

# IIROC NOTICE

## **Rules Notice Request for Comments**

Dealer Member Rules

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*Contact:*

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[aramcharan@iiroc.ca](mailto:aramcharan@iiroc.ca)

**14-0148**  
**June 12, 2014**

## **Margin requirements for debt security obligations of supranational entities**

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

On May 7, 2014, the Board of Directors (“Board”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) approved the publication for comment of the proposed amendments to Dealer Member Rule 100.2(a)(ii) (“proposed amendments”). The objective of the proposed amendments is to extend the margin requirements that currently apply solely to debt securities issued by the International Bank for Reconstruction and Development, to debt securities issued by other comparable supranational entities.

Specifically, the proposed amendments as set out in Attachment A would:

- replace the specific reference to only one supranational entity, the International Bank for Reconstruction and Development, with the term “supranational entity”; and



- add the definition of the term “supranational entity”, which includes the high a credit rating criterion of Aaa or AAA for the entity to qualify.

## **Issues and specific proposed amendments**

### ***Current Rules***

IIROC’s existing general margin requirement framework with respect to government debt, allows preferred margin treatment for debt security obligations that are issued or guaranteed by a single national government whose risk of default is considered to be very low. The debt security obligations of Canada, the United Kingdom, the United States and any other national government with a Aaa or AAA credit rating are recognized for the preferred margin treatment in that framework. The proposed amendments would extend this margin treatment rationale to debt security obligations that are guaranteed by multiple national governments where the risk of default is considered to be very low.

The International Bank for Reconstruction and Development is a supranational entity<sup>1</sup> that offers loans to middle-income developing countries. These loans are funded primarily through the International Bank for Reconstruction and Development (IBRD) issuing bonds on international capital markets. These debt securities are obligations of the IBRD. Current IIROC Dealer Member Rule 100.2(a)(ii) stipulates that the margin requirements for IBRD debt security obligations vary from 0.50%, for a 90-day term-to-maturity, to 5% for a long term debt security. This Dealer Member Rule does not currently apply to debt security obligations of any other supranational entity.

Margin rates applicable to debt instruments issued by other supranational entities (including bonds and other obligations) are currently set out in Dealer Member Rule 100.2(a)(iv), *Other non-commercial bonds and debentures (not-in default)*. These margin rates differ from those applicable to IBRD debt obligations and currently set at 10% of the debt obligation’s market value.

In recent years, the number of debt instruments issued by other supranational entities has significantly increased. Furthermore, IIROC staff have reviewed and compared information with respect to supranational entities from a number of sources—including the Bank of Canada, Basel Committee on Banking Supervision, the Canadian Securities Administrators, Financial Industry Regulatory Authority, Moody’s Investor Services, Standard & Poor’s Rating Services and various supranational entities—which in our view support the rationale for the proposed amendments. As part of that review, we compared key facts on various supranational entities,

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<sup>1</sup> In general, a supranational institution is an institution owned by the governments of two or more countries. The institution is usually established by international treaties in order to pursue specified policy objectives (e.g. to promote economic development of their less -developed or regional member countries) and are generally not subject to commercial law. (Source: Standard & Poor’s)



the credit rating reviews of various supranational entities, credit rating agencies' credit rating methodology for supranational entities, and the reduced-risk treatment of debt security obligations of specific supranational entities by other jurisdictions and/or regulatory organizations. In light of these factors, IIROC staff believe that it is necessary and appropriate to apply the same margin requirements to debt security obligations of the IBRD and other supranational entities that have a similar risk profile.

### ***Comparison across other jurisdictions/regulatory organizations***

Other jurisdictions and regulatory organizations have established their own criteria and/or definition for supranational entities, which would allow for a more favourable margin treatment to be applied to these debt instruments. In general, these regulatory regimes permit high-credit quality supranational entities to be treated favourably from a risk perspective, which supports our proposed amendments use of a high credit rating criterion.

