

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

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Contact:

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**09-0050
February 13, 2009**

Amendments to Dealer Member Rules Regarding Conversion and Reconversion Offset Strategies

Summary of nature and purpose of Proposed Amendments

On January 28, 2009, 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 the Dealer Member Rules (the Rules) that would amend and clarify the key language used in describing the calculations for determining the minimum capital and margin requirements for Conversions and Reconversions throughout the IIROC Rulebook.

Dealer Member Rule 100 currently refers to Conversions (Long Tripos) and Reconversions (Short Tripos) in the three sections:

- *Option and security combinations* – 100.9(g)(v), 100.9(g)(vi), 100.10(g)(v) and 100.10(g)(vi)
- *Index option combinations with index baskets and index participation units* – 100.9(h)(ii)(E), 100.9(h)(ii)(F), 100.10(h)(ii)(E) and 100.10(h)(ii)(F)



- *Index option combinations with index futures contracts* – 100.9(h)(v)(E), 100.9(h)(v)(F), 100.10(h)(v)(E) and 100.10(h)(v)(F).

While each of these sections indicates the same fundamental structure for either a Conversion (Long Tripo) or Reconversion (Short Tripo), the key language used in describing the calculation for determining the minimum margin requirement is inconsistent between the sections.

Moreover, because the rules relating to Conversions and Reconversions do not require the strikes on the calls and puts to be the same, it is important that the rules are clear in describing how to calculate the minimum required margin, because there is the potential that the maximum loss may not be covered if one incorrectly uses exercise values relating to the calls when the exercise values relating to the puts should have been used, and vice versa.

In particular, IIROC's analysis indicates that the current key language used in the Reconversion offsets is imprecise and, in some scenarios, can lead to under-margining of the Reconversion offset positions. These issues can be addressed through rule wording changes that will correct the calculation methodology for Reconversions, and at the same time, make clear and consistent, the calculation methodology for both Conversions and Reconversions in the three sections of Dealer Member Rule 100 where they are present

The primary objective of the Proposed Amendments is to make explicit which option's exercise values are to be used in calculating minimum capital and margin requirements. The secondary objective of the Proposed Amendments is housekeeping in nature, and it is to ensure language consistency across the three sections where these offsets are present.

Issues and specific Proposed Amendments

The current IIROC Dealer Member Rules do not clearly indicate which options (calls or puts) to use in the calculations, resulting in the potential for inaccurate minimum margin or capital requirements. IIROC Dealer Member Rules for options are designed to cover maximum loss scenarios.

For a Conversion (Long Tripo) the main margin calculation can be expressed mathematically as follows:

Margin = (Market Value Stock – Option with the Lowest Exercise Value) + (Long Put Value – Short Call Value)

In order for the rules to cover the maximum loss scenario, it is necessary that the rules stipulate that the options with the lowest exercise value are used in the calculation. If the calculation uses the higher exercise value options, an inaccurate amount will result, reflecting the maximum possible gain. Therefore, the language for the three long tripo combination sections [100.9(g)(v), 100.9(h)(ii)(E), and 100.9(h)(v)(E) for customer positions; and 100.10(g)(v), 100.10(h)(ii)(E), and 100.10(h)(v)(E) for Dealer Member positions] have been



simplified and clarified to refer to “whichever is lower”. Furthermore, the words “an equivalent number of” have been added to 100.9(h)(v)(E) and 100.10(h)(v)(E) to maintain language consistency across the long tripo combination sections.

For a Reconversion (Short Tripo), the main margin calculation can be expressed mathematically as follows:

Margin = (Option with the Highest Exercise Value – Market Value Stock) + (Long Call Value – Short Put Value)

In order for the rules to cover the maximum loss scenario, it is necessary that the rules stipulate that the highest exercise value options are used in the calculation. If the calculation is done properly, the margin requirement equals the maximum potential loss. If the calculation uses the lower exercise value options, an inaccurate amount will result, reflecting the maximum possible gain. Consequently, the language for the three short tripo combination sections [100.9(g)(vi), 100.9(h)(ii)(F), and 100.9(h)(v)(F) for customer positions; and 100.10(g)(vi), 100.10(h)(ii)(F), and 100.10(h)(v)(F) for Dealer Member positions] have been simplified and clarified to refer to “whichever is higher”. In addition, the words “an equivalent number of” have been added to 100.9(h)(v)(F) and 100.10(h)(v)(F) to maintain language consistency across the short tripo combination sections.

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

Proposed Rule Classification

In deciding to propose these amendments, IROC identified that there was a need to clarify and harmonize the language and calculation methodology used in determining the minimum capital and margin requirements for Conversions and Reconversions.

To address 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 determined that the Proposed Amendments are a Public Comment Rule proposal.

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

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

The specific purpose of the Proposed Amendments is to amend and clarify the key language used in describing the calculations for determining the minimum capital and margin requirements for Conversions and Reconversions in order to ensure that the risk of these positions is adequately covered.



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

It is not anticipated that there will be any system impacts resulting from the implementation of these rule changes. The Bourse de Montréal (the Bourse) is also in the process of passing this amendment. Implementation of this amendment will therefore take place once both the Corporation and the Bourse have received approval to do so from their respective recognizing regulators.

Request for public comment

Comments are sought on the Proposed Amendments. Comments should be made in writing. Two copies of each comment should be delivered by March 16, 2009 (30 days from the publication date of this notice). One copy should be addressed to the attention of:

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Investment Industry Regulatory Organization of Canada,
Suite 1600, 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

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 “IIROC Rulebook – Dealer Member Rules – Policy Proposals and Comment Letters Received”).



Questions may be referred to:

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Attachments

[Attachment A – Proposed Amendments](#)

[Attachment B – Black-line copy of IIROC Dealer Member Rule 100 reflecting amendments](#)