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

IIROC NOTICE

Rules Notice
Request for Comment
Dealer Member Rules

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Proposed amendments to Dealer Member Rule 100.10(k) Optional use of TIMS or SPAN

Summary of nature and purpose of proposed Rule

On June 25, 2015, the Board of Directors (the Board) of the Investment Industry Regulatory Organization of Canada (IIROC) approved the publication for comment of proposed amendments ("Proposed Amendments") to Dealer Member Rule 100.10(k) regarding the optional use of TIMS[1] or SPAN[2] for margining Dealer Member firm account positions constituted exclusively of positions in derivatives at the Bourse de Montréal (the Bourse).

[1] "TIMS" means the Theoretical Intermarket Margin System methodology used for calculating derivatives margin requirements.

[2] "SPAN" means the Standard Portfolio Analysis methodology used for calculating derivatives margin requirements.

The main purpose of the Proposed Amendments is to harmonize and ensure consistency with pending changes to related rules at the Bourse[3] and the Canadian Derivatives Clearing Corporation[4] (CDCC) that support and underlie Dealer Member Rule 100.10(k).

Issues and specific proposed amendments

Relevant history

On April 21 2015, the Autorité des marchés financiers (AMF) and the Ontario Securities Commission (OSC) approved the proposed "Amendments to the Risk Manual of the Canadian Derivatives Clearing Corporation to Address Procyclicality of Margin". Once implemented this amendment will modify the margin interval calculation used by CDCC in order to comply with the Principles for Financial Market Infrastructures (PFMI) requirements[5].

IIROC Dealer Member Rule 100.10(k) and Bourse Article 9002 both reference specific elements that comprise the current margin interval calculation that must be used in applying either TIMS or SPAN. As a result, the pending change to CDCC's margin methodology requires related changes to Dealer Member Rule 100.10(k) (and Bourse Article 9002) in order to maintain a uniform margin interval calculation methodology for Dealer Member regulatory reporting and clearing house margin requirements.

Current rule

Current Dealer Member Rule 100.10(k) was originally implemented in January 2005 as a result of the adoption of risk-based margining using TIMS and SPAN by the Bourse in collaboration with CDCC. This risk-based margining approach uses a portfolio valuation model to calculate margin requirements, which takes into consideration the volatility and correlation of the underlying securities in the portfolio. Rule 100.10(k) gives Dealer Members the option to apply the same regulatory capital requirement as the clearing house requirement for their Bourse-listed inventory positions.

Current Dealer Member Rule 100.10(k) contains a reference to the specific elements that comprise the current margin interval formula:

$$MI = 3 \times \sqrt{2} \times Max[\sigma_{20days}; \sigma_{90days}; \sigma_{260days}]$$

- *Where 'MI' means margin interval.*
- *'3' is for a 99% confidence interval.*

3 http://www.m-x.ca/publi_circulaires_en.php

4 http://www.cdcc.ca/publications_notices_en

5 "The PFMIs are a part of a set of 12 key standards that the international community considers essential to strengthen and preserve financial stability" See Bank for International Settlements (*www.bis.org*), "Principles for Financial Market Infrastructures", (April 2012).

- *'* $\sqrt{2}$ *' is for two days coverage.*
- *'* $Max[\sigma_{20days};\sigma_{90days};\sigma_{260days}]$ *' is the maximum standard deviation (also known as volatility estimator) of percentage fluctuations in daily settlement values over the most recent 20, 90 and 260 business days.*

CDCC's analysis indicates that the current margin interval calculation methodology is procyclical, because its volatility estimator is determined by the use of the maximum volatility between 20, 90 and 260 days.[6] As such, the current methodology may determine margin requirements that are positively correlated with market, business or credit cycle fluctuations which may cause or exacerbate financial instability by requiring:

- additional initial margin in periods of turbulent markets, which could exacerbate market stress and volatility, resulting in supplementary margins; and
- very low levels of initial margin in periods of expansion, which could lead to excessive leverage and thus increase the risk of feeding market bubbles.[7]

CDCC's proposed new margin methodology is designed to address these perceived fundamental procyclical flaws and to comply with PFMI requirements. The main difference between the current margin methodology and the proposed margin methodology is the change in the way the 'σ' (volatility estimator) is calculated. CDCC's proposed methodology uses an Exponentially Weighted Moving Average (EWMA) with a 0.99 decay rate, coupled with a minimal floor margin calibrated with 10 years of data. In comparison, and as noted above, the current methodology uses the maximum 'σ' of the standard deviation of the daily variation over 20, 90 and 260 days as a volatility estimator.

