



# IIROC NOTICE

## Rules Notice Request for Comment

Dealer Member Rules

**Comments Due By: November 8, 2018**

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**18-0153**  
**August 9, 2018**

## **Proposed Amendments to Dealer Member Rules and Form 1 regarding the securities concentration test and designated rating organizations**

### **Executive Summary**

IIROC is proposing amendments to its Dealer Member Rules (**DMRs**) and Form 1 (collectively, the **Proposed Amendments**) that are designed to bring debt securities with a normal margin rate of 10% or less (**debt securities margined at  $\leq 10\%$** ) into the existing securities concentration test. The Proposed Amendments also update the use of credit ratings, and references to credit rating agencies, in the DMRs and Form 1.

The primary objective of the Proposed Amendments is to prevent undue concentrations in certain debt securities margined at  $\leq 10\%$ .



#### The Proposed Amendments:

- introduce the definition of a “designated rating organization” (**DRO**) into the DMRs and Form 1
- add a minimum DRO current credit rating requirement for Canadian bank paper to qualify as an eligible investment for client free credit segregation purposes
- create a new Schedule 9 that includes separate, but related, tests for debt securities margined at  $\leq 10\%$  and current Schedule 9 positions
- apply a credit rating risk-weighting methodology to scale debt securities margined at  $\leq 10\%$  into the existing securities concentration test framework.

#### Impacts

Our review indicates that potential regulatory capital impacts, if any, are limited to a small number of Dealer Members. The Proposed Amendments limit the ability of Dealer Members to take on material positions in higher risk, lower-rated debt securities. The risk-weighting methodology we developed should allow Dealer Members to continue to conduct their core debt market business without any material impact. However, as discussed in section 4, we ask stakeholders to provide comments regarding the Proposed Amendments’ potential operational impacts.

The Proposed Amendments build upon the existing Schedule 9 securities concentration-test framework, which should smooth implementation. Dealer Members will need to ensure their compliance systems provide satisfactory credit rating agency monitoring to meet the new requirements.

#### How to Submit Comments

Comments are sought on the Proposed Amendments, including any matter that they do not specifically address. Comments should be made in writing. Two copies of each comment letter should be delivered by November 8, 2018 (90 days from the publication date of this Notice). One copy should be addressed to the attention of:

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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  
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**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](http://www.iiroc.ca) under the heading “Rulebook - IIROC Dealer Member Rules - Proposed Policy”).**

Questions may be referred to:

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## 1. Discussion of the Proposed Amendments

### 1.1 Schedule 9 (Concentration of Securities) of Form 1

Schedule 9 of Form 1 addresses securities concentration risk by measuring and assessing a Dealer Member's aggregate capital exposure to any single security, group of related securities of the same issuer, or precious metals position. The aggregate capital exposure is referred to as the "amount loaned" on Schedule 9 and may be composed of an issuer position(s) or precious metals position carried by the Dealer Member in inventory, client margin accounts, or overdue cash or delivery against payment (**DAP**) and receipt against payment (**RAP**) accounts.

Schedule 9 sets out defined thresholds of regulatory capital for the purpose of measuring securities concentration. A capital charge applies when the amount loaned exceeds a defined threshold. The purpose of a capital charge is to provide sufficient coverage against the increased risk associated with exposing a large portion of the Dealer Member's capital to a concentrated position.

A potential gap exists under the current DMRs because Schedule 9 does not include debt securities margined at  $\leq 10\%$ .

### 1.2 Original Proposal

In 2014, we published proposed amendments to the securities concentration test in IIROC Rules Notice [14-0298](#) (the **Original Proposal**). These amendments were part of a more comprehensive proposal that also included proposed amendments regarding client free credit usage requirements.

The Original Proposal brought corporate debt securities with a normal margin rate of 10% or less and other non-commercial debt securities with a normal margin rate of 10% into the Schedule 9 concentration test. This approach proposed to combine these debt securities margined at  $\leq 10\%$  with any related equity-type securities currently tested under Schedule 9 (**current Schedule 9 positions**)<sup>1</sup> and then test the combined total against the existing thresholds on Schedule 9. We developed a risk-weighting adjustment factor that allowed the amount loaned for these debt securities to be reduced by 50% if they matured within 3 years.

In 2016, we withdrew the Original Proposal, as detailed in IIROC Rules Notice [16-0090](#)<sup>2</sup>. In so doing, our stated intention was to develop a revised proposal, focused on refining the

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<sup>1</sup> The current Schedule 9 positions tested are equity securities, convertibles, debt and other securities with a normal margin rate greater than 10%, and precious metal positions, including all certificates and bullion of the particular precious metal.

<sup>2</sup> IIROC Rules Notice [16-0090](#) details our decision to withdraw the proposed amendments to the securities concentration test and move forward with proposed amendments to the client free credit



concentration risk-weighting methodology for debt securities. We also advised that in considering revised proposed amendments to the securities concentration test, we would review the use of credit ratings, and references to credit rating agencies, in our DMRs.

