

## IIROC NOTICE

### **Rules Notice Request for Comment Dealer Member Rules**

*Please distribute internally to:*

Credit  
Institutional  
Internal Audit  
Legal and Compliance  
Operations  
Regulatory Accounting  
Senior Management  
Trading Desk

*Contact:*

Mindy Kwok  
Information Analyst, Member Regulation Policy  
416 943-6979  
[mkwok@iiroc.ca](mailto:mkwok@iiroc.ca)

**12-0057  
February 17, 2012**

### **Amendments to Dealer Member Rules to permit partial swap offset strategies and the corresponding housekeeping amendments**

#### **Summary of nature and purpose of proposed amendments**

On January 31, 2012, the Board of Directors (the Board) of the Investment Industry Regulatory Organization of Canada (IIROC) approved the republication for comment of the proposed amendments to Dealer Member Rules, that would permit partial swap offsets [Dealer Member Rules 100.4F(a) and (d)] and the corresponding “housekeeping” amendments to unhedged swap positions [Dealer Member Rules 100.2(j) and (k)] (collectively, the Proposed Amendments).

The Proposed Amendments are intended to achieve the following objectives:

- to ensure that the capital requirements reflect the reduced position risk of partial swap offsets on interest rate and total performance swaps by extending the current margin treatment for swaps offsets to partial swap offsets in Dealer Member Rules 100.4F(a) and (d); and



- to clarify the minimum margin requirements for unhedged interest rate and total performance swap positions by explicitly stating in Dealer Member Rules 100.2(j) and (k) that there are two types of margin required (i.e. inventory margin and customer account margin).

### **Relevant proposal history**

The original proposed amendments to Dealer Member Rules 100.4F(a) and 100.4F(d), that would permit reduced margin for partial swap offset strategies were previously published for comment with IIROC Rules Notice 09-0049 on February 13, 2009. No public comments were received and no revisions have been made to them in the current proposal. In response to CSA comments received on the original proposed amendments to Dealer Member Rules 100.4F(a) and 100.4F(d), IIROC staff agreed to make “housekeeping” amendments to Dealer Member Rules 100.2(j) and 100.2(k) in order to clarify the minimum margin requirements for unhedged swap positions.

### **Reasons for republication**

IIROC is republishing the Proposed Amendments for public comment for the following reasons:

1. to incorporate the “housekeeping” amendments for margining unhedged swap positions into the original proposed amendments for margining partial swap offset positions, because it is essential to properly determining the capital required for a partial swap offset strategy; and
2. to provide an opportunity for the public to review and revisit the original proposed amendments on partial swap offsets with the additional “housekeeping” amendments, as it has been more than two years since the publication for comment of the original proposed amendments on partial swap offsets.



## **Issues and specific Proposed Amendments**

### **CURRENT RULES**

#### *Dealer Member Rules 100.4F(a) and 100.4F(d)*

Current Rules 100.4F(a) and 100.4F(d) stipulate that swap positions (for each pair of interest rate swap or total performance swap offsets) may be netted where the notional amount of the offsetting swap or underlying security position is the same. The current rules, however, are silent on the question of whether partial offsets between two positions with different notional amounts are permitted. Consequently, under current rules even partially offset positions would be required to be margined separately, which results in a higher overall margin requirement than necessary to cover the positions' risk.

The following two examples are used to illustrate the rationale for allowing partial swap offsets:

1. A Dealer Member is long two interest rate swaps with underlying notional amounts of \$50 million and \$25 million, respectively, and short an interest rate swap with an underlying notional amount of \$50 million. Assuming all positions are either fixed or variable, current Rule 100.4F(a) would allow for the netting of the \$50 million long and short swap positions but would require margin on the remaining \$25 million long swap position.
2. Another Dealer Member is long one interest rate swap of \$75 million and short one interest rate swap of \$50 million. Assuming all positions are either fixed or variable, current Rule 100.4F(a) does not allow these positions to be offset because the notional amounts are not the same. Margin would be required on both the \$75 million and the \$50 million swap positions, although the risk exposure is equivalent to holding a single \$25 million long swap position.

IIROC is of the opinion that partial offsets should be allowed, given that the economic risk exposures that are inherent in these two scenarios are the same.

This logic applies equally to total performance swap offsets, as a result, it is proposed that partial offsets also be allowed for total performance swaps.

