IIROC NOTICE

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Amendment to Dealer Member Rule 100.10(f)(vi) Box Spread

Overview and objective of the amendment

The Board of Directors of the Investment Industry Regulatory Organization of Canada ("IIROC") have approved for implementation the attached amendment to Dealer Member Rule 100.10(f)(vi) *Box Spread*. The amendment is effective October 1, 2015.

The primary objective of the amendment is to clarify the capital calculation for Dealer Member inventory account positions in a box spread option offset strategy, in order to ensure that the calculated