## 13.1.3 IDA Regulations 100.4A, 100.4B, 100.4C, 100.4D, 100.4E and 100.4K – Extending Debt Offsets to Customer Positions

**INVESTMENT DEALERS ASSOCIATION OF CANADA**

**EXTENDING DEBT OFFSETS TO CUSTOMER POSITIONS**
**(REGULATIONS 100.4A, 100.4B, 100.4C, 100.4D, 100.4E AND 100.4K)**

### I. OVERVIEW

The concept of allowing reduced margin for valid market risk reduction strategies is well established throughout the Association's capital and margin requirements, which are set out in Regulation 100. Most sections within Regulation 100 allow both customers and Member firms, with specific security and/or derivative combinations or offset strategies, to take advantage of reduced margin requirements. However, use of the currently permissible reduced margin offset strategies relating to debt is restricted to only Member firm positions and the rationale for this restriction has been recently questioned.

### A. Current Rules

The debt offset sections in question are as follows:

- Regulation 100.4A – Governments, maturity over one year
- Regulation 100.4B – Governments, maturity within one year
- Regulation 100.4C – Debt securities
- Regulation 100.4D – Mortgage-backed securities
- Regulation 100.4E – Strip coupons or residuals
- Regulation 1004K – Government of Canada bond futures contracts and security combinations

### B. The Issue(s)

The main issue is that use of the above mentioned debt offsets regulations is restricted to only Member firm positions. The rationale for this restriction has been questioned as the concept of equally allowing reduced margin and capital requirements to both customers and member firms for valid market risk reduction strategies is well established throughout most margin regulations. For example, both customers and member firms are allowed to take advantage of reduced margin and capital requirements for specific offset positions involving equities, capital shares, convertible securities, exercisable securities, futures and option contracts.

It is believed that some of the debt offset regulations were created several years ago, when it was more difficult for customers to adequately monitor and manage their debt offsets. However, given the efficiency of today's capital markets, the sophistication of investors and the trading and monitoring infrastructure supporting them, there does not appear to be any unique reasons to continue restricting the use of the debt offset regulations to only Member firm positions.

The secondary issue is the differences between margin requirements for debt offsets between the IDA and the Bourse de Montréal ("Bourse"), as the Bourse allows customer debt offsets involving futures contracts and debt security combinations for margin purposes. It is important that this difference be eliminated to maintain regulatory consistency across market participants in the country.

### C. Objective(s)

The objectives of the proposed rule changes are to allow customers to benefit from the reduced margin requirements for a number of debt offsets that are already available to Member firms and to eliminate the differences between IDA and Bourse margin regulations regarding customer positions in debt offsets.

### D. Effect of Proposed Rules

The proposed rule changes are not expected to have any negative impact on market structure, members, non-members, customers, competition or costs of compliance. They are expected to be positive overall as customers would now have the ability to make more efficient use of their capital through lower margin requirements for their debt offset positions. Furthermore, with the elimination of the margin difference for customer debt offsets between the two self-regulatory organizations compliance is expected to be more streamlined.

## II. DETAILED ANALYSIS

### A. Present Rules, Relevant History and Proposed Policy

As previously mentioned, the reduced margin requirements for debt offsets in Regulations 100.4A through E and 100.4K are only available to Member firm positions. Because of this restriction, customers are required to separately margin offsetting debt positions (long and short positions) although the combined positions represent valid market risk reduction strategies. Valid market risk reduction strategies normally benefit from lower margin requirements and are recognized throughout Regulation 100 and Form 1 for both customer and member firm positions for a large number for specific offset positions involving equities, capital shares, convertible securities, exercisable securities, futures, forwards and options (listed and over-the-counter).

The analysis conducted looked at why use of the debt offset regulations was restricted to member firms and whether the conditions that supported the restriction changed; would use of the debt offsets pose any unique risk issues in comparison to the other offsets that may be used by customers; and does the Bourse allow debt offsets to customers in determining margin and capital requirements for debt offsets.

The debt offset regulations were created several years ago, when it was more difficult for customers to adequately monitor and manage their debt offsets and the more recent debt offset regulation amendments did not evaluate the rational for the usage restriction, and simply continued it to maintain consistency throughout the debt offset regulations. However, given the efficiency of today’s capital markets, the sophistication of investors and the trading and monitoring infrastructure supporting them, we do not believe that there would be any significant difficulties with the monitoring and management of customer debt offsets.

