of the greater of the margin required on the long and short position [Proposed Reg.100.4C(k)]

The proposed amendments to Regulation 100.4K (also included as Attachment #1) seek to make corresponding changes to the requirements for offset positions Government of Canada bond futures contract and debt securities to keep consistency with amended Regulation 100.4C.

Offset positions involving Canadian debt securities and Government of Canada bond futures contracts

Table II below summarizes the current requirements set out in and the proposed amendments to Regulation 100.4K for debt offset positions in involving Government of Canada bond futures contract positions:

Table II – Debt offset positions involving Government of Canada bond futures contract positions:

Offset Strategy	Current Requirement	Proposed Requirement
Government of Canada bonds offset with Government of Canada bond futures of same maturity band	Positions may be offset on a net market value basis [Reg.100.4K(a)]	Positions may be offset on a net market value basis [Proposed Reg.100.4K(a)]
Government of Canada bonds offset with Government of Canada bond futures of different maturity bands	Sum of the normal margin requirement on the long and short positions	50% of the greater of the margin required on the long and short position [Proposed Reg.100.4K(b)]
Provincial bonds offset with Government of Canada bond futures of same maturity band	Greater of the margin required on the long and short position [Reg.100.4K(b)]	50% of the greater of the margin required on the long and short position [Proposed Reg.100.K(c)]
Municipal bonds offset with Government of Canada bond futures of same maturity band	Sum of the normal margin requirement on the long and short positions	Same except where municipal has credit rating of single A or higher, 50% of the greater of the margin required on the long and short position [Proposed Reg.100.4K(d)]
Corporate bonds offset with Government of Canada bond futures of same maturity band	Sum of the normal margin requirement on the long and short positions	Same except where corporate has credit rating of single A or higher, greater of the margin required on the long and short position [Proposed Reg.100.4K(e)]

B Issues and Alternatives Considered

The alternative of expanding permissible offsets only to debt securities of adjacent maturity bands was considered but it was decided that the alternative would ignore the risk reduction of offset positions of different maturity bands and secondly would not be consistent with the Value at Risk (VaR) modeling approach, the regulatory use of which is being considered by the IDA, that permits offsets across all maturity bands.

C Comparison with Similar Provisions**United Kingdom***Strategy based rules*

The UK strategy based rules only allow for complete offsets between the long and short positions of the same issue. For positions in securities of same and adjacent maturity bands, the offset coefficients which reflect the interrelationship of the volatility of the long and short positions that are being matched are used to determine the extent that market risk is reduced.

Value at Risk (VaR) modeling

Recognizing that risk-based margining rules are more efficient than strategy-based rules in assessing market risk, the Financial Services Authority permits the use of VaR models for calculating the "position risk requirement" for positions held and offsets involving debt securities.

United States

Strategy based rules

The US strategy based rules allow complete offsets for positions in US and Canadian government debt of the same subcategory of maturity and partial offset in case of bonds of different maturity subcategories to which risk weights (haircut percentages) are applied. For municipal bonds, the larger of long and short positions is regarded as the position at risk. In some cases, a complete offset is allowed in other cases a haircut is applied to the market value of the position at risk regardless of the category of maturity.

Value at Risk (VaR) modeling

In November 2003 the SEC issued for comment new Alternative Net Capital Requirements (ANCR) based on Basel II. The ANCR proposal makes use of the Basel II capital standards available to U.S. securities dealers provided the dealer maintains tentative net capital of at least USD \$1 billion and net capital of at least USD \$500 million and, where the dealer is part of a financial conglomerate, grants to the SEC conglomerate-wide regulatory jurisdiction. Once adopted, this proposal will allow the use of VaR modeling to determining the capital required on a dealer's proprietary trading book, including positions held and offsets involving debt securities.

D Systems Impact of Rule

It is not believed that the implementation of this amendment will have any significant impact on the Member's systems. The Bourse de Montréal is also in the process of passing similar amendment relating to offset involving Government of Canada bond futures contracts. Implementation of this amendment will therefore take place once both the IDA and the Bourse de Montréal have received approval to do so from their respective recognizing regulators.

E Best Interests of the Capital Markets

The Board has determined that the public interest rule is not detrimental to the best interests of the capital markets.