## 2. Analysis

### 2.1 Inclusion in the IIROC Rules and Form 1 of the defined term, designated rating organization

We propose to repeal the various references to specific credit rating agencies in the DMRs and replace them with the defined term “designated rating organization”. We will define this term in Form 1, General Notes and Definitions as follows:

“designated rating organization” means a credit rating organization, or its designated affiliate, designated under National Instrument 25-101.”

We also propose to include the following definition of “designated rating organization” in Dealer Member Rule 1.1 (Plain Language Rule (PLR) 1200 when implemented), where we typically place definitions used throughout the rules:

“designated rating organization” means the same meaning as set out in Form 1, General Notes and Definitions.”

In 2012, the Canadian Securities Administrators (CSA) granted DRO status to:

- DBRS Limited
- Fitch, Inc.
- Moody’s Canada Inc.
- Standard & Poor’s Rating Services (Canada)<sup>3</sup>.

We do not plan to include a list of current DROs in the DMRs, nor have we attempted to list every equivalent DRO rating in all cases. Instead, readers should refer back to Canadian securities legislation to determine current DROs and equivalent ratings.

Table 1 lists all of the references to specific credit rating agencies in the current DMRs and PLR rulebook. We plan to repeal these references and replace with the new definition above.

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usage requirements. We implemented the amendments to the client free credit usage requirements in March 2017 (IIROC Notice [17-0068](#)).

<sup>3</sup> “Canadian Securities Regulators Grant Designated Rating Organization Status under New Regulatory Framework”, ([CSA | What's New | Canadian securities regulators grant Designated Rating Organization status under new regulatory framework](#)).



**Table 1 – IIROC rule references for credit rating agencies**

No.	Credit Rating Agency Reference in IIROC Rules	Dealer Member Rule Book Reference	PLR Equivalent Reference	Form 1 Reference
1.	"Dominion Bond Rating Service"	100.2(a)(v)(3) 100.4C(i) 100.4C(v) 100.4E(f) 100.4K(ii) 100.4K(iii)	5130(2)(xvi) 5614(2) 5618(2) 5621(2) 5622(2) 5623(2) 5624(2) 5631(2)	None
2.	"Moody's Investors Service, Inc."	100.2(a)(i) 1200.3(d)	4384(2)	Statement D Schedule 2
3.	"Moody's"	100.2(a)(v)(4)	5130(2)(xvi) 5210(2) 5211(2) 5614(2) 5618(2) 5621(2) 5622(2) 5623(2) 5624(2) 5631(2)	None
4.	"Moody's Investors Service"	100.4C(i) 100.4C(v) 100.4E(f) 100.4K(ii) 100.4K(iii)		None
5.	"Standard & Poor's Corporation"	100.2(a)(i) 1200.3(d)	5130(2)(xvi) 4384(2) 5210(2) 5211(2) 5614(2) 5618(2) 5621(2) 5622(2) 5623(2) 5624(2) 5631(2)	Statement D Schedule 2



No.	Credit Rating Agency Reference in IIROC Rules	Dealer Member Rule Book Reference	PLR Equivalent Reference	Form 1 Reference
6.	“Standard & Poor’s”	100.2(a)(v)(4)		None
7.	“Standard & Poor’s Bond Record”	100.4C(i) 100.4C(v) 100.4K(ii) 100.4K(iii)		None
8.	“Standard and Poor’s Bond Record”	100.4E(f)		None
9.	“Canadian Bond Rating Service”	100.2(a)(v)(3) 100.4C(i) 100.4C(v) 100.4E(f) 100.4K(ii) 100.4K(iii)		None

### Current standard

In the DMRs, we generally do not intend to change the existing credit rating qualification standard. In most cases, use of the term DRO will follow the current IIROC standard, which simply requires that the security meet the minimum credit rating from one or more DRO, with no adjustment, penalty or disqualification if a different DRO has issued a non-qualifying credit rating for the security.

### Stricter standards

A stricter DRO qualification standard will apply for:

- determining Canadian bank paper eligibility for client free credit segregation (section 2.2)
- determining exclusions and credit rating risk weightings for the debt securities concentration test (section 2.6).

We propose the DRO qualification standard that “no DRO has a lower current credit rating” for:

- other non-commercial debt securities<sup>4</sup> rated “A” to qualify for exclusion from concentration testing
- qualifying short-term financial institution debt that is highly rated to qualify for exclusion from concentration testing

<sup>4</sup> “Other non-commercial debt securities” are primarily made up of lower credit-rated debt issued by governments other than Canada, the United Kingdom and the United States.





- Canadian bank paper that is highly rated to qualify for client free credit segregation purposes.