Customers are currently allowed to take advantage of reduced margin requirements for their offsetting positions in equities; index baskets; index participation units; capital shares; convertible securities; exercisable securities (e.g. warrants and rights); commodity and financial futures and forward contracts; and listed and over-the-counter equity options, index options, index participation unit options and bond options. In comparison to these other offsetting positions, debt offsets are not expected to create any unique risk issues.

The Bourse allows offsets, which are referred to as combinations in determining margin and capital requirements in client and participant accounts. In particular, Bourse Rule 9323 (Futures Contracts and Security Combinations) allows customer debt offsets for the following debt securities and futures contracts combinations:

(a) Bond futures contracts combinations with Group I securities (Government of Canada, United States, United Kingdom and other foreign national governments debt securities that are rated AAA);

(b) Bond futures contracts combinations with Group II securities (Provinces of Canada and International Bank of Reconstruction and Development debt securities);

(c) Bond futures contracts combinations with Group III securities (Municipal, school and hospital corporations and religious orders debt securities);

(d) Bond futures contracts combinations with Group V securities (Corporations and trust and mortgage loan companies – non-negotiable and non-transferable securities);

(e) Canadian banker’s acceptance futures contracts combinations with banker’s acceptance.

Rule 9323 is similar to Association Regulation 100.4K (Government of Canada Bond Futures Contracts and Security Combinations) except that it is for customers. This difference between the Bourse’s Rule and the IDA’s regulation is significant and has the potential to cause regulatory uncertainty for customers and member firms. Therefore, this difference should be eliminated to maintain regulatory consistency across markets and investors in the country.

The proposed rules would amend Regulations 100.4A (Governments, maturity over one year), 100.4B (Governments, maturity within one year), 100.4C (Debt securities), 100.4D (Mortgage-backed securities), 100.4E (Strip coupons or residuals) and 100.4K (Government of Canada bond futures contracts and security combinations) by adding the words “or a customer” immediately following the words “Where a Member” in order to extend the debt offset margin requirements to include customer positions.

**B. Issues and Alternatives Considered**

The alternative considered was to leave the current margin and capital requirements unchanged. This alternative was not chosen, because debt offsets are valid risk reduction strategies whether they are used by member firms or customers and there does not appear to be any significant difficulties posed with the management or monitoring of customer debt offset positions. In addition, it was considered important that there be regulatory consistency regarding margin and capital requirements between the Bourse and the IDA.

**C. Comparison with Similar Provisions**

U.S. securities industry rules, NASD Rule 2520 (Margin Requirements) and U.S. Securities Exchange Act of 1934 Section 3 (Definitions and Application of Title), allow customers to take advantage of reduced margin requirements for offsetting long and short positions in exchangeable or convertible securities; exempted securities, which include obligations of the U.S. government, states and municipal corporations, and highly rated foreign debt securities; and non-equity securities (investment grade debt securities and other marginable non-equity securities). For offsetting positions in exempted securities and non-equity securities the margin requirement is a percentage of the current market value of the net long or net short positions and the percentage can range from 1 percent to 20 percent depending on the particular security.

**D. Systems Impact of Rule**

The implementation of these proposed rule amendments will result in little or no systems impact as there are existing reduced margin calculations for other recognized customer offsets under IDA Regulation 100 and Bourse Rule 9323.

**E. Best Interests of the Capital Markets**

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

**F. Public Interest Objective**

According to 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 with respect to extending debt offsets to customer positions. The purposes of the proposal are to: "facilitate fair and open competition in securities transactions generally; and standardize industry practices where necessary or desirable for investor protection".

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.

Because the proposed amendments recognize that these debt offsets are valid market risk reduction strategies in customer accounts, they have been determined to be in the public interest.

**III. COMMENTARY**

**A. Filing in Other Jurisdictions**

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

**B. Effectiveness**

The proposed rules are expected to be effective as it would recognize debt offsets in customer accounts as valid market risk reduction strategies by reducing the margin and capital requirements for the offsetting debt positions. Furthermore, the proposed rules would eliminate the difference in customer margin requirements between the Bourse and the IDA for offsets involving futures contracts and debt security combinations.