An overview of the existing provisions found in other jurisdictions and/or regulatory organizations is as follows:

- *Basel Committee on Banking Supervision*

The Basel Committee on Banking Supervision (BCBS) sets its own evaluation criteria for multilateral development banks (a sub-category of supranational entities). The BCBS also publishes a list of multilateral development banks (which currently include 10 supranational entities<sup>2</sup>) that are eligible for a 0% risk weight. The 10 supranational entities are: (1) the African Development Bank, (2) the Asian Development Bank, (3) the European Bank for Reconstruction and Development, (4) the European Investment Bank, (5) the Inter-American Development Bank, (6) the International Bank for Reconstruction and Development, (7) the International Finance Corporation, (8) the Nordic Investment Bank, (9) the Council of Europe Development Bank, and (10) the Caribbean Development Bank. Each of these supranational entities, with the exception of the Caribbean Development Bank, have received a 'Aaa' or 'AAA' credit rating from Moody's and Standard & Poor's Corporation, respectively.

- *National Instruments 45-106 - Prospectus and Registration Exemptions, and 81-102 - Mutual Funds*

National Instruments 45-106 (NI 45-106) and 81-102 each define the following entities as "permitted supranational agency":

- the African Development Bank,

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<sup>2</sup> The current list of multilateral development entities recognized under the Basel Committee on Banking Supervision is published January 2001 in their Consultative Document: The Standardized Approach to Credit Risk.



- the Asian Development Bank,
- the Caribbean Development Bank,
- the European Bank for Reconstruction and Development,
- the Inter-American Development Bank,
- the International Bank for Reconstruction and Development, and
- the International Finance Corporation.

In addition to these entities, NI 81-102 also defines the European Investment Bank as a “permitted supranational agency”. Each of these entities has been rated ‘Aaa’ or ‘AAA’ by Moody’s or Standard & Poor’s Corporation, respectively, with the exception of the Caribbean Development Bank which is currently rated ‘Aa1’ and ‘AA’.

A comparison of qualifying supranational entities under the IIROC proposed rule and permitted supranational entities by the BCBS and/or under NI 45-106 and NI 81-102 is set out in Attachment C.

- *Financial Industry Regulatory Authority (FINRA) in the U.S.*

Under FINRA’s margin requirements (FINRA Rule 4210), debt securities issued by a supranational entity are included within the definitions of a “highly rated foreign sovereign debt securities”, “investment grade debt securities” and “major foreign sovereign debt” and are given preferred margin treatments. Further, FINRA relies on credit rating criteria, rather than a list of supranational entities, to determine eligibility under these definitions.

### ***Proposed Rule***

The regulatory issue that the proposed amendments are intended to address arises from the fact that currently, higher margin requirements (i.e. 10% of market value) apply to debt securities issued by other highly rated supranational entities than those that apply to debt securities issued by the International Bank for Reconstruction and Development (i.e. 0.50%, for a 90-day term-to-maturity debt security, to 5.00% for a long term debt security). To address this issue, the proposed amendments to Dealer Member Rule 100.2(a)(ii) seek to bring greater uniformity to the application of margin requirements to debt security obligations of highly rated supranational entities. Given the importance of this issue in better achieving the intent of this rule, IIROC staff are of the opinion that extending the current margin treatment of Dealer Member Rule 100.2(a)(ii) to other supranational entities that meet a ‘Aaa’ or ‘AAA’ credit rating from Moody’s or Standard & Poor’s, respectively, is an appropriate way of addressing this issue. Further, utilizing the credit rating provided by Moody’s and Standard & Poor’s is also consistent with IIROC margin requirements for debt securities issued by foreign federal governments—the same governments that guarantee the obligations of these highly rated



supranational entities. Additionally, a definition of supranational entity would be added to the rule that would include the credit rating criterion.

The proposed amendments define “supranational entity” as an entity whose capital is provided by two or more national governments, whose obligations are explicitly or implicitly guaranteed by those governments, and who is currently rated Aaa by Moody’s or AAA by Standard & Poor’s Corporation. We used the words “implicitly guaranteed” in the proposed definition, because a supranational entity is able to, at any time, call on those governments who have committed capital to the supranational entity, to service the debt security obligations of the supranational entity.