The proposed rule amendments and a black-line copy of the Dealer Member Rules affected by these amendments are set out in Attachments B and C.



Dealer Member Rules 100.2(j) and 100.2(k)

The current Dealer Member Rules 100.2(j) and 100.2(k) do not explicitly state that inventory margin is to be provided, irrespective of the type of counterparty to the swap transaction, although the rules has always been intended to reflect this methodology. Without this distinction, the calculation could result in reduced or zero margin required in the Dealer Member's account.

**PROPOSED RULES**

Dealer Member Rules 100.4F(a) and 100.4F(d)

The proposed amendments to Dealer Member Rules 100.4F(a) and 100.4F(d) for margining partial swap offset strategies are required to align the capital requirements for each offset with its respective risk. Specifically, the proposed amendments to Dealer Member Rules 100.4F(a) and 100.4F(d) set out in Attachment B would:

- add the term “or agreements” to cover the situation where multiple swap contracts are entered into; and
- specifically permit the provision of reduced margin for the partial offset of swap agreements.

These proposed amendments were previously approved by the Board on December 16, 2008.

Dealer Member Rules 100.2(j) and 100.2(k)

The purpose of the “housekeeping” amendments to Dealer Member Rules 100.2(j) and 100.2(k) for margining unhedged swap transactions is to clarify there are two types of margin required (i.e. inventory margin and customer account margin). Specifically, the proposed “housekeeping” amendments to Dealer Member Rules 100.2(j) and 100.2(k) set out in Attachment B would:

- add the subheadings “Inventory margin” and “Customer account margin”, respectively to reflect that there are two types of margin required; and
- add the term “customer account margin” to emphasize that margin must be provided by the customer, where needed.

The Proposed Amendments and a black-line copy of the Dealer Member Rules affected by these amendments are set out in Attachments B and C.

***IIROC Notice 12-0057 Rules Notice – Request for Comments – Amendments to Dealer Member Rules to permit partial swap offset strategies and the corresponding housekeeping amendments***



### **Rule making process**

The Proposed Amendments were developed by IIROC staff and recommended for approval by the FAS Capital Formula Subcommittee and the Financial Administrators Section, two policy advisory committees of IIROC.

### **Issues and alternatives considered**

The Proposed Amendments do not create any onerous new obligations for Dealer Members and have been drafted to clarify the existing requirements with unhedged swap positions and to accurately reflect the reduced risk of partial swap offset strategies. Furthermore, no alternatives have been considered.

### **Proposed Rule classification**

In deciding to propose these amendments, IIROC identified that there was a need to permit reduced margin for partial offsets involving either interest rate swaps or total performance swaps, because Dealer Members should be motivated through the capital requirements to at least partially reduce/hedge position risk and the margin requirements for unhedged swap positions needed to be clear.

This need was assessed as being in the public interest and not detrimental to the best interests of the capital markets. As a result, the Board has classified the Proposed Amendments as a Public Comment Rule proposal and is not contrary to the public interest.

### **Effects of the Proposed Amendments on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance**

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

The Proposed Amendments are intended to promote the efficient use of capital and to align the capital and margin requirements with the offset risk as well as to clarify the calculation of capital requirements in the current rules on unhedged swap positions. It is believed that the Proposed Amendments will have no impact in terms of capital market structure, competition generally, cost of compliance and conformity with other rules. The Proposed Amendments do 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.

### **Technological implications and implementation plan**

IIROC does not expect any significant technological implications for Dealer Members as a result of the Proposed Amendments.

### **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 March 19, 2012 (30 days from the publication date of this notice). One copy should be addressed to the attention of:

Mindy Kwok  
Information Analyst, Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
Suite 2000, 121 King Street West  
Toronto, Ontario, M5H 3T9

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, Ontario, M5H 3S8  
[marketregulation@osc.gov.on.ca](mailto: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](http://www.iiroc.ca) under the heading “IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received”).