We propose the following DRO qualification standard for determining the applicable credit-rating risk weighting adjustment factors for debt securities:

- if only one current credit rating that rating applies
- if two current credit ratings, the lower rating applies
- if more than two current credit ratings, refer to the highest two ratings and apply the lower rating
- where no security credit rating exists, the issuer credit rating minus 1 IIROC adjustment factor ranking may be used.

## 2.2 Minimum credit rating requirement for Canadian bank paper that is eligible for client free credit segregation purposes

We propose minimum credit rating requirements for Canadian bank paper that is eligible for client free credit segregation purposes.

In order to qualify, Canadian bank paper will need to meet the minimum DRO current credit rating and qualification standards indicated in columns 2 and 3:

<b>Securities eligible for client free credit segregation purposes</b>		
<b>1. Category</b>	<b>2. Minimum designated rating organization current credit rating</b>	<b>3. Qualification(s)</b>
Canadian bank paper with an original maturity of 1 year or less <sup>5</sup>	R-1(low), F1, P-1, A-1(low)	No <b>designated rating organization</b> has a lower current credit rating  Must be issued by a Canadian <b>chartered bank</b>

<sup>5</sup> As previously detailed in IIROC Notice [16-0090](#), only Canadian Bank with an *original term to maturity* that is within 1 year is eligible to meet the client free credit segregation obligations. This requirement is meant to ensure that only Canadian Bank Paper that is exempt from the Bank Recapitalization (Bail-in) Conversion Regulations is eligible for client free credit segregation purposes. See Bank Recapitalization (Bail-in) Conversion Regulations: SOR/2018-57, (<http://www.gazette.gc.ca/rp-pr/p2/2018/2018-04-18/html/sor-dors57-eng.html>).



### **2.3 New Schedule 9: separate, but related, tests for debt and current Schedule 9 positions**

The risk profiles for debt and equity securities are different. We believe the best approach to include debt securities margined at  $\leq 10\%$  within the securities concentration test framework is to test these securities separately from current Schedule 9 positions. We believe that separate tests will:

- reduce complexity
- increase transparency
- measure risk more accurately than combining these exposures.

Therefore, we propose to separate Schedule 9 into three sections:

- Schedule 9 - Summary Sheet
- Schedule 9A - General Security Test (current Schedule 9)
- Schedule 9B - Debt Security Test.

To supplement this notice, we have included:

- a reference table (Appendix B), which highlights the changes to current Schedule 9 made on proposed Schedules 9, 9A, and 9B
- a simplified example to demonstrate the reporting methodology for proposed Schedules 9, 9A and 9B (Appendix C).

### **2.4 Schedule 9 – Summary Sheet**

Under the proposal, amount loaned exposures for current Schedule 9 positions and debt issuer securities margined at  $\leq 10\%$  are initially calculated and reported separately under Schedules 9A and 9B. The top ten amount loaned exposures from Schedules 9A and 9B will feed into the Schedule 9 Summary Sheet (hereafter **Schedule 9**). Dealer Members will report the adjusted amount loaned for each issuer and any applicable concentration charges on Schedule 9. On Schedule 9, the amount loaned exposures are subject to the same concentration threshold(s) and equivalent concentration charge requirements.

#### **Calculation requirements**

The proposed notes and instructions to Schedule 9 will provide the fundamental calculation requirements for determining the (1) amount loaned, (2) concentration thresholds, and (3) concentration charges that are applicable for both Schedules 9A and 9B concentration exposures. These requirements are the same as current Schedule 9, with a notable proposed



amendment to allow an adjustment to the amount loaned calculation for security positions financed by limited recourse loans (this is a carry-over from the Original Proposal).

### **Ranking concentration exposures on Schedule 9**

Dealer Members will rank the issuer concentration exposures reported on Schedule 9 according to the amount loaned and determine what, if any, concentration charges are applicable for Statement B reporting. We also clarify in proposed Note 11 to Schedule 9, that concentration exposures exceeding thresholds measured at 1/3 of Risk Adjusted Capital (**RAC**) are ranked first on Schedule 9, even if the calculated amount loaned is less than an exposure in a non-related issuer exposure.<sup>6</sup>

### **Multiple exposures**

The same methodology for determining lower concentration threshold limits for additional issuer exposures that applies under current Schedule 9 note 10(d), will apply to the exposures reported on Schedule 9. For example, if the largest amount loaned exposure reported on Schedule 9 is greater than 1/2 of RAC, the next amount loaned exposure is measured against 1/2 of RAC<sup>7</sup>, whether it originates from Schedule 9A or 9B. This treatment will also apply to positions from the same issuer that are tested separately under the General Security Test and the Debt Security Test.

### **Maximum concentration charge**

We also propose that capital charges for debt security exposures originating from Schedule 9B be limited to the loan value of the issuer security(ies) for long positions and the market value of short positions. For current Schedule 9 positions originating from Schedule 9A there is no change to the current concentration charge approach: long positions are limited to loan value; and no explicit cap on charges for short positions.

