

13.1.3 IDA Regulation 100.4E - Offsets Between Strip Coupon Positions and / or Residual Debt Positions

INVESTMENT DEALERS ASSOCIATION OF CANADA – IDA REGULATION 100.4E - OFFSETS BETWEEN STRIP COUPON POSITIONS AND / OR RESIDUAL DEBT POSITIONS

I Overview

A Current rules

Current IDA Regulation 100.4E, (the Regulation) allows for offsets between government bond and strip coupon positions, and government bond and residual debt positions, subject to meeting specified conditions. The rule, however, is silent on permitting reduced margin offsets between strip coupon positions, between residual debt positions, and between strip coupon and residual debt positions.

B The issue(s)

Consequently, each position within each of these offsets would be required to be margined separately, which would result in higher overall margin requirements than if they were treated as offsets. These higher overall margin requirements are not aligned with the reduced risk of these offsets and therefore, more margin is currently required than what is needed to address their risk.

C Objectives

The main objective of the proposed rule changes is to align the margin and capital requirements for each offset with its respective risk by allowing:

- offsets between strip coupon positions;
- offsets between residual debt positions; and
- offsets between strip coupon and residual debt positions.

As a secondary objective, we are also proposing to make clarifying wording changes to the Regulation as a whole.

D Effect of proposed rules

The proposed amendments are intended to promote the efficient use of capital and to align the capital and margin requirements with the offset risk. There are no negative impacts on market structure, on Members and non-Members, or on competition or cost of compliance. The proposed amendments are also consistent with other IDA rules and regulations.

II Detailed analysis

A Present rules, relevant history and proposed policy

The current Regulation permits offsets between regular bonds and strip coupon positions, and offsets between regular bonds and residual debt positions, provided these offsets meet the conditions specified in the Regulation. However, it is silent on allowing reduced margin offsets between strip coupon positions, between residual debt positions or between strip coupon and residual debt positions. These offsets represent reduced risk in comparison to unhedged positions involving the same instruments and should therefore qualify for reduced margin or capital treatments. The proposed amendments are only applicable to debt instruments issued or guaranteed by the Government of Canada or a province of Canada. Furthermore, specified conditions must be met before the proposed offset rules are applicable.

We are proposing that for offsets where the long and short positions involve debt instruments (bonds, debentures, strip coupons or residuals) that are issued or guaranteed by the Government of Canada or based on such, the reduced margin and capital requirements be “the excess of the margin required on the long (or short) position over the margin required on the short (or long) position, respectively.” This same reduced margin and capital treatment would also apply to offsets where the long and short positions involve debt securities that are issued or guaranteed by any province of Canada or based on such.

Furthermore, we are proposing that for offsets where the long and short positions involve debt instruments that are issued or guaranteed by the Government of Canada and any province of Canada or based on such, the reduced margin and capital requirements be “50% of the total margin required for both positions otherwise determined in the Regulations.” This higher

margin requirement is to cover additional risks inherent in offsets where the positions are essentially combinations of federal and provincial debt instruments.

In summary, the Association proposes to amend the Regulation to recognize offsets between residual debt positions, between strip coupon positions, and offsets between residual debt and strip coupon positions. The proposed changes are set in detail in the attached amendment board resolution and amendment black-line copy.

B Issues and alternatives considered

No alternative proposals were considered as the proposals seek to establish specific offset rules that are not currently recognized in the IDA rules.

C Comparison with similar provisions

Many countries, including the U.S. and the U.K., have restrictions on stripping bonds. In addition, in the U.K., only U.K. Government bonds are eligible, while in the U.S., only bonds issued by the Federal Government or Government agencies are eligible to be stripped. In general, offsets between these debt instruments may not be allowed unless under strict circumstances where sophisticated financial models may be involved. There are no descriptive rules in UK or US that are similar to what Canada has or proposes to have in this regard. Since Canada has a much more developed stripped bond market structure, it is more crucial than in other major markets such as the U.S. and the U.K. for Canada to have clear and specific regulations that permit Members and clients to better manage risks and promote efficient use of capital.

D Systems impact of rule

We believe that the proposed amendments will have no impact in terms of capital market structure, competition, cost of compliance and conformity with other rules. The Bourse de Montréal is also in the process of passing these amendments. Implementation of these amendments will therefore take place once both the Association 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 the Association's order of recognition as a self regulatory organization, the Association shall, where requested, provide in respect of a proposed rule change "a concise statement of its nature, purposes 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 the margining of offsets involving residual debt positions, strip coupon positions, and between the two products. The purposes of the proposal are to "facilitate an efficient capital-raising process and to facilitate transparent, efficient and fair secondary market trading" and to "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. Based on the significance of these proposed amendments they have been determined to be public interest in nature.

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, Newfoundland and Labrador, Nova Scotia and Saskatchewan.

B Effectiveness

An assessment of the effectiveness of the proposed rules in addressing the issues has been discussed above.