F Public Interest Objective

According to subparagraph 14(c) of the IDA's Order of Recognition as a self regulatory organization, the IDA shall, where requested, provide in respect of a proposed rule change "a concise statement of its nature, purposes (having regard to paragraph 13 above) and effects, including possible effects on market structure and competition". Statements have been made elsewhere as to the nature and effects of the proposals. The purposes of the proposal are to:

- facilitate an efficient capital-raising process and to facilitate transparent, efficient and fair capital requirement to manage the risks and the availability of relief to members at different degrees; and
- facilitate fair and open competition in securities transactions generally;

The proposal does not permit unfair discrimination among customers, issuers, brokers, dealers, members or others. It does not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes.

It has been determined that this proposal is in the public interest as these amendments seek to expand the number of offsets available to Member firms and revise the existing rules to remove excess conservatism.

III COMMENTARY

A Filing in Other Jurisdictions

These proposed amendments will be filed for approval in Alberta, British Columbia, Ontario and Quebec and will be filed for information in Manitoba, Nova Scotia and Saskatchewan.

B Effectiveness

The detailed assessment of the effectiveness of the proposed rules has been provided elsewhere in this paper.

C Process

These proposed amendments were developed and recommended for approval by the FAS Capital Formula Subcommittee and recommended for approval by the FAS Executive Committee and the Financial Administrators Section ("FAS").

IV SOURCES

References:

- IDA Regulation 100
- Rule 15c3-1(c)(2)(vi)(A) relating to the margin treatment of government securities, Securities Exchange Act of 1934
- Rule 15c3-1(c)(2)(vi)(B) relating to the margin treatment of municipal government securities, Securities Exchange Act of 1934
- Proposed SEC Alternative Net Capital Requirements (ANCR), November 2003
- FSA Interim Prudential Sourcebook: Investment Businesses – Chapter 10, Rules 10-100 to 10-107 – Interest Rate Method of calculating Position Risk Requirement

V OSC REQUIREMENT TO PUBLISH FOR COMMENT

The IDA is required to publish for comment the accompanying amendments. The Association has determined that the entry into force of the proposed amendments would be in the public interest. Comments are sought on the proposed amendments. Comments should be made in writing. One copy of each comment letter should be delivered within 30 days of the publication of this notice, addressed to the attention of Jane Tan or Arif Mian, Investment Dealers Association of Canada, Suite 1600, 121 King Street West, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of the Manager of Market Regulation, Ontario Securities Commission, 20 Queen Street West, 19th Floor, Box 55, Toronto, Ontario, M5H 3S8.

Questions may be referred to:

Jane Tan, MBA
Information Analyst, Regulatory Policy,
Investment Dealers Association of Canada
Suite 1600, 121 King West
Toronto, Ontario
M5H 3T9
Tel: 416-943-6979
E-mail: jtan@ida.ca

or

Arif Mian
Specialist, Regulatory Policy
Investment Dealers Association of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9
Tel:(416) 943 4656
Email: amian@ida.ca

INVESTMENT DEALERS ASSOCIATION OF CANADA

AMENDMENTS TO REGULATIONS 100.4C AND 100.4K RELATING TO OFFSET POSITIONS IN DEBT SECURITIES AND RELATED FUTURES CONTRACTS

BOARD RESOLUTION

THE BOARD OF DIRECTORS of the Investment Dealers Association of Canada hereby makes the following amendments to the By-laws, Regulations, Forms and Policies of the Association:

1. Amending Regulation 100.4C by adding the phrase “the total margin required in respect of both positions shall be the greater of the margin required on the long or short position” at the end of the first paragraph.
2. Amending Regulation 100.4C(a) by deleting the words “Canada and” immediately preceding the words “U.S. Treasury only”.
3. Amending Regulation 100.4C by deleting the following phrase immediately after section (h) “the margin required in respect of both positions shall be the greater of the margin required on the long or short position”.
4. Amending Regulation 100.4C by inserting the following text after section (h):

“Where a Member has a short and long position in the following groups of securities (identified by reference to the paragraphs and clauses of Regulation 100.2) the total margin required in respect of both positions shall be 50% of the greater of the margin required on the long or short position:

<i>Long (Short)</i>		<i>Short (Long)</i>
(i) 100.2(a)(i) (Canada only)	and	100.2(a)(i) (Canada of different maturity bands)
(j) 100.2(a)(i) (Canada only)	and	100.2(a)(ii) (Province of Canada only of same or different maturity bands)
(k) 100.2(a)(ii) (Province of Canada only)	and	100.2(a)(ii) (Province of Canada only of same or different maturity bands)
(l) 100.2(a)(i) (Canada only)	and	100.2(a)(iii) (Canada municipal only)
(m) 100.2(a)(ii) (Province of Canada only)	and	100.2(a)(iii) (Canada municipal only)”