Questions may be referred to:

Mindy Kwok  
Information Analyst, Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
416-943-6979

***IIROC Notice 12-0057 Rules Notice – Request for Comments – Amendments to Dealer Member Rules to permit partial swap offset strategies and the corresponding housekeeping amendments***



[mkwok@iroc.ca](mailto:mkwok@iroc.ca)

### **Attachments**

- Attachment A – Board Resolution
- Attachment B – Proposed Amendments to Dealer Member Rules
- Attachment C – Black-line of Proposed Amendments
- Attachment D – Proposed Plain Language Version of Dealer Member Rules 100.4F(a) & (d) and 100.2(j) &(k)

## **Attachment A**

### **INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**

#### **AMENDMENTS TO DEALER MEMBER RULES TO PERMIT PARTIAL SWAP OFFSETS STRATEGIES AND THE CORRESPONDING HOUSEKEEPING AMENDMENTS**

##### **BOARD RESOLUTION**

BE IT RESOLVED ON THE 31st DAY OF January, 2012, THAT:

1. The English and French versions of the proposed amendments to the Dealer Member Rules regarding the margin requirements for offset swap strategies and unhedged swap positions involving interest rate swaps and total performance swaps, in the form presented to the Board of Directors (the “Board”):
  - (a) be approved for republication for public comment for 30 days;
  - (b) the President be authorized to approve such non-material changes to the proposed amendments resulting from the public comments or as may be necessary in securing the approval of the Recognizing Regulators as required under the IIROC Terms and Conditions of Recognition, such approval to constitute final approval for implementation by the Board of the proposed amendments;
  - (c) be brought back to the Board for approval in final form where there are material changes to the proposed amendments resulting from the public comments or the Recognizing Regulators.

## **Attachment B**

### **INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**

#### **AMENDMENTS TO DEALER MEMBER RULES TO PERMIT PARTIAL SWAP OFFSET STRATEGIES AND THE CORRESPONDING HOUSEKEEPING AMENDMENTS**

##### **PROPOSED AMENDMENTS**

1. Dealer Member Rules 100.4F(a) and (d) are amended by:
  - (a) Adding the words “or agreements” after the words “swap agreement”; and
  - (b) Adding the words “notional amount or same partial” after the words “reference to the same”.
  
2. Dealer Member Rule 100.2(j) is amended by:
  - (a) Adding the subtitle “Inventory margin” after the first sentence;
  - (b) Adding the words “Dealer Member’s” before the word “obligation”;
  - (c) Deleting the word “the” immediately before the word “entitlement”;
  - (d) Adding in the word “inventory” before the word “components”;
  - (e) Adding the subtitle “Customer account margin” after clause (ii);
  - (f) Deleting the words “The counterparty to the interest rate swap agreement shall be considered the Dealer Member’s customer. No”;
  - (g) Adding the words “No customer account” immediately before the words “margin is required for”;
  - (h) Deleting the words “an interest rate swap entered into with a customer,” immediately before the words “which is an acceptable institution.”;
  - (i) Replacing the words “is an” with the word “are” immediately before the words “acceptable institution.”;
  - (j) Replacing the words “institution. The” with the words “institutions relating to the interest rate swap agreement. The customer account” immediately after the words “which is an acceptable”; and
  - (k) Adding the words “customer account” immediately before the words “margin requirement for customers which are other”.
  
3. Dealer Member Rule 100.2(k) is amended by:
  - (a) Adding the subtitle “Inventory margin” after the title “Total Performance Swaps”;
  - (b) Adding the words “Dealer Member’s” before the word “obligation”;

## **Attachment B**

- (c) Deleting the word “the” immediately before the word “entitlement”;
- (d) Adding in the word “inventory” before the word “components”;
- (e) Adding the subtitle “Customer account margin” after clause (ii);
- (f) Deleting the words “The counterparty to the total performance swap agreement shall be considered the Dealer Member’s customer. No”;
- (g) Adding the words “No customer account” immediately before the words “margin is required for a total performance swap”;
- (h) Replacing the words “a total performance swap entered into with a customer, which is an acceptable institution. The” with the words “customers which are acceptable institutions relating to the total performance swap agreement. The customer account”; and
- (i) Adding the words “customer account” immediately before the words “margin requirement for customers which are other”.

**INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**

**AMENDMENTS TO DEALER MEMBER RULES TO PERMIT PARTIAL SWAP OFFSET STRATEGIES AND THE  
CORRESPONDING HOUSEKEEPING AMENDMENTS**

**BLACK-LINE COPY**

**Dealer Member Rules 100.4F(a) and (d)**

**100.4F. Swap Positions Offset**

For the purposes of this regulation, a “**fixed interest rate**” is an interest rate, which is not reset at least every 90 days, a “**floating interest rate**” is an interest rate, which is not a fixed interest rate and “**realization clause**” is an optional clause within a total performance swap agreement which allows the Dealer Member to close out the swap agreement at the realization price (either the buy-in or sell-out price) of the security position involved in the offset.