In addition, as detailed below in subsection 2.6.5, which discusses the risk-weighting methodology for Schedule 9B (Debt Security Test), we propose an adjustment factor for determining the concentration charge for debt securities margined at  $\leq 10\%$ . The adjusted

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<sup>6</sup> This ranking methodology is implied in Note 10(d) to current Schedule 9, which states that if a violation is incurred at the 1/3 RAC threshold, additional exposures on any other non-related issuer are measured at 1/2 RAC. If violations over 1/3 RAC are not ranked first on Schedule 9 there is the risk that the proper threshold reduction sequencing for additional exposures will not be applied properly. Exposures measured against a 1/3 RAC threshold that do not exceed the threshold should not receive priority ranking.

<sup>7</sup> Note that related or “non-arm’s length” securities” and non-marginable securities of an issuer held in cash accounts are always measured against a 1/3 RAC threshold.



concentration charge rate ensures that the concentration charge is equivalent to the “150% of the excess” requirement applicable to current Schedule 9 positions.<sup>8</sup>

## **2.5 Schedule 9A – General Security Test (current Schedule 9)**

Proposed Schedule 9A requires detailed reporting on the individual exposures for each issuer, according to the same framework as current Schedule 9. The notes and instructions to Schedule 9A provide details regarding:

- issuer securities tested
- exclusions
- treatment of exposures to broad based index positions.

The proposed notes and instructions to Schedule 9A come from current Schedule 9 and there are no material changes, other than noted in section 2.4 above.

## **2.6 Schedule 9B – Debt Security Test**

Proposed Schedule 9B requires detailed reporting on the individual exposures for each issuer, according to the same framework as current Schedule 9, with new columns for disclosing the credit rating risk-weighting adjustments available (columns 10 and 11), and the credit rating adjusted concentration charge rate (column 12). The credit rating risk-weightings adjust-down the amount loaned for eligible debt securities and the credit rating adjusted charge rate readjusts the calculated concentration charge, if any, on Schedule 9. The notes and instructions to Schedule 9B provide details regarding:

- issuer securities tested
- exclusions
- Dealer Member’s own inventory position netting allowance
- additional amount loaned adjustments available through credit rating risk-weighting adjustments
- credit rating adjusted concentration charge rate for calculating the concentration charge on Schedule 9.

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<sup>8</sup> As detailed in current Schedule 9, note 10, concentration charges apply at a rate of 150% of the excess of the calculated amount loaned exposure over the concentration threshold, which is a prescribed fraction (typically 2/3) of the Dealer Member’s pre-concentration risk adjusted capital (RAC) and minimum capital.



### 2.6.1 Issuer securities tested

The Debt Security Test methodology applies to debt securities margined at  $\leq 10\%$ . These securities are tested separately from the other securities of an issuer included for testing under the General Security Test. An issuer position must include all debt issuance classes or series of securities for an issuer (i.e. all long and short positions in debt securities margined at  $\leq 10\%$ , other than debt securities specifically excluded from testing).

### 2.6.2 Exclusions

The Debt Security Test methodology excludes non-commercial debt securities with a normal margin rate of 10% or less and financial institution debt with an original maturity of 1 year or less that meet the following minimum designated rating organization current credit rating requirements:

<b>Exclusions from Schedule 9B</b>			
<b>Category</b>		<b>Minimum designated rating organization current credit rating</b>	<b>Qualification</b>
1.	Non-commercial debt securities with a normal margin rate of less than 10%, issued or guaranteed by the following: <ul style="list-style-type: none"> <li>• national governments of Canada, United Kingdom, and United States</li> <li>• Canadian provincial governments</li> <li>• the International Bank for Reconstruction and Development</li> <li>• Canadian and United Kingdom municipal corporations.</li> </ul>	Not applicable (N/A)	Not applicable (N/A)
2.	Other non-commercial debt securities with a normal margin rate of 10% or less	A	No <b>designated rating organization</b> has a lower current credit rating
3.	Debt obligations and other evidences of indebtedness with an original maturity of 1 year or less, issued or guaranteed by the following: <ul style="list-style-type: none"> <li>• A Canadian financial institution qualifying as an acceptable institution</li> <li>• A foreign financial institution qualifying as an acceptable institution</li> </ul>	R-1(low), F1, P-1, A-1(low)	No <b>designated rating organization</b> has a lower current credit rating



### **2.6.3 Netting allowances for debt security inventory positions**

Dealer Members are allowed to exclude debt margin offsets recognized in DMR 100 from proposed Schedule 9B. Non-commercial debt securities must meet eligibility requirements to qualify for a debt margin offset under DMR 100.4C, which include the following requirements:

- offsetting securities must mature within the same periods referred to in DMR 100.2 for the purpose of determining margin
- offsetting securities must have a single A or higher credit rating.