**C. Process**

This proposal was developed and recommended for approval by the FAS Capital Formula Subcommittee, and reviewed and recommended for approval by the Financial Administrators Section.

## IV. SOURCES

References:

- IDA Regulations 100.4A through K (Offsets)
- IDA Regulation 100.8 (Commodity Futures Contracts and Futures Contract Options)
- IDA Regulations 100.9 and 100.10 (Customer and Member positions in options, futures and other equity-related derivatives)
- IDA Regulation 100.11 (Over-the-Counter Options)
- Bourse de Montréal's Rule 9323 (Futures Contracts and Security Combinations)
- NASD Rule 2520 (Margin Requirements)
- U.S. Securities Exchange Act of 1934 Section 3 (Definitions and Application of Title)

## V. OSC REQUIREMENT TO PUBLISH FOR COMMENT

The IDA is required to publish for comment the accompanying proposed 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 Answerd A. Ramcharan, Specialist, Regulatory Policy, 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:

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**INVESTMENT DEALERS ASSOCIATION OF CANADA**

**EXTENDING DEBT OFFSETS TO CUSTOMER POSITIONS (REGULATIONS 100.4A, 100.4B, 100.4C, 100.4D, 100.4E AND 100.4K)**

**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. Regulations 100.4A, 100.4B, 100.4C, 100.4D, 100.4E and 100.4K are amended by adding the following words immediately following the words “Where a Member”:

   “or a customer”

BE IT RESOLVED THAT the Board of Directors adopts, on this 27th day of September 2006 the English and French versions of these amendments. The Board of Directors also authorizes the Association Staff to make the minor changes that shall be required from time to time by the securities administrators with jurisdiction. These amendments shall take effect on the date determined by the Association Staff.

## INVESTMENT DEALERS ASSOCIATION OF CANADA

## EXTENDING DEBT OFFSETS TO CUSTOMER POSITIONS (REGULATIONS 100.4A, 100.4B, 100.4C, 100.4D, 100.4E AND 100.4K)

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**Offsets**

100.4A. **Governments, Maturity Over One Year**

Where a Member or a customer

(a) Owns securities described in clause (i) or (ii) of Regulation 100.2(a) of one maturity maturing over one year, and

(b) Has a short position in securities

(i) Issued or guaranteed by the same issuer of the securities referred to in (a) (provided that for these purposes each of the provinces of Canada shall be regarded as the same issuer as any other province),

(ii) Maturing over one year,

(iii) Maturing within the same periods for the purpose of determining margin rates as the securities referred to in (a), and

(iv) With a market value equal to the securities referred to in (a) (with the intent that no offset shall be permitted in respect of the market value of a long (or short) position which is in excess of the market value of the short (or long) position.

The two positions may be offset and the required margin computed with respect to the net long or net short position only. This Regulation 100.4A also applies to future purchase and sales commitments.

100.4B. **Governments, Maturity Within One Year**

Where a Member or a customer

(a) Owns securities described in clause (i) or (ii) of Regulation 100.2(a) maturing within one year, and

(b) Has a short position in securities

(i) Issued or guaranteed by the same issuer of the securities referred to in (a) (provided that for these purposes each of the provinces of Canada shall be regarded as the same issuer as any other province),

(ii) Maturing within one year, and

(iii) With a market value equal to the securities referred to in (a) (with the intent that no offset shall be permitted in respect of the market value of a long (or short) position which is in excess of the market value of the short (or long) position

The margin required shall be the excess of the margin on the long (or short) position over the margin required on the short (or long) position. This Regulation 100.4B also applies to future purchase and sale commitments.

100.4C. **Debt Securities**

Where a Member or a customer 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 positions:

| Long (Short) | | Short (Long) |
|---|---|---|
| (a) 100.2(a)(i) (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) | and | BAX futures contract |

Where a Member or a customer 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:

| Long (Short) | | Short (Long) |
|---|---|---|
| (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 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) |

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 offsetting positions must mature within the same periods referred to in Regulation 100.2 for the purpose of determining margin rates; and

(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 Montreal under the “BAX” trading symbol.