C Process

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

IV Sources

References:

- IDA Regulations 100.2(a)(xi) and 100.4E
<http://ida.knotia.ca/Knowledge/View/Document.cfm?Ktype=445&linkType=toc&dbID=210711341&tocID=483>
<http://ida.knotia.ca/Knowledge/View/Document.cfm?Ktype=445&linkType=toc&dbID=210711341&tocID=490>
- Strip Bonds Information Centre
www.stripbonds.info/international/

V Requirement to publish for comment

The IDA is required to publish for comment the accompanying proposed amendments so that the issue referred to above may be considered by recognizing regulators staff.

The Association has determined that the entry into force of the proposed policies and amendments would be in the public interest. Comments are sought on the proposed policies and 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 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.

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IDA website (www.ida.ca under the heading "Rule Book & Bulletins" and sub-heading "Regulatory Policy Proposals and Comment Letters Received").

Questions may be referred to:

Answerd Ramcharan,
Specialist, Regulatory Policy,
Investment Dealers Association of Canada
(416) 943-5850
aramcharan@ida.ca

Investment Dealers Association of Canada

**IDA Regulation 100.4E - Offsets between strip coupon positions and / or residual debt positions
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. Regulation 100.4E is repealed and replaced as follows,

"100.4E. Strip coupon and / or residual debt positions

Government debt

Where a Member or customer holds the following offset positions and:

- (i) the offset positions mature within the same time period;
- (ii) the time periods are the time periods referred to in Regulation 100.2(a);
- (iii) the offset positions are denominated in Canadian dollars; and
- (iv) the market value of the short position is equal to the market value of the long position;

the margin required is as follows:

(a) Bond or debenture and strip coupon or residual debt positions

- (i) for 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 strip coupon or residual portion of such debt instruments; or
- (ii) for 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 strip 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), respectively.

- (iii) for a short (or long) position in bonds or debentures issued or guaranteed by the Government of Canada and a long (or short) position in a strip coupon or residual portion of a debt instrument issued or guaranteed by a province of Canada; or
- (iv) for a short (or long) position in bonds or debentures issued or guaranteed by a province of Canada and a long (or short) position in a strip coupon or residual portion of a debt instrument issued or guaranteed by the Government of Canada;

the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.

(b) Strip coupon positions

- (i) for a short (or long) position in a strip coupon and a long (or short) position in a strip coupon, and the strip coupons are from debt instruments issued or guaranteed by the Government of Canada; or
- (ii) for a short (or long) position in a strip coupon and a long (or short) position in a strip coupon, and the strip coupons are from debt instruments issued or guaranteed by any province of Canada;

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, respectively.

- (iii) for a short (or long) position in a strip coupon of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position in a strip coupon of a debt instrument issued or guaranteed by a province of Canada;

the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.

(c) Residual debt positions

- (i) for a short (or long) position in a residual and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by the Government of Canada; or
- (ii) for a short (or long) position in a residual and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by any province of Canada;

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, respectively.

- (iii) for a short (or long) position in a residual portion of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a residual portion of a debt instrument issued or guaranteed by a province of Canada;

the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.

(d) Strip coupon and residual debt positions

- (i) for a short (or long) position in a strip coupon and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by the Government of Canada; or
- (ii) for a short (or long) position in a strip coupon and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by any province of Canada;

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, respectively.

- (iii) for a short (or long) position in a strip coupon of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a residual portion of a debt instrument issued or guaranteed by a province of Canada; or
- (iv) for a short (or long) position in a residual portion of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a strip coupon of a debt instrument issued or guaranteed by a province of Canada;

the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.

Foreign currency debt

(e) Bond or debenture and strip coupon or residual debt positions

Where a Member holds a short (or long) position in bonds or debentures referred to in Regulation 100.2(a)(i) denominated in a currency other than Canadian dollars, and also holds a long (or short) position in the stripped or residual portion of such debt instruments denominated in the same currency, the margin shall be the excess of the margin required on the short (or long) 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:

- (i) 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; and
- (ii) Margin in respect of bonds or debentures issued or guaranteed by a particular government may only be netted against the margin required for the stripped coupon or residual portion of debt instruments of the same government, which mature within the same periods referred to in Regulation 100.2(a)(i) for the purpose of determining margin rates.

Corporate debt

(f) Bond or debenture and strip coupon or residual debt positions

Where a Member holds a short (or long) position in bonds or debentures issued by a corporation with a single A or higher rating by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard and Poor's Bond Record, 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 greater of the margin required on the long (or short) position and the margin required on the short (or long) position, to a maximum 20% margin rate, provided that the margin may only be determined as aforesaid on the basis that:

- (i) The offset is permitted only to the extent that the market value of the two positions is equal, and no 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; and
- (ii) Margin required in respect of bonds or debentures issued by a corporation may only be offset against the margin required for the stripped coupon or residual portion of debt instruments of the same issuer, which mature within the same periods referred to in Regulation 100.2(a)(xi) for the purpose of determining margin rates."