We propose additional netting allowances for Schedule 9B inventory reporting. Dealer Members may calculate a debt issuer, concentration exposure on a net basis, subject to the requirement that offsetting securities must meet the seniority relationship described below.

Dealer Members may net within and across the maturity band periods referred to in DMR 100.2 (PLR 5200) to calculate their own inventory net long (short) exposure for an issuer's debt securities margined at  $\leq 10\%$ . However, the offsetting of positions is only allowed if:

- the positions are of the same seniority, or
- the short position is junior in the statutory creditor hierarchy, or contractually subordinated, to the long position.

This is similar to the netting framework outlined by the Basel Committee on Banking Supervision in their 2014 report on measuring and controlling large exposures.<sup>9</sup> The principle underlying this netting allowance is that the short position is junior to the long position, which may result from:

- statutory subordination
- contractual subordination, or
- any other recognized and enforceable means.

### **2.6.4 Credit rating risk-weighting adjustments to amount loaned**

The reported amount loaned may be reduced by applying a risk-weighting adjustment factor if the debt security(ies) meets the minimum current credit requirement from at least one designated rating organization as indicated in the following table:

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<sup>9</sup> See Basel Committee on Banking Supervision, Standards, "Supervisory framework for measuring and controlling large exposures (<https://www.bis.org/publ/bcbs283.pdf>) (April 2014), pg. 10.



<b>Credit rating risk-weighting adjustments for debt securities margined at 10% or less</b>				
	<b>Minimum designated rating organization long term rating</b>	<b>Minimum designated rating organization short term rating</b>	<b>Adjustment factor</b>	<b>Multiple designated rating organization current credit ratings</b>
1.	AAA	R-1(low), F1, P-1, A-1(low)	40%	If only one current credit rating, that rating applies.
2.	AA to A	Not applicable	60%	
3.	BBB	R-2, F3, P-3, A-3	80%	
4.	Below BBB	Below R-2, F3, P-3, A-3	100%	If two current credit ratings, the lower rating applies.
5.	Not rated	Not rated	100%	
				If more than two current credit ratings, refer to the highest two ratings and apply the lower rating.

In order to qualify for a risk-weighting adjustment factor, the following additional eligibility standards apply:

- commercial debt securities must be ranked senior to any outstanding equity securities from the same issuer in the statutory creditor hierarchy, or contractually
- where no security credit rating exists, the “issuer credit rating minus 1 IIROC adjustment factor ranking” may be used (subject to the multiple designated rating organization current credit rating methodology). For example, if the security is not rated, but the issuer has a credit rating of AA, the security may use a credit rating of BBB and is eligible for an adjustment factor of 80%.
- structured finance products as defined in National Instrument 25-101 are not eligible for credit rating risk-weighting adjustments.

Dealer Members can apply the credit rating risk-weighting adjustment factors as an additional allowable adjustment to the existing amount loaned calculations detailed in the notes to Schedule 9.



## 2.6.5 Adjusted concentration charge rate for calculating concentration charge on Schedule 9

We propose to maintain the same concentration charge rate for all securities covered by Schedule 9, which is 150%. In order to maintain the 150% concentration charge rate it is necessary to apply an adjustment factor to normalize the concentration charge for debt securities eligible for credit rating risk-weighting adjustments. This is because the credit rating risk-weighting adjustment to the amount loaned also acts to reduce the original concentration charge rate.

For example, adjusting a “AAA” debt security’s amount loaned value by a 40% adjustment factor and testing it against 2/3 RAC is comparable to testing an unadjusted exposure against a 5/3 RAC threshold. Table 2 compares adjusted and unadjusted equivalent exposures and capital charges.

**Table 2 – Adjusted and unadjusted equivalent exposures and capital charges**

Category	1. Amount Loaned	2. Adjusted Amount Loaned (40%)	3. RAC	4. 2/3 RAC	5. 5/3 RAC	6. Capital Charge (150% Rate) <sup>10</sup>	7. Adjusted Concentration Charge Rate (Amount Loaned/Adjusted Amount Loaned)	8. Adjusted Capital Charge
1.Unadjusted (5/3 RAC Threshold)	\$1,700	n/a	\$1,000	n/a	\$1,666.67	\$50.00	n/a	n/a
2.Adjusted (2/3 RAC Threshold)	\$1,700	\$680	\$1,000	\$666.67	n/a	\$20.00	2.50	\$50.00

Dealer Members will report the adjusted concentration charge rate on Schedule 9 and use it to calculate concentration charges, if applicable.

This adjustment ensures that we do not cap concentration charges below the full market value of short position exposures and the full loan value exposure of long positions.

## 2.7 Assessing the credit rating risk-weighting adjustments to amount loaned

One of the challenges in determining appropriate adjustment factors for debt securities is that these securities have a *lower probability of loss* but a *higher potential exposure to loss* (higher amount loaned exposure) than the current Schedule 9 positions tested. Current Schedule 9 positions have higher margin rates than debt securities, which leads to different margin rate haircuts in determining a Dealer Member’s pre-concentration RAC, which is the threshold for securities concentration testing.