100.4D. **Mortgage-Backed Securities**

Where a Member or a customer holds a short (or long) position in bonds or debentures issued or guaranteed by the Government of Canada and also holds a long (or short) position in an instrument described in Regulation 100.2(h) guaranteed by the Government of Canada (a "mortgage-backed security"), the margin required shall be the excess of the margin required on the long (or short) position over the margin required on the short (or long) position, provided that the net margin may only be determined as aforesaid on the basis that:

(a) Margin required in respect of a short (or long) position in bonds or debentures may only be netted against margin required in respect of a long (or short) position in mortgage-backed securities to the extent that the market value of the two positions is equal, and no such netting or offset shall be permitted in respect of the market value of a short (or long) position which is in excess of the market value of the long (or short) position;

(b) Margin required in respect of bonds or debentures may only be netted against the margin required for mortgage-backed securities which mature within the same period referred to in Regulation 100.2(a) for the purpose of determining margin rates;

(c) Notwithstanding the foregoing, if the market value of a long (or short) position in mortgage-backed securities equals or exceeds the remaining principal amount of such position and the mortgages underlying such mortgage-backed securities position are subject to being repaid with or without penalty in full at the option of the mortgagee prior to maturity, the margin required shall be the greater of the margin as determined otherwise under Regulation 100.2 for (i) the long (or short) position in mortgage-backed securities or (ii) the short (or long) position in bonds or debentures.

100.4E. **Strip Coupons or Residuals**

**Government Debt**

Where a Member or a customer holds a short (or long) position in bonds or debentures denominated in Canadian dollars issued or guaranteed by either the Government of Canada or by a province of Canada and also holds a long (or short) position in the stripped coupon or residual portion of such debt instruments, the margin required shall be the excess of the margin required on the long (or short) position over the margin required on the short (or long) position, provided that the net margin may only be determined as aforesaid on the basis that:

(a) Margin required in respect of a short (or long) position in bonds or debentures may only be netted against margin required in respect of a long (or short) position in stripped coupons or residuals to the extent that the market value of the two positions is equal, and no such netting or offset shall be permitted in respect of the market value of a short (or long) position which is in excess of the market value of the long (or short) position;

(b) Margin required in respect of bonds or debentures issued or guaranteed by the Government of Canada may only be netted against the margin required for the stripped coupon or residual coupon of other Government of Canada instruments which mature within the same periods referred to in Regulation 100.2(a) for the purpose of determining margin rates; and

(c) Margin required in respect of bonds or debentures issued or guaranteed by a province of Canada may only be netted against the margin required for the stripped coupon or residual portion of other province of Canada instruments which mature within the same periods referred to in Regulation 100.2(a) for the purpose of determining margin rates.

Notwithstanding the foregoing provisions of this Regulation 100.4E, where a Member or a customer holds:

(i) A short (or long) position in bonds or debentures issued or guaranteed by the Government of Canada and a long (or short) position in the stripped or residual portion of bonds or debentures issued or guaranteed by a province of Canada, or

(ii) A short (or long) position in bonds or debentures issued or guaranteed by a province of Canada and a long (or short) position in the stripped or residual portion of bonds or debentures issued or guaranteed by the Government of Canada,

The margin required shall be 50% of the total margin required for both positions otherwise determined under the Regulations, provided that such margin may only be determined as aforesaid on the basis that:

(iii) Margin required in respect of a short (or long) position in bonds or debentures may only be netted against margin required in respect of a long (or short) position in stripped coupons or residuals to the extent that the market value of the two positions is equal, and no such netting or offset shall be permitted in respect of the market value of a short (or long) position which is in excess of the market value of the long (or short) position;

(iv) Margin required in respect of bonds or debentures may only be netted against the margin required for the stripped coupon or residual coupon of instruments which mature within the same periods referred to in Regulation 100.2(a) for the purpose of determining margin rates.

(v) The bonds and debentures and the stripped coupon or residual coupon of such debt instruments are both denominated in Canadian dollars."

100.4K. **Government of Canada Bond Futures Contracts and Security Combinations**

Where a Member or a customer 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) 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 and 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.

(c) 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)(ii) Province of Canada only maturing within the same or different 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.

(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.