IIROC OCRCVM
Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Request for Comments
IIROC Rules

22-0122
August 4, 2022

Comments Due By: October 3, 2022

Please distribute internally to:

Institutional
Legal and Compliance
Regulatory Accounting
Senior Management
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Proposed amendments to permit reduced margin for swap position partial offsets held in inventory

Executive Summary

IIROC is proposing amendments to the IIROC Rules (**Proposed Amendments**) that would permit margin reductions for Dealer Member (**Dealer**) inventory offsets of:

- non-equivalent notional amounts between two swap positions, and
- non-equivalent quantities between swap positions and underlying securities.

The purpose of the Proposed Amendments is to align the margin requirements for swap contract offsets with the net position risk by extending the current margin treatment for swap offsets to partial swap offsets.

How to Submit Comments

Comments on the Proposed Amendments should be in writing and delivered by **October 3, 2022** (60 days from the publication of this notice) to:

Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: memberpolicymailbox@iiroc.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at www.iiroc.ca.

Rules Notice - Table of Contents

1. Relevant background

1.1 Issue

The IIROC Rules allow margin reductions for Dealer inventory swap offset strategies where the notional amount of the offsetting swap is the same or in some cases, the Dealer holds an equivalent quantity of underlying securities. The current rules are silent on whether partial offsets between two positions with different notional amounts or quantities are permitted for reduced margin purposes.

1.2 History

We proposed amendments for partial swap offsets in 2009 (Notice 09-0049) and republished the proposal in 2012 (Notice 12-0057) to include housekeeping amendments to the minimum margin requirements for unhedged swap positions. In 2018 (Notice 18-0177) we withdrew the proposal due to the passage of time and developments in the OTC derivatives regulation. Our intention was to publish a new proposal in the future. In the meantime, three Dealers sought relief from the requirement in the rules that offsetting swap notional amounts are to be the same in order to net swap positions for margin purposes.

1.3 Exemptive relief granted

In 2018 (Notice 18-0147), the IIROC's Board of Directors granted exemptions to the three Dealers allowing them to reduce the margin they provided for partial offsets of certain swap positions held in their inventory. Each exemption is void upon the earlier of:

- the implementation of proposed amendments to the Rules concerning partial swap offsets,
- the decision not to proceed with such proposed amendments,
- IIROC determining that partial swap offsets on interest rate swaps or total performance swaps is no longer an effective risk mitigation strategy for regulatory margin purposes, or
- five years following the approval of the exemptions (i.e., June 27, 2023).

2. Discussion of Proposed Amendments

2.1 Proposed Amendments

The objective of the Proposed Amendments is to align the margin requirements for swap offsets with the net position risk by extending the current margin treatment for same notional amount swap offsets to partial swap offsets. We are proposing to amend sections 5680 to 5683 of the IIROC Rules to allow margin reductions where the Dealer has an inventory offset of:

- two interest rate swaps,
- two total performance swaps,

- the fixed or floating rate component of an interest rate swap and federal government debt securities, or
- a total performance swap and underlying securities.

with the same or different (i.e. partial offsets) notional amounts or quantities.

The text of the Proposed Amendments is set out in Attachment B and a blackline of the changes is set out in Attachment A.

2.2 Analysis

Partial offsets provide the same position risk hedge as offsets where the notional is the same. However, under current rules partially offset positions would need to be margined separately, which results in a higher overall margin requirement than necessary. The following examples illustrate the rationale for allowing partial swap offsets:

- A Dealer Member is long two interest rate swaps with notional amounts of $50 million and $25 million, respectively, and short an interest rate swap with a notional amount of $50 million in its inventory. Assuming all positions are either fixed or variable, section 5680 would allow for the netting of the $50 million long and short swap positions but would require margin on the remaining $25 million long swap position.
- Another Dealer Member is long one interest rate swap of $75 million and short one interest rate swap of $50 million in its inventory. Assuming both positions are either fixed or variable, section 5680 would not allow these positions to be offset because the notional amounts are not the same. Margin would be required on both the $75 million and the $50 million swap positions, although the risk exposure is equivalent to holding a single $25 million long swap position.

Based on these examples, IIROC's view is that margin reductions for partial offsets should be allowed as the net position risk exposures are the same as non-partial offsets. This rationale also applies to total performance swap offsets and offsets between swaps and underlying securities. The margin reduction for these offsets does not reduce the counterparty margin requirements. The Dealer must still obtain margin from each swap counterparty relating to the credit risk exposure as required in section 5442.

2.3 Alternatives considered

No alternative proposals were considered as the proposal seeks to establish specific offset rules that are currently not recognized in the IIROC Rules.