CDCC's review and backtesting analysis indicate that the proposed new margin methodology reduces procyclicality, and is within its risk appetite of a 99% coverage level for its margin requirement against the two-day Profit & Loss.[8]

Proposed rule

The Proposed Amendments will harmonize Dealer Member Rule 100.10(k) with the relevant Bourse and CDCC proposed amendments by:

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6 CDCC Notice No. 2014-159, pg.2.

7 See CDCC Notice No. 2014-159, p.5 and BIS, "Principles for Financial Market Infrastructures", (April 2012).

8 For a detailed description and analysis of CDCC's new margin methodology, see CDCC Notice No. 2014-159.

- deleting the definition of the specific margin interval elements, which will no longer be used by CDCC;
- deleting the requirement that the Bourse must approve all changes to the assumptions used by CDCC in determining capital requirements prior to implementation;
- adding IIROC's right to restrict the application of the rule if we judge its use inappropriate for Dealer Member capital requirements; and
- deleting all references to the TIMS methodology, because it is no longer used by CDCC.

The Proposed Amendments parallel the proposed amendments to Bourse Article 9002 with the exception of an additional provision in the Proposed Amendments that will give IIROC the right to restrict the application of Dealer Member Rule 100.10(k) if IIROC judge the continued use of the margin methodology inappropriate for Dealer Member capital requirements (the "Restriction").

IIROC believes it is appropriate for IIROC to retain the discretion contemplated by the Restriction in order to maintain control over inputs to the Capital Formula and regulatory framework as part of satisfying IIROC's Dealer Member financial compliance responsibilities. IIROC would exercise the Restriction under the following circumstances:

- where we have material concerns with any subsequent changes to the CDCC margin methodology; and
- where our material concerns were not adequately addressed through CDCC's Risk Management Advisory Committee (RMAC).

Issues and alternatives considered

Other possible alternatives, such as the status quo or repealing Dealer Member Rule 100.10(k), were not considered practical or beneficial. The alternative chosen will harmonize and ensure consistency with the pending changes to the related rules at the Bourse and CDCC.

Rule-making process

The Proposed Amendments were developed by IIROC staff in collaboration with Bourse staff and recommended for approval by the FAS Capital Formula Subcommittee and the Financial Administrators Section, which are two IIROC policy advisory committees.

Comparison with similar provisions

International Standards

Bank for International Settlements – Principles for Financial Market Infrastructures (PFMIs)

The Proposed Amendments result from proposed changes to CDCC's margin interval calculation methodology, which is used in Dealer Member Rule 100.10(k) to calculate the capital requirements for a Dealer Member's inventory positions in Bourse-listed derivatives. The proposed changes to CDCC's margin interval calculation methodology are required in order to ensure compliance with the PFMIs, which provide international standards for payment, clearing and settlement systems, including central counterparties. The PFMIs have been issued by the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO), which are recognized as international standard –setting bodies by the Financial Stability Board.

Proposed Rule classification

Statements have been made elsewhere as to the nature and effects of the Proposed Amendments. The purpose of the Proposed Amendments is to 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.

The Board therefore has determined that the Proposed Amendments are not contrary to the public interest.

Due to the extent and substantive nature of the Proposed Amendments, they have been classified as a Public Comment Rule proposal.

Effects of the proposed Rule on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance

The Proposed Amendments will benefit Dealer Members by ensuring that Dealer Member Rule 100.10(k) remains consistent with proposed Bourse Article 9002 and the proposed CDCC margin interval calculation methodology. Dealer Member Rule 100.10(k) does not directly affect a large number of stakeholders because it is limited to Dealer Member inventory positions in Bourse-listed derivatives. In addition, only a small number of Dealer Members use Dealer Member Rule 100.10(k) to determine capital requirements.

We believe that the Proposed Amendments:

(i) will have no impact in terms of capital market structure, competition generally, cost of compliance and conformity with other rules;

(ii) do not permit unfair discrimination among customers, issuers, brokers, dealers, members or others; and

(iii) do not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes.