5. Amending Regulation 100.4C by adding the following words in subsection (iii) after the word “securities”, “offsets described in items (i) to (k) can be of different maturity bands, all other” and deleting the word “in” immediately preceding the words “offsetting positions”.
6. Amending Regulation 100.4C by adding the word “; and” at the end of subsection (iv).
7. Amending Regulation 100.4C by adding the following new subsection (v) “securities offsets described in items (l) and (m), Canada Municipal will only be eligible for offset if they have a long-term issuer credit rating of a single A or higher by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard & Poor's Bond Record.”.
8. Amending Regulation 100.4K by adding the word “Contracts and Securities Combinations” in the heading.
9. Amending Regulation 100.4K by replacing the words “where a Member” with the phrase “Where a Member holds offset positions in Government of Canada notional bond futures contracts (including future purchase and sale commitments) and securities, described in paragraphs (a) to (e), the margin requirement for both positions shall be as follows:”.
10. Amending Regulation 100.4K(a) by deleting the first word “Holds” and “5 year or 10 year” immediately preceding the words “Government of Canada” and replacing the words “maturing 3 to 11 years” after the words “Regulation 100.2(a)(i) with the words “Canada only and of same maturity band”.
11. Amending Regulation 100.4K by inserting the following text after section (a):

- “(b) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(i) Canada only of different maturity bands, the two positions may be offset and the required margin shall be 50% of the greater of the margin required on the long or short position.”
12. Amending Regulation 100.4K(b) by renumbering it to 100.4K(c), deleting the first word “Holds” and “5 year or 10 year” immediately preceding the words “Government of Canada” and replacing the words “or Regulation 100.2(a)(v) maturing 3 to 11 years” with the words “Province of Canada only maturing within the same or different maturity bands” and inserting the words “50% of” immediately preceding the words “the greater of”.
13. Amending Regulation 100.4K by inserting the following text after section (c):
- “(d) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(iii) Canada Municipal only maturing within the same maturity band, the margin requirement in respect of both positions shall be 50% of the greater of the margin required on the long or short position.
- (e) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(v) Corporate maturing within the same maturity band, the margin requirement in respect of both positions shall be the greater of the margin required on the long or short position.

provided the foregoing offset may only be determined on the basis that:

- i) securities in offsetting positions must be denominated in the same currency;
- ii) securities described in Regulation 100.2(a)(iii) Canada Municipal will only be eligible for offset if they have a long-term issuer credit rating of a single A or higher by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody’s Investors Service or Standard & Poor’s Bond Record;
- iii) securities described in Regulation 100.2(a)(iv) Corporate will only be eligible for offset if they are not convertible and have a single A or higher rating by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody’s Investors Service or Standard & Poor’s Bond Record; and
- iv) the market value of the offsetting positions is equal and no offset is permitted in respect of the market value of the short (or long) position which is in excess of the market value of the long (or short) position.”

PASSED AND ENACTED BY THE Board of Directors this 19th day of January 2005, to be effective on a date to be determined by Association staff.

INVESTMENT DEALERS ASSOCIATION OF CANADA

AMENDMENTS TO REGULATIONS 100.4C AND 100.4K RELATING TO OFFSET POSITIONS IN DEBT SECURITIES AND RELATED FUTURES CONTRACTS

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100.4C. Debt Securities

Where a Member has a short and long position in the following groups of securities (identified by reference to the paragraphs and clauses of Regulation 100.2) the total margin required in respect of both positions shall be the greater of the margin required on the long or short position:

<i>Long (Short)</i>	<i>Short (Long)</i>
(a) 100.2(a)(i) (Canada and U.S. Treasury only) and	100.2(a)(ii) (Province of Canada only)
(b) 100.2(a)(i) (Canada and U.S. Treasury only) and	100.2(a)(iii) (Canada municipal only)
(c) 100.2(a)(i) (Canada only) and	100.2(a)(i) (U.S. Treasury only)
(d) 100.2(a)(i) (Canada and U.S. Treasury only) and	100.2(a)(v) (corporate)
(e) 100.2(a)(ii) (Province of Canada only) and	100.2(a)(iii) (Canada municipal only)
(f) 100.2(a)(ii) (Province of Canada only) and	100.2(a)(v) (corporate)
(g) 100.2(a)(v) (corporate) and	100.2(a)(v) (corporate) of the same issuer
(h) 100.2(b) (Canadian chartered bank acceptances only)	BAX futures contract