Other supranational entities that do not meet the proposed definition of “supranational entity” in the rule would continue to be subject to the margin requirements set out in Dealer Member Rule 100.2(a)(iv), *Other non-commercial bonds and debentures (not in default)*.

The proposed amendments and a black-line-copy of the amended Dealer Member Rule affected by these amendments are set out in Attachments A and B.

### **Issues and alternatives considered**

One of the issues IIROC staff faced in developing the proposed amendments to Dealer Member Rule 100.2(a)(ii), is that there is a global shift in attitude and rule making towards preventing the undue reliance on credit ratings in assessing the credit risk of a security. While we appreciate that concern and that in large part it related to illiquid structured products whose underlying assets and capitalization were questionable, the IIROC proposed amendments relate to debt security obligations of very visible, established and transparent government-supported entities who are capitalized by two or more national governments and are highly rated, Aaa or AAA.

In developing the amendments to Dealer Member Rule 100.2(a)(ii), two alternatives were considered, in addition to the approach that is being proposed. The first was to add individual supranational entities on a request by request basis within the rule. The second was to add them on a request by request basis to a separate “list of qualifying supranational entities” within a guidance note. While consideration was given to those two alternatives, IIROC staff are proposing an approach that is more principles based, objective and self-policing (e.g. by describing the elements that must be met to be a supranational entity under the rule versus deciding case by case).



## **Rule-making process**

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

## **Proposed amendments classification**

Statements have been made elsewhere as to the nature and purpose of the proposed amendments, as well as in the analysis. The purposes of the proposed amendments are to:

- maintain rules that are necessary or appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity; and
- promote just and equitable requirements that would ensure efficient use of Dealer Member capital.

The Board therefore has determined that the proposed amendments are not contrary to 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 amendments on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance**

The proposed amendments will not have any significant impact on Dealer Members or non-Dealer Members, market structure or competition. Furthermore, it is not expected that there will be any significant increase in the costs of compliance as a result of the proposed amendments.

The proposed amendments do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in furtherance of IIROC's regulatory objectives. They do not impose costs or restrictions on the activities of market participants (including Dealer Members and non-Dealer Members) that are disproportionate to the goals of the regulatory objectives sought to be realized.

## **Technological implications and implementation plan**

The proposed amendments will have no material impact on Dealer Members' systems. As such, it is intended that the proposed amendments will be implemented shortly after approval is received from IIROC's 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 10, 2014 (90 days from the publication date of this notice). One copy should be addressed to the attention of:

Answerd Ramcharan  
Specialist, Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
121 King Street West, Suite 2000  
Toronto, Ontario, M5H 3T9  
aramcharan@iiroc.ca

The second copy should be addressed to the attention of:

Manager of Market Regulations  
Ontario Securities Commission  
19<sup>th</sup> Floor, Box 55  
20 Queen Street West  
Toronto, Ontario, M5H 3T9  
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:

Answerd Ramcharan  
Specialist, Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
E-mail: [aramcharan@iiroc.ca](mailto:aramcharan@iiroc.ca)  
Tel.: 416-943-5850

### **Attachments**

- Attachment A – Proposed amendments to Dealer Member Rule 100.2(a)(ii) regarding margin requirements for debt security obligations of supranational entities
- Attachment B – Black-line copy of the proposed amendments regarding margin requirements for debt security obligations of supranational entities
- Attachment C – Comparison of qualifying supranational entities under the IIROC proposed rule and permitted supranational entities by the BCBS and in NI 81-102

**INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA  
PROPOSED AMENDMENTS TO DEALER MEMBER RULE 100.2(a)(ii)  
PROPOSED AMENDMENTS**

1. Dealer Member Rule 100.2(a)(ii) is amended by:
  - (a) Replacing the words “the International Bank for Reconstruction and Development” with the words “supranational entity”;
  - (b) Adding the sentence ““supranational entity” means an entity whose capital is provided by two or more national governments, whose obligations are explicitly or implicitly guaranteed by those governments, and who is currently rated Aaa by *Moody’s* or AAA by *Standard & Poor’s Corporation*.” after the words “5% of market value”.



**INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA  
PROPOSED AMENDMENTS TO DEALER MEMBER RULE 100.2(A)(II)  
BLACK-LINE COPY**

**PROPOSED RULE**

“100.2. For the purpose of Rule 17.13 and this Rule 100 the following margin requirements are hereby prescribed:

(a) Bonds, Debentures, Treasury Bills and Notes

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(ii) Bonds, debentures, treasury bills and other securities of or guaranteed by any province of Canada and obligations of ~~the International Bank for Reconstruction and Development~~ a supranational entity, maturing (or called for redemption):

within 1 year	2% of market value multiplied by the fraction determined by dividing the number of days to maturity by 365
over 1 year to 3 years	3% of market value
over 3 years to 7 years	4% of market value
over 7 years to 11 years	5% of market value
over 11 years	5% of market value

“supranational entity” means an entity whose capital is provided by two or more national governments, whose obligations are explicitly or implicitly guaranteed by those governments, and who is currently rated Aaa by Moody’s or AAA by Standard & Poor’s Corporation.”

**Attachment C  
to IROC Notice 14-0148**

**COMPARISON OF QUALIFYING SUPRANATIONAL ENTITIES UNDER THE IROC PROPOSED RULE AND  
PERMITTED SUPRANATIONAL ENTITIES BY THE BCBS AND THE CANADIAN SECURITIES  
ADMINISTRATORS IN NATIONAL INSTRUMENT 81-102**

Issuer		Moody's Credit Ratings <sup>3</sup>	S&P's Credit Ratings <sup>4</sup>	IROC Propo sed Rule	BCBS <sup>5</sup>	NI 81- 102 <sup>6</sup>
1.	African Development Bank	Aaa	AAA	✓	✓	✓
2.	Asian Development Bank	Aaa	AAA	✓	✓	✓
3.	EUROFIMA European Company for the Financing of Railroad Rolling Stock		AAA	✓		
4.	European Atomic Energy Community		AAA	✓		
5.	European Bank for Reconstruction and Development	Aaa	AAA	✓	✓	✓
6.	European Central Bank (Unsolicited Ratings)	Aaa	AAA	✓		
7.	European Coal & Steel Community in Liquidation		AAA	✓		
8.	European Investment Bank	Aaa	AAA	✓	✓	✓
9.	European Investment Fund	Aaa	AAA	✓		
10.	European Union	Aaa	AAA	✓		
11.	IDB Trust Services Ltd.	Aaa	AAA	✓		
12.	Inter-American Development Bank	Aaa	AAA	✓	✓	✓
13.	International Bank for Reconstruction and Development (part of The World Bank Group)	Aaa	AAA	✓	✓	✓
14.	International Finance Corporation (part of The World Bank Group)	Aaa	AAA	✓	✓	✓
15.	Islamic Development Bank	Aaa	AAA	✓		
16.	Nordic Investment Bank	Aaa	AAA	✓	✓	
17.	Council of Europe Development Bank	Aaa	AA+	✓	✓	
18.	International Finance Facility for Immunisation	(P)Aaa	AA+	✓		
19.	Caribbean Development Bank	Aa1	AA		✓	✓
20.	North American Development Bank	Aaa	A+	✓		

<sup>3</sup> Moody's Research & Ratings/Sovereign & Supranational <<https://www.moodys.com>>. Accessed October, 2013.

<sup>4</sup> Standard & Poor's Government Rating List: Supranational <<http://www.standardandpoors.com/ratings/supranational/ratings-list/en/us/?subSectorCode=40&sectorId=1221186707758&subSectorId=1221187348524>>. Accessed: January 7, 2013.

<sup>5</sup> Basel Committee on Banking Supervision – The Standardized Approach to Credit Risk. Published in January, 2001.

<sup>6</sup> National Instrument 81-102 *Mutual Funds*, definition of “permitted supranational agency”