2.4 Comparison with similar provisions

In 2013, Bank for International Settlements (BIS) and International Organization of Securities Commissions (IOSCO) published a consultative paper[1] with the primary objective to propose higher minimum margin requirements across the board for all un-hedged position in non-centrally-cleared derivatives. There is little discussion on how hedge strategies would be recognized for margin purposes, but there is a comment relevant to hedges in footnote 18 of the consultation paper, which states the following:

> *"Subject to approval by the relevant supervisory authority, a limited degree of netting may be performed at the level of a specific derivatives contract to compute the notional amount that is applied to the margin rate. As an example, one pay fixed-interest-rate swap with a maturity of three years and a notional of 100 could be netted against another pay-floating interest-rate swap with a maturity of three years and a notional of 50 to arrive at a single notional of 50 to which the appropriate margin rate would be applied. Derivatives with different fundamental characteristics such as underlying, maturity and so forth may not be netted against each other for the purpose of computing the notional amount against which the standardised margin rate is applied."*

This comment was retained in later updates of this consultative paper in 2015, 2019, and 2020, and we believe it supports the concept of partial offset hedges and aligns with IIROC's Proposed Amendments.

3. Impact of the Proposed Amendments

We believe that the Proposed Amendments will have no material impact in terms of capital market structure, competition generally, the cost of compliance and conformity with other rules. The Proposed Amendments do not permit unfair discrimination among customers, issuers, brokers, Dealers or others.

Dealer Members will benefit from the clarified capital requirements, which may result in increased utilization of the strategy and more efficient allocation of capital. The capital markets will benefit because the amended capital requirements will more accurately correspond to net position risk.

3.1 Economic Impact Assessment

We need to consider undertaking an economic impact assessment of the anticipated costs and benefits of our rule proposals as part of our regulatory process. We determined it was not necessary to perform an economic impact assessment of the Proposed Amendments as the proposed margin rate changes:

- extend existing minimum margin requirements for swap offsets to partial swap offsets
- codify existing exemptions granted to Dealers for partial swap offsets

- result in margin rate levels that adequately address the net position risks associated with holding swap position hedges in Dealer inventory.

3.2 Capital and margin impacts

In 2019, we surveyed the impacted Dealers on the expected capital requirement reduction from the Proposed Amendments. The following table[2] provides the consolidated information of the capital requirement implication to Dealers:

Type of swap offset strategies	Total expected capital requirement reduction (benefited) from Proposed Amendments
Swap vs. swap positions	Approximately $692,000,000
Swap vs. underlying positions	Approximately $375,000,000 - $409,000,000

4. Implementation

After we receive approval from our Recognizing Regulators, we intend to implement the Proposed Amendments within 30 days.

5. Policy development process

5.1 Regulatory purpose

The Proposed Amendments are intended to achieve the following objectives:

- establish and maintain rules that are necessary or appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity, and
- ensure that the capital requirements reflect the reduced net position risk of partial swap offsets on interest rate and total performance swaps by extending the current margin treatment for swaps offsets to partial swap offsets.

5.2 Rule making process

The Board of Directors of IIROC ("Board") has determined the Proposed Amendments to be in the public interest and on June 22, 2022 approved them for public comment.

The Proposed Amendments were developed in consultation with the IIROC's Financial and Operations Advisory Section (**FOAS**) Executive Committee, FOAS Capital Formula Subcommittee, and the full FOAS. These advisory committees supported the Proposed Amendments.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the CSA, IIROC may recommend that revisions be made to the applicable proposed amendments. If the revisions and comments received are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the proposed amendments as revised will be subject to approval by the CSA. If the revisions or comments are material, the proposed amendments including any revisions will be submitted to the Board for approval for republication or implementation as applicable.

6. Attachments

Attachment A - Blackline copy of the Proposed Amendments to IIROC Rules

Attachment B - Clean copy of the Proposed Amendments

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[1] Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) and Board of the International Organization of Securities Commissions (IOSCO) publication on margin requirements for non-centrally cleared derivatives, September 2013 with updated versions in March 2015, July 2019, and April 2020.

[2] The figures are based on information provided by the Dealers for the 2019 year.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

PROPOSED AMENDMENTS TO PERMIT REDUCED MARGIN FOR SWAP POSITION PARTIAL OFFSETS HELD IN INVENTORY

CLEAN COPY OF THE PROPOSED AMENDMENTS TO THE IIROC RULES

OFFSETS ONLY AVAILABLE FOR DEALER MEMBER INVENTORY POSITIONS

SWAP POSITIONS

5680. Offset involving two interest rate swap positions

(1) Where a *Dealer Member* inventory account contains the following pairing:

(i) a position in one or more *interest rate swaps* requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar fixed (or floating) interest rate amounts,

and

(ii) another position in one or more *interest rate swaps* entitling it to receive (or requiring it to pay) a fixed (or floating) interest rate amount denominated in the same currency and within the same *maturity band* for margin purposes as the *interest rate swap* or swaps referred to in clause 5680(1)(i),

the two positions in clauses 5680(1)(i) and 5680(1)(ii) may be offset and the minimum margin required for both positions may be computed as the net of the *normal margin required* for each position, provided that the *normal margin required* on the *fixed interest rate* payment (or receipt) component position may only be offset against the *normal margin required* on the *fixed interest rate* receipt (or payment) component position, and the *normal margin required* on the *floating interest rate* payment (or receipt) component position may only be offset against the *normal margin required* on the *floating interest rate* receipt (or payment) component position.