**(a) Interest Rate Swap versus Interest Rate Swap Offset**

Where a Dealer Member

- (i) is a party to an interest rate swap agreement or agreements requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar fixed (or floating) interest rate amounts calculated with reference to a notional amount;

and

- (ii) is a party to another offsetting interest rate swap agreement or agreements entitling it to receive (or requiring it to pay) a fixed (or floating) interest rate amount calculated with reference to the same notional amount or same partial notional amount, denominated in the same currency and is within the same maturity band for margin purposes as the interest rate swap referred to in (i);

the margin required in respect of the positions in (i) and (ii) may be netted, provided that margin on fixed interest rate component payment (or receipt) positions may only be offset against margin on fixed interest rate component receipt (or payment) positions, and margin on floating interest rate component payment (or receipt) positions may only be offset against margin on other floating interest rate component receipt (or payment) positions.

.  
.  
**(d) Total Performance Swap versus Total Performance Swap Offset**

Where a Dealer Member:

(i) is a party to a total performance swap agreement [or agreements](#) requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar amounts calculated based on the performance of a stipulated underlying security or basket of securities, with reference to a notional amount;

and

(ii) is a party to another total performance swap agreement [or agreements](#) entitling it to receive (or requiring it to pay) amounts calculated based on the performance of the same underlying security or basket of securities, with reference to the same [notional amount or same partial](#) notional amount and denominated in the same currency;

the margin required in respect of the positions in (i) and (ii) may be netted, provided that margin on performance component payment (or receipt) positions may only be offset against margin on performance component receipt (or payment) positions, and margin on floating interest rate component payment (or receipt) positions may only be offset against margin on other floating interest rate component receipt (or payment) positions.

**Dealer Member Rules 100.2(j) and (k)**

**(j) Interest Rate Swaps**

For the purposes of this regulation, a "fixed interest rate" is an interest rate, which is not reset at least every 90 days and a "floating interest rate" is an interest rate, which is not a fixed interest rate.

[Inventory margin](#)

On interest rate swap agreements where payments are calculated with reference to a notional amount, the [Dealer Member's](#) obligation to pay and ~~the~~ entitlement to receive shall each be margined as separate [inventory](#) components as follows:

(i) Where a component is a payment calculated according to a fixed interest rate, the margin required shall be the margin rate specified in Rule 100.2(a)(i) for a security with the same term to maturity as the outstanding term of the swap, multiplied by 125% and in turn multiplied by the notional amount of the swap;

- (ii) Where a component is a payment calculated according to a floating interest rate, the margin required shall be the margin rate specified in Rule 100.2(a)(i) for a security with the same term to maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

Customer account margin

~~The counterparty to the interest rate swap agreement shall be considered the Dealer Member's customer. No~~ No customer account margin is required for ~~an interest rate swap entered into with a customer,~~ customers which ~~is an~~ are acceptable ~~institution.~~

~~The~~ institutions relating to the interest rate swap agreement. The customer account margin requirement for customers, which are acceptable counterparties, shall be any market value deficiency calculated relating to the interest rate swap agreement. The customer account margin requirement for customers which are other counterparties shall be any loan value deficiency calculated relating to the interest rate swap agreement, determined by using the same margin requirements for each swap component as calculated in clauses (i) and (ii) above.

**(k) Total Performance Swaps**

Inventory margin

On total performance swap agreements, the Dealer Member's obligation to pay and ~~the~~ entitlement to receive shall each be margined as separate inventory components as follows:

- (i) Where a component is a payment calculated based on the performance of a stipulated underlying security or basket of securities, with reference to a notional amount, the margin requirement shall be the normal margin required for the underlying security or basket of securities relating to this component, based on the market value of the underlying security or basket of securities;
- (ii) Where a component is a payment calculated according to a floating interest rate, the margin required shall be the margin rate specified in Rule 100.2(a)(i) for a security with the same term to maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

Customer account margin

~~The counterparty to the total performance swap agreement shall be considered the Dealer Member's customer. No~~ No customer account margin is required for ~~a total performance swap entered into with a customer, which is an acceptable institution.~~ The customers which are acceptable institutions relating to the total performance swap

## **Attachment C**

[agreement. The customer account](#) margin requirement for customers, which are acceptable counterparties, shall be any market value deficiency calculated relating to the total performance swap agreement. The [customer account](#) margin requirement for customers which are other counterparties shall be any loan value deficiency calculated relating to total performance rate swap agreement, determined by using the same margin requirements for each swap component as calculated in clauses (i) and (ii) above.

**INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**

**AMENDMENTS TO DEALER MEMBER RULES TO PERMIT PARTIAL SWAP OFFSET STRATEGIES AND THE  
CORRESPONDING HOUSEKEEPING AMENDMENTS**

**PROPOSED PLAIN LANGUAGE VERSION OF DEALER MEMBER RULES 100.4F(A) & (D) AND  
100.2(J) & (K)**

**Proposed Plain Language Dealer Member Rule sections 5440 through to 5442:**

**INTEREST RATE AND TOTAL PERFORMANCE SWAPS**

**5440. Interest rate swaps**

- (1) On *interest rate swap* agreements where payments are calculated with reference to a notional amount, the *Dealer Member's* obligation to pay and entitlement to receive must each be margined as separate components as follows:
  - (i) Where a component is a payment calculated according to a *fixed interest rate*, the margin required is the margin rate percentage specified in subsection 5210(1) Category (i) for a security with the same term to maturity as the outstanding term of the swap, multiplied by 125% and in turn multiplied by the notional amount of the swap;
  - (ii) Where a component is a payment calculated according to a *floating interest rate*, the margin required is the margin rate percentage specified in subsection 5210(1) Category (i) for a security with the same term to maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

**5441. Total performance swaps**

- (1) On *total performance swap* agreements, where payments are calculated with reference to a notional amount, the *Dealer Member's* obligation to pay and entitlement to receive must each be margined as separate components as follows:
  - (i) Where a component is a payment calculated based on the performance of a stipulated *underlying security* or basket of securities, with reference to a notional amount, the margin requirement is the *normal margin* required for the *underlying security* or basket of securities relating to this component, based on the market value of the *underlying security* or basket of securities;
  - (ii) Where a component is a payment calculated according to a *floating interest rate*, the margin required is the margin rate percentage specified in subsection 5210(1) Category (i) for a security with the same term to

maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

**5442. Swap client account margin requirement**

- (1) The counterparty to the swap agreement is considered the *Dealer Member's* client and the minimum margin the *Dealer Member* must obtain from the swap client is as follows:
  - (i) Where the swap client is an acceptable institution, no client account margin is required; or
  - (ii) Where the swap client is an acceptable counterparty or regulated entity, the client account margin is any market value deficiency calculated relating to the swap agreement; or
  - (iii) Where the counterparty is an other counterparty, the client account margin is any *loan value* deficiency calculated relating to the swap agreement determined by using the same approach as set out in sections 5440 and 5441 for *Dealer Member* swap positions.

**Proposed Plain Language Dealer Member Rule sections 5680 and 5682:**

**OFFSETS ONLY AVAILABLE FOR DEALER MEMBER INVENTORY POSITIONS**

**SWAP POSITIONS**

**5680. Offset involving two interest rate swap agreements**

- (1) Where a Dealer Member
  - (i) is a party to an *interest rate swap* agreement or agreements requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar fixed (or floating) interest rate amounts calculated with reference to a notional amount;and
  - (ii) is a party to another offsetting *interest rate swap* agreement or agreements entitling it to receive (or requiring it to pay) a fixed (or floating) interest rate amount calculated with reference to the same notional amount or same partial notional amount, denominated in the same currency and is within the same *maturity band* for margin purposes as the *interest rate swap* referred to in (i);

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

against the *normal margin required* on the *fixed interest rate* receipt (or payment) component position, and the *normal margin required* on the *floating interest rate* payment (or receipt) component position may only be offset against the *normal margin required* on the *floating interest rate* receipt (or payment) component position.

**5682. Offsets involving total performance swap agreements and underlying securities**

- (1) **Offset involving two total performance swap agreements** - Where a Dealer Member:
- (i) is a party to a *total performance swap* agreement or agreements requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar amounts calculated based on the performance of a stipulated *underlying security* or basket of securities, with reference to a notional amount;
- and
- (ii) is a party to another *total performance swap* agreement or agreements entitling it to receive (or requiring it to pay) amounts calculated based on the performance of the same *underlying security* or basket of securities, with reference to the same notional amount or same partial notional amount and denominated in the same currency;

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