Technological implications and implementation plan

We do not expect there to be any system impacts resulting from the implementation of the Proposed Amendments. It is anticipated that the Proposed Amendments will be implemented to coincide with the implementation of the related Bourse and CDCC proposed amendments after receiving approval by the Recognizing Regulators.

Request for public comment

Comments are sought on the Proposed Amendments. Comments should be made in writing. Two copies of each comment letter should be delivered by September 14, 2015 (60 days from the publication date of this notice). One copy should be addressed to the attention of:

Bruce Grossman
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Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, ON M5H 3T9
bgrossman@iiroc.ca

The second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, ON M5H 3S8
marketregulation@osc.gov.on.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (**www.iiroc.ca** under the heading "Rulebook - IIROC Dealer Member Rules - Proposed Policy").

Questions may be referred to:

Bruce Grossman
Senior Information Analyst, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
(416) 943-5782
bgrossman@iiroc.ca

Attachments

Attachment A - Text of proposed amendments to Dealer Member Rule 100.10(k)

Attachment B - Proposed amendments to Dealer Member Rule 100.10(k)

Attachment C - Black-line of proposed amendments to Dealer Member Rule 100.10(k)

Investment Industry Regulatory Organization of Canada

Margin Requirements for Inventory Positions in Bourse-listed Derivatives – Proposed Amendments to Dealer Member Rule 100.10(k) Optional use of TIMS or SPAN

Text of Proposed Amendments

1. Dealer Member Rule 100.10(k) is as amended by:

   (a) deleting the words "TIMS or" in the title of the rule;

   (b) deleting the words ", as the case may be," immediately before the words "by the Standard Portfolio Analysis ("SPAN") methodology";

   (c) deleting the words "or by the Theoretical Intermarket Margin System ("TIMS") methodology,";

   (d) deleting the sentence "All changes to the assumptions used by the Canadian Derivatives Clearing Corporation shall be approved by the Bourse de Montréal prior to implementation to ensure that the continued use of the SPAN and TIMS methodologies for regulatory purposes is appropriate."

   (e) deleting the sentence "The selected methodology (either SPAN or TIMS) must be used consistently and cannot be changed without the prior consent of the Bourse de Montréal."

   (f) deleting the words "or the TIMS methodology" immediately after the words "If the Dealer Member firm selects the SPAN methodology";

   (g) replacing the words "those methodologies" with the words "this methodology";

   (h) deleting the sentence "For the purpose of the present article, "margin interval" means the product of the three following elements:

      (i) the maximum standard deviation of percentage fluctuations in daily settlement values over the most recent 20, 90 and 260 business days; multiplied by

      (ii) three (for a 99% confidence interval); and multiplied by

      (iii) the square root of 2 (for two days coverage)."

   (i) adding the sentence "The Corporation may restrict the application of this Rule 100.10(k), if it considers continued use of the SPAN methodology to be inappropriate for Dealer Member capital requirements." at the end of the rule.

Investment Industry Regulatory Organization of Canada

Margin Requirements for Inventory Positions in Bourse-Listed Derivatives – Proposed Amendments to Dealer Member Rule 100.10(k) Optional use of TIMS or SPAN

Clean Copy of Proposed Amendments

1. A clean copy of proposed amendments to Dealer Member Rule 100.10(k) is as follows:

"**(k) Optional use of SPAN**

With respect to a Dealer Member firm account constituted exclusively of positions in derivatives listed at the Bourse de Montréal, the capital required may be the one calculated by the Standard Portfolio Analysis ("SPAN") methodology using the margin interval calculated and the assumptions used by the Canadian Derivatives Clearing Corporation.

If the Dealer Member firm selects the SPAN methodology, the capital requirements calculated under this methodology will supersede the requirements stipulated in Rule 100.

The Corporation may restrict the application of this Rule 100.10(k), if it considers continued use of the SPAN methodology to be inappropriate for Dealer Member capital requirements."