BE IT RESOLVED THAT the Board of Directors adopt, on this 12th day of December 2007, 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

IDA Regulation 100.4E - Offsets between strip coupon positions and / or residual debt positions

Black-line copy of proposed amendments

“100.4E. Strip Coupons or Residuals ~~coupon and / or residual debt positions~~”

Government Debt ~~debt~~

~~Where a Member holds a short (or long) position in bonds or debentures~~ or customer holds the following offset positions and:

- ~~(i) the offset positions mature within the same time period;~~
- ~~(ii) the time periods are the time periods referred to in Regulation 100.2(a);~~
- ~~(iii) the offset positions are 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; and~~
- ~~(iv) the market value of the short position is equal to the market value of the long position;~~

~~the margin required is as follows:~~

(a) Bond or debenture and strip coupon or residual debt positions

- ~~(i) for 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 strip coupon or residual portion of such debt instruments; or~~
- ~~(ii) for 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 strip 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), respectively.~~

- ~~(iii) for a short (or long) position in bonds or debentures issued or guaranteed by the Government of Canada and a long or (short) position in a strip coupon or residual portion of a debt instrument issued or guaranteed by a province of Canada; or~~
- ~~(iv) for a short (or long) position in bonds or debentures issued or guaranteed by a province of Canada and a long (or short) position in a strip coupon or residual portion of a debt instrument issued or guaranteed by the Government of Canada;~~

~~the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.~~

(b) Strip coupon positions

- ~~(i) for a short (or long) position in a strip coupon and a long (or short) position in a strip coupon, and the strip coupons are from debt instruments issued or guaranteed by the Government of Canada; or~~
- ~~(ii) for a short (or long) position in a strip coupon and a long (or short) position in a strip coupon, and the strip coupons are from debt instruments issued or guaranteed by any province of Canada;~~

~~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 respectively.~~

- ~~(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 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;~~

~~(iii) — for a short (or long) position in a strip coupon of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position in a strip coupon of a debt instrument issued or guaranteed by a province of Canada;~~

~~the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.~~

(c) Residual debt positions

~~(i) — for a short (or long) position in a residual and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by the Government of Canada; or~~

~~(ii) — for a short (or long) position in a residual and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by any province of Canada;~~

~~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, respectively.~~

~~(iii) — for a short (or long) position in a residual portion of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a residual portion of a debt instrument issued or guaranteed by a province of Canada;~~

~~The~~the margin required shall be 50% of the total margin required for both positions otherwise determined ~~underin~~in 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.~~

(d) Strip coupon and residual debt positions

~~(i) — for a short (or long) position in a strip coupon and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by the Government of Canada; or~~

~~(ii) — for a short (or long) position in a strip coupon and a long (or short) position in a residual, and the residual portions are from debt instruments issued or guaranteed by any province of Canada;~~

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, respectively.

(iii) for a short (or long) position in a strip coupon of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a residual portion of a debt instrument issued or guaranteed by a province of Canada; or

(iv) for a short (or long) position in a residual portion of a debt instrument issued or guaranteed by the Government of Canada and a long (or short) position of a strip coupon of a debt instrument issued or guaranteed by a province of Canada;

the margin required shall be 50% of the total margin required for both positions otherwise determined in the Regulations.

Foreign Currency Debt

(e) Bond or debenture and strip coupon or residual debt positions

Where a Member holds a short (or long) position in bonds or debentures referred to in Regulation 100.2(a)(i) denominated in a currency other than Canadian dollars, and also holds a long (or short) position in the stripped or residual portion of such debt instruments denominated in the same currency, the margin shall be the excess of the margin required on the short (or long) 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:

(e.i) 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; and

(e.ii) Margin in respect of bonds or debentures issued or guaranteed by a particular government may only be netted against the margin required for the stripped coupon or residual portion of debt instruments of the same government, which mature within the same periods referred to in Regulation 100.2(a)(i) for the purpose of determining margin rates.

Corporate Debt

(f) Bond or debenture and strip coupon or residual debt positions

Where a Member holds a short (or long) position in bonds or debentures issued by a corporation with a single A or higher rating by any of Canadian Bond Rating Service, Dominion Bond Rating Service, Moody's Investors Service or Standard and Poor's Bond Record, 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 greater of the margin required on the long (or short) position and the margin required on the short (or long) position, to a maximum 20% margin rate, provided that the margin may only be determined as aforesaid on the basis that:

(f.i) The offset is permitted only to the extent that the market value of the two positions is equal, and no 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; and

(f.ii) Margin required in respect of bonds or debentures issued by a corporation may only be offset against the margin required for the stripped coupon or residual portion of debt instruments of the same issuer, which mature within the same periods referred to in Regulation 100.2(a)(xi) for the purpose of determining margin rates.