<sup>10</sup> The capital charge calculation: ((Gross or Adjusted Amount Loaned – RAC Threshold) x Capital Charge Rate).

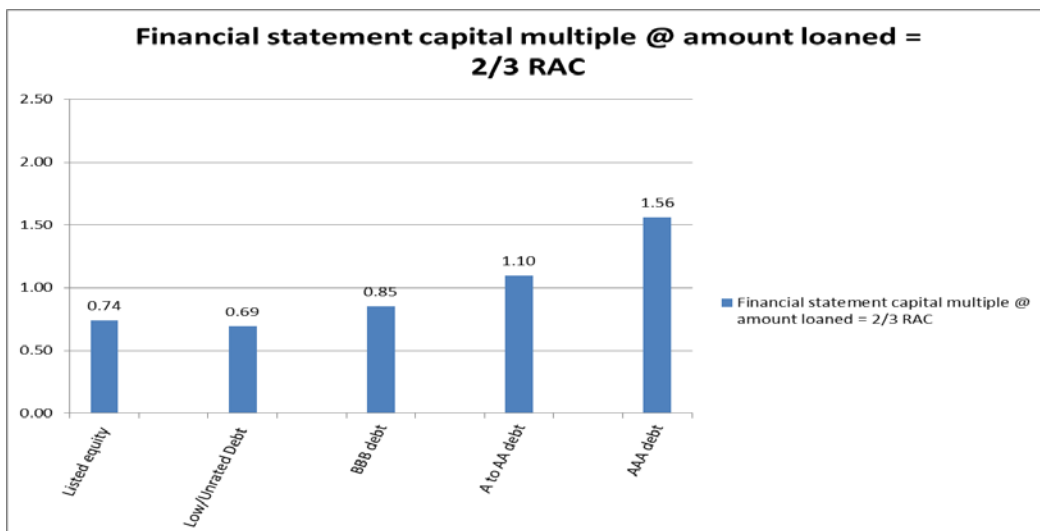




One way to assess the proposed credit rating risk-weighting adjustment factors, which considers margin rate differentials, is to compare the maximum market value exposures possible for different investment products under various RAC exposure testing scenarios. Exhibit A provides comparative data for a Dealer Member where financial statement capital is the same under each investment scenario. The financial statement capital multiple is the ratio of the amount invested in the security over the firm’s financial statement capital. The Exhibit A ratios show the maximum exposures for each security that will result in an amount loaned exposure of 2/3 RAC, which is the maximum concentration exposure that will not attract a capital charge for a first exposure in a non-related security.

Exhibit A shows that a Dealer Member may have a maximum market value exposure in a listed security margined at 30% that is 74% of its financial statement capital without exceeding the 2/3 RAC exposure limit. The proposed adjustment factors allow incrementally higher exposures for debt securities with higher credit-risk ratings.

**Exhibit A – Maximum financial statement capital multiples for equity and risk-weighted debt (amount loaned @ 2/3 RAC)<sup>11</sup>**



**2.8 Issues and alternatives considered**

As detailed in [IIROC Rules Notice 16-0090](#), we withdrew the Original Proposal and committed to develop revised proposed amendments that would consider the use of credit ratings as a risk-weighting tool to scale debt securities margined at <=10% into the securities concentration test.

<sup>11</sup> This example provides ratios for a simple capital structure where there is one asset (security) in each case, and the RAC is determined by deducting the security’s margin rate. All of the debt securities shown have a margin rate of 10%. The listed equity has a margin rate of 30%.



We considered a wide range of alternatives in developing the Proposed Amendments. In 2016, we developed an alternative proposal that relied on a progressive, concentration charge-weighting methodology for debt securities. However, after considerable review, including consultations with IIROC’s Financial and Operations Advisory Section (FOAS) Capital Formula Subcommittee, we reassessed our approach, and developed the Proposed Amendments.

We believe the Proposed Amendments address the concerns identified in the Original Proposal and represent an effective approach to introduce debt securities margined at  $\leq 10\%$  into the current securities concentration test framework. In addition, relying on the term designated rating organization aligns the IIROC rules with securities laws.

## 2.9 Comparison with similar provisions

Table 3 provides an overview of IIROC’s securities concentration rules, compared with the rules in the United Kingdom (U.K.) and the United States (U.S.).