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

MARGIN REQUIREMENTS FOR INVENTORY POSITIONS IN BOURSE-LISTED DERIVATIVES – PROPOSED AMENDMENTS TO DEALER MEMBER RULE 100.10(K) OPTIONAL USE OF TIMS OR SPAN

BLACK-LINE OF PROPOSED AMENDMENTS

Dealer Member Rule 100.10(k):

(k) Optional use of ~~TIMS or~~ SPAN

With respect to a Dealer Member firm account constituted exclusively of positions in derivatives listed at the Bourse de Montréal, the capital required may be the one calculated~~, as the case may be,~~ by the Standard Portfolio Analysis ("SPAN") methodology ~~or by the Theoretical Intermarket Margin System ("TIMS") methodology,~~ using the margin interval calculated and the assumptions used by the Canadian Derivatives Clearing Corporation. ~~All changes to the assumptions used by the Canadian Derivatives Clearing Corporation shall be approved by the Bourse de Montréal prior to implementation to ensure that the continued use of the SPAN and TIMS methodologies for regulatory purposes is appropriate.~~

~~The selected methodology (either SPAN or TIMS) must be used consistently and cannot be changed without the prior consent of the Bourse de Montréal.~~ If the Dealer Member firm selects the SPAN methodology ~~or the TIMS methodology~~, the capital requirements calculated under ~~those methodologies~~this methodology will supersede the requirements stipulated in Rule 100.

~~For the purpose of the present article, "margin interval" means the product of the three following elements:~~

~~(i) the maximum standard deviation of percentage fluctuations in daily settlement values over the most recent 20, 90 and 260 business days; multiplied by~~

~~(ii) three (for a 99% confidence interval); and multiplied by~~

~~(iii) the square root of 2 (for two days coverage)~~

The Corporation may restrict the application of this Rule 100.10(k), if it considers continued use of the SPAN methodology to be inappropriate for Dealer Member capital requirements.

Appendix 1

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

BOARD RESOLUTION

MARGIN REQUIREMENTS FOR INVENTORY POSITIONS IN BOURSE-LISTED DERIVATIVES – PROPOSED AMENDMENTS TO DEALER MEMBER RULE 100.10(K) OPTIONAL USE OF TIMS OR SPAN

BE IT RESOLVED ON THE 25TH DAY OF JUNE, 2015 THAT:

1. The English and French versions of the proposed amendments to Dealer Member Rule 100.10(k) regarding the optional use of TIMS or SPAN for margining Dealer Member inventory positions in Bourse de Montréal-listed derivatives, in the form presented to the Board of Directors:
   (a) be approved for publication for public comment;
   (b) be approved for submission to the Recognizing Regulators for review and approval;
   (c) be determined to be in the public interest; and
   (d) be approved for implementation if there are no material public comments or material comments from the Recognizing Regulators.
2. The President be authorized to approve such non-material changes to the proposed amendments prior to publication and/or implementation as the President considers necessary and appropriate.

Appendix 2

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

MARGIN REQUIREMENTS FOR INVENTORY POSITIONS IN BOURSE-LISTED DERIVATIVES – PROPOSED AMENDMENTS TO DEALER MEMBER RULE 100.10(K) OPTIONAL USE OF TIMS OR SPAN

TEXT OF PROPOSED AMENDMENTS

1. Dealer Member Rule 100.10(k) is as amended by:

   (a) deleting the words "TIMS or" in the title of the rule;

   (b) deleting the words ", as the case may be," immediately before the words "by the Standard Portfolio Analysis ("SPAN") methodology";

   (c) deleting the words "or by the Theoretical Intermarket Margin System ("TIMS") methodology,";

   (d) deleting the sentence "All changes to the assumptions used by the Canadian Derivatives Clearing Corporation shall be approved by the Bourse de Montréal prior to implementation to ensure that the continued use of the SPAN and TIMS methodologies for regulatory purposes is appropriate."

   (e) deleting the sentence "The selected methodology (either SPAN or TIMS) must be used consistently and cannot be changed without the prior consent of the Bourse de Montréal."

   (f) deleting the words "or the TIMS methodology" immediately after the words "If the Dealer Member firm selects the SPAN methodology";

   (g) replacing the words "those methodologies" with the words "this methodology";

   (h) deleting the sentence "For the purpose of the present article, "margin interval" means the product of the three following elements:

      (i) the maximum standard deviation of percentage fluctuations in daily settlement values over the most recent 20, 90 and 260 business days; multiplied by

      (ii) three (for a 99% confidence interval); and multiplied by

      (iii) the square root of 2 (for two days coverage)."

   (i) adding the sentence "The Corporation may restrict the application of this Rule 100.10(k), if it considers continued use of the SPAN methodology to be inappropriate for Dealer Member capital requirements." at the end of the rule.