~~the margin required in respect of both positions shall be the greater of the margin required on the long or short position:~~ Where a Member has a short and long position in the following groups of securities (identified by reference to the paragraphs and clauses of Regulation 100.2) the total margin required in respect of both positions shall be 50% of the greater of the margin required on the long or short position:

<u><i>Long (Short)</i></u>	<u><i>Short (Long)</i></u>
<u>(i) 100.2(a)(i) (Canada only)</u> and	<u>100.2(a)(i) (Canada of different maturity bands)</u>
<u>(j) 100.2(a)(i) (Canada only)</u> and	<u>100.2(a)(ii) (Province of Canada only of same or different maturity bands)</u>
<u>(k) 100.2(a)(ii) (Province of Canada only)</u> and	<u>100.2(a)(ii) (Province of Canada only of same or different maturity bands)</u>
<u>(l) 100.2(a)(i) (Canada only)</u> and	<u>100.2(a)(iii) (Canada municipal only)</u>
<u>(m) 100.2(a)(ii) (Province of Canada only)</u> and	<u>100.2(a)(iii) (Canada municipal only)</u>

provided the foregoing offset may only be determined on the basis that:

- (i) securities described in Regulation 100.2(a)(v) (corporate) and 100.2(b) (bank paper) will only be eligible for offset if they are not convertible and have a single A or higher rating by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard & Poor's Bond Record;
- (ii) securities in offsetting positions must be denominated in the same currency;
- (iii) ~~securities offsets described in items (i) to (k) can be of different maturity bands, all other in~~ offsetting positions must mature within the same periods referred to in Regulation 100.2 for the purpose of determining margin rates;

- (iv) the market value of the offsetting positions is equal and no offset shall be permitted in respect of the market value of the short (or long) position which is in excess of the market value of the long (or short) position; and
- (v) securities offsets described in items (l) and (m), Canada Municipal will only be eligible for offset if they have a long-term issuer credit rating of a single A or higher by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard & Poor's Bond Record.

For the purposes of this Regulation 100.4C, securities described in Regulation 100.2(b) (bank paper) are eligible for the same offsets set out above as securities described in Regulation 100.2(a)(v) (corporate).

For the purposes of this Regulation 100.4C, the term "BAX futures contracts" shall mean the three-month Canadian bankers acceptance futures contracts that trade on the Bourse de Montréal under the "BAX" trading symbol.

100.4K. Government of Canada Bond Futures Contracts and Securities Combinations

Where a Member holds offset positions in Government of Canada notional bond futures contracts (including future purchase and sale commitments) and securities, described in paragraphs (a) to (e), the margin requirement for both positions shall be as follows:

- (a) Holds a long (or short) position in a 5-year or 10-year Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(i) Canada only and of maturing 3 to 11 years same maturity band, the two positions may be offset and the required margin computed in respect to the net long or net short position only.
- (b) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(i) Canada only of different maturity bands, the two positions may be offset and the required margin shall be the 50% of the greater of the margin required on the long or short position.
- (b)(c) Holds a long (or short) position in a 5-year or 10-year Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(ii) Province of Canada only maturing within the same or different maturity bands or Regulation 100.2(a)(v) maturing in 3 to 11 years, the margin requirement in respect of both positions shall be 50% of the greater of the margin required on the long or short position.
- (d) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(iii) Canada Municipal only maturing within the same maturity band, the margin requirement in respect of both positions shall be 50% of the greater of the margin required on the long or short position.
- (e) a long (or short) position in a Government of Canada notional bond futures contract and a short (or long) position in the securities described in Regulation 100.2(a)(v) Corporate maturing within the same maturity band, the margin requirement in respect of both positions shall be the greater of the margin required on the long or short position.

provided the foregoing offset may only be determined on the basis that:

- i) securities in offsetting positions must be denominated in the same currency;
- ii) securities described in Regulation 100.2(a)(iii) Canada Municipal will only be eligible for offset if they have a long-term issuer credit rating of a single A or higher by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard & Poor's Bond Record;
- iii) securities described in Regulation 100.2(a)(iv) Corporate will only be eligible for offset if they are not convertible and have a single A or higher rating by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard & Poor's Bond Record; and
- iv) the market value of the offsetting positions is equal and no offset is permitted in respect of the market value of the short (or long) position which is in excess of the market value of the long (or short) position.