5681. Offsets involving interest rate swaps and federal government debt security positions

(1) **Offset involving fixed interest rate swap component and federal government debt security positions -** Where a *Dealer Member* inventory account contains the following pairing:

(i) a position in one or more *interest rate swaps* requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar *fixed interest rate* amounts,

and

(ii) a long (or short) position in *Canada debt securities*, *United States debt securities*, or any other *debt securities* described in category (i) of subsection 5210(1) denominated in the same currency as the the *interest rate swap* or swaps and with a *term to maturity* that is within the same *maturity band* for margin purposes as the *interest rate swap* or swaps, the two positions in clauses 5681(1)(i) and 5681(1)(ii) may be offset and the minimum margin required for both positions may be computed as the net of the *normal margin required* for each position. Any margin requirement calculated for the separate *floating interest rate* receipt (or payment) component position will continue to be required unless that position separately qualifies for the offset set out in subsection 5681(2).

(2) **Offset involving floating interest rate swap component and federal government debt security positions -** Where a *Dealer Member* inventory account contains the following pairing:

(i) a position in one or more *interest rate swaps* requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar *floating interest rate* amounts,

and

(ii) a long (or short) position in *Canada debt securities*, *United States debt securities*, or any other *debt securities* described in category (i) of subsection 5210(1) denominated in the same currency as the *interest rate swap* or swaps and maturing within one year,

the two positions in clauses 5681(2)(i) and 5681(2)(ii) may be offset and the minimum margin required for both positions may be computed as the net of the *normal margin required* in respect of the positions. Any margin requirement calculated for the separate *fixed interest rate* receipt (or payment) component position will continue to be required unless that position qualifies for the offset set out in subsection 5681(1).

5682. Offset involving two total performance swap positions

(1) Where a *Dealer Member* inventory account contains the following pairing:

(i) a position in one or more *total performance swaps* requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar amounts calculated based on the performance of a stipulated *underlying security* or basket of securities,

and

(ii) another position in one or more *total performance swaps* entitling it to receive (or requiring it to pay) amounts calculated based on the performance of the same *underlying security* or basket of securities and denominated in the same currency,

the two positions in clauses 5682(1)(i) and 5682(1)(ii) may be offset and the minimum margin required for both positions may be computed as the net of the *normal margin required* for each position, provided that the *normal margin required* on the performance payment (or receipt) component position may only be offset against the *normal margin required* on the performance receipt (or payment) component position, and the *normal margin required* on the *floating interest rate* payment (or receipt) component position may only be offset against the *normal margin required* on the *floating interest rate* receipt (or payment) component position.

5683. Offsets involving total performance swaps and underlying security positions

(1) **Offset involving short total performance swap component and long underlying security positions -** Where a *Dealer Member* inventory account contains the following pairing:

(i) a short position in one or more *total performance swaps*,

and

(ii) a long position in the same *underlying security* or basket of securities,

the two positions in clauses 5683(1)(i) and 5683(1)(ii) may be offset and the minimum margin required for both positions may be computed as either:

(iii) where it can be demonstrated that sell-out risk relating to the offset has been mitigated:

(a) through the inclusion of a *realization clause* in the *total performance swap*, which allows the *Dealer Member* to close out the swap using the sell-out price for the long position in the *underlying security* or basket of securities, or

(b) since, due to the features inherent in the long position in the *underlying security* or basket of securities or the market on which the *underlying security* or basket of securities trades, the realization value of the long position in the *underlying security* or basket of securities is determinable at the time the *total performance swap* is to expire and this value will be used as the closeout price for the swap,

the net of the *normal margin required* for each position.

or

(iv) where sell-out risk relating to the offset has not been mitigated, the net of the *normal margin required* for each position plus 20% of the *normal margin required* on the hedged portion of the long position in the *underlying security* or basket of securities.

(2) **Offset involving long total performance swap component and short underlying security positions -** Where a *Dealer Member* inventory account contains the following pairing:

(i) a long position in one or more *total performance swaps*,

and

(ii) a short position in the same *underlying security* or basket of securities,

the two positions in clauses 5682(3)(i) and 5682(3)(ii) may be offset and the minimum margin required for both positions may be computed as either:

(iii) where it can be demonstrated that buy-in risk relating to the offset has been mitigated:

(a) through the inclusion of a *realization clause* in the *total performance swap*, which allows the *Dealer Member* to close out the swap using the buy-in price for the short position in the *underlying security* or basket of securities, or

(b) since, due to the features inherent in the short position in the *underlying security* or basket of securities or the market on which the *underlying security* or basket of securities trades, the realization value of the short position in the *underlying security* or basket of securities is determinable at the time the *total performance swap* is to expire and this value will be used as the closeout price for the swap,

the net of the *normal margin required* for each position.

or

(iv) where buy-in risk relating to the offset has not been mitigated, the net of the *normal margin required* for each position plus 20% of the *normal margin required* on the hedged portion of the short position in the *underlying security* or basket of securities.

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