**Table 3 – Investment firm securities concentration rules in three jurisdictions**

Jurisdiction	Securities concentration rules	Notable Exemptions
1. U.K. - Financial Conduct Authority (FCA); and EU Legislation – Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR)	Article 392 of the CRR defines a large exposure as an institution’s exposure to a client or group of connected clients, which in aggregate equals or exceeds 10% of the firm’s eligible capital. In general, large exposures may not exceed 25% of the firm’s eligible capital.(See Articles 392 and 395-397 CRR)	There are a number of eligible exemptions, including: asset items constituting claims on: <ul style="list-style-type: none"> <li>• central governments</li> <li>• central banks</li> <li>• public sector entities</li> <li>• international organizations</li> <li>• multilateral development banks.</li> </ul> The CRR also allows some discretionary authority to the relevant “competent authorities” to determine other possible exemptions.(Article 400 CRR and See FCA IFPRU 8.2)
2. U.S. - Securities and Exchange Commission (SEC)	SEC Rules identify an undue concentration, subject to capital charges, if the value of a security exceeds 10% of tentative net capital. (SEC Rule 15c3-1)	“Exempted securities” such as U.S. Treasury securities. (SEC Rule 15c3-1)
3. Canada - IIROC current	IIROC Rules identify securities concentrations, subject to capital charges, in issuer positions and precious metals positions that exceed the defined percentage of Risk Adjusted Capital (RAC) in Schedule 9. (IIROC Form 1, Schedule 9)	<ul style="list-style-type: none"> <li>• Securities required to be in segregation or safekeeping</li> <li>• Debt securities margined at <math>\leq 10\%</math>.</li> <li>• Stripped coupons and residuals if they are held on a book based system and are in respect of federal and provincial debt instruments</li> </ul> (IIROC Form 1, Schedule 9)
4. Canada - IIROC proposed	IIROC Rules identify securities concentrations, subject to capital charges, in issuer positions and precious metals positions that exceed the defined	<ul style="list-style-type: none"> <li>• Securities required to be in segregation or safekeeping,</li> <li>• Stripped coupons and residuals if they are held on a book based system and are in</li> </ul>



Jurisdiction	Securities concentration rules	Notable Exemptions
	<p>percentage of Risk Adjusted Capital (RAC) in Schedule 9.</p> <p>Schedule 9 has separate sub-schedules for calculating exposures to debt securities margined at <math>\leq 10\%</math> (Debt Security Test) and other securities and precious metal positions margined at <math>&gt; 10\%</math> (General Security Test)</p> <p>(Proposed IIROC Form 1, Schedule 9)</p>	<p>respect of federal and provincial debt instruments</p> <ul style="list-style-type: none"> <li>Non-commercial debt securities with a normal margin rate of less than 10% issued or guaranteed by the following: <ul style="list-style-type: none"> <li>national governments of Canada, United Kingdom, and United States</li> <li>Canadian provincial governments</li> <li>the International Bank for Reconstruction and Development</li> <li>Canadian and United Kingdom municipal corporations</li> </ul> </li> <li>Other non-commercial debt securities with a normal margin rate of 10% or less (DRO rating requirement)</li> <li>Debt obligations and other evidences of indebtedness with an original maturity of 1 year or less, issued or guaranteed by the following: <ul style="list-style-type: none"> <li>a Canadian financial institution qualifying as an acceptable institution (DRO rating requirement)</li> <li>a foreign financial institution qualifying as an acceptable institution (DRO rating requirement)</li> </ul> </li> </ul> <p>(Proposed IIROC Form 1, Schedule 9)</p>

Table 4 provides references to similar regulatory provisions regarding minimum DRO current credit rating requirements and qualification standards.

**Table 4 – Sources for proposed DRO minimum ratings and qualifications**

IIROC Notice Section Reference	Minimum designated rating organization current credit rating	Qualification	Securities law or other jurisdiction regulatory requirements
2.2 Minimum credit rating requirement for Canadian bank paper that is eligible for client free credit segregation purposes	R-1(low), F1, P-1, A-1(low)	No designated rating organization has a lower current credit rating	Section 1.1, definition of “designated rating” ((b) Commercial Paper/Short Term Debt), National Instrument 81-102 <i>Mutual Funds</i>
2.6.2 Exclusions ( <i>from</i> )	R-1(low), F1, P-1, A-1(low)	No designated rating	Section 1.1, definition of



IIROC Notice Section Reference	Minimum designated rating organization current credit rating	Qualification	Securities law or other jurisdiction regulatory requirements
<p><i>Schedule 9B regarding qualifying financial institution debt with an original maturity of 1 year or less)</i></p>		<p>organization has a lower current credit rating</p>	<p>“designated rating” ((b) Commercial Paper/Short Term Debt), National Instrument 81-102 <i>Mutual Funds</i></p> <p>Section 1.1, definition of “cash equivalent” ((c) a Canadian financial institution, or a financial institution that is not incorporated or organized under the laws of Canada...), National Instrument 81-102 <i>Mutual Funds</i></p>
<p>2.6.2 Exclusions (from Schedule 9B regarding Other non-commercial debt securities with a normal margin rate of 10% or less )</p>	<p>A</p>	<p>No designated rating organization has a lower current credit rating</p>	<p>Section 1.1, definition of “designated rating” ((b) Long Term Debt), National Instrument 81-102 <i>Mutual Funds</i></p>
<p>2.6.4 Credit rating risk-weighting adjustments to amount loaned</p>	<p><i>Minimum investment grade debt securities eligible for adjustment factor:</i></p> <p><u>Long term rating:</u> BBB</p> <p><u>Short term rating:</u> R-2, F3, P-3, A-3</p>	<p><i>Multiple designated rating organization current credit ratings:</i></p> <p>If only one current credit rating, that rating applies.</p> <p>If two current credit ratings, the lower rating applies.</p> <p>If more than two current credit ratings, refer to the highest two ratings and apply the lower rating.</p>	<p><i>Minimum investment grade debt securities eligible for adjustment factor:</i></p> <p>Subsection 10.1(6), definition of “investment grade corporate debt security”, Companion Policy 21-101 CP <i>Marketplace Operation</i></p> <p>Section 1.1, definition of “designated rating”, National Instrument 44-101 <i>Short Form Prospectus Distributions</i></p> <p><i>Multiple designated rating organization current credit ratings:</i></p>



IIROC Notice Section Reference	Minimum designated rating organization current credit rating	Qualification	Securities law or other jurisdiction regulatory requirements
			Section 3.6.2.2 Multiple assessments, Capital Adequacy Requirements (CAR), Chapter 3 - Credit Risk - Standardized Approach, Office of the Superintendent of Financial Institutions (OSFI)

### 3. Impacts of the Proposed Amendments

The Proposed Amendments address the potential concentration risk posed by corporate debt and “other” non-commercial debt securities. We believe that revising Schedule 9 into separate sub-schedules for the General Security Test and the Debt Security Test will limit any unintended impacts that might result from aggregating all issuer securities into a single schedule for concentration testing.

The risk-weighting methodology we developed should allow Dealer Members to continue to conduct their core debt market business without any material impact. As part of our review, we conducted a Dealer Member debt concentration survey in 2016, which indicated that the potential regulatory capital impacts, if any, would be limited to a very small number of Dealer Members. All surveyed debt issuer exposures were within the Proposed Amendments’ concentration thresholds.<sup>12</sup> However, as discussed in section 4, we ask stakeholders to provide comments regarding the Proposed Amendments’ potential operational impacts.

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

### 4. Implementation

The Proposed Amendments build upon the existing Schedule 9 framework for securities concentration testing, which should ease the implementation process. They will require Dealer

<sup>12</sup> The survey included 35 Dealer Members. There were no reported issuer exposures greater than RAC and only 3 Dealer Members reported debt issuer exposures with gross loan values greater than 2/3 RAC. Only 1 Dealer Member reported multiple issuer exposures with gross loan values greater than 1/2 RAC. No Dealer Member triggered a concentration charge. The top 3 Dealer Members’ largest exposures were all in debt issuer securities with a credit rating between “A-AA” from a DRO.



Member and/or service-provider expense to ensure that existing compliance systems capture the new debt security exposures, and provide satisfactory DRO monitoring.

The stricter DRO monitoring standards indicated in section 2.1 will likely represent the greatest compliance challenge; however, we believe that complying with these requirements is feasible because we sourced these standards from Canadian securities legislation and OSFI.

We will implement the Proposed Amendments upon approval by the recognizing regulators within a reasonable period.

#### **4.1 Comments –potential operational impacts**

While we are seeking comments on all aspects of the Proposed Amendments, we also ask stakeholders to comment on:

- i. the implementation costs for the Proposed Amendments. If material, please provide details regarding the estimated costs where possible.
- ii. the expected operational impact on your firm of the Proposed Amendments generally, and the stricter DRO monitoring standards detailed in section 2.1 specifically.

### **5. Policy Development Process**

#### **5.1 Regulatory purpose**

We intend the Proposed Amendments 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
- promote the protection of investors.

#### **5.2 Regulatory process**

The Board of Directors of IIROC (**Board**) has determined the Proposed Amendments to be in the public interest and on June 27, 2018 approved them for public comment.

We developed the Proposed Amendments, and IIROC policy advisory committees (the FOAS Capital Formula Subcommittee and the FOAS) supported them.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend revisions 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 Recognizing Regulators. If the revisions or comments are material, we will



submit the Proposed Amendments including any revisions to the Board for approval for republication or implementation as applicable.

## **6. Appendices**

[Appendix A](#) - Black-line comparison of the Proposed Amendments to current DMRs and Form 1

[Appendix B](#) - Proposed Schedules 9, 9A, and 9B, and Notes and Instructions – Reference Table

[Appendix C](#) - Simplified Example – Reporting on proposed Schedules 9, 9A, and 9B

[Appendix D](#) - Black-line comparison of the plain language version of the Proposed Amendments to the most recently published proposed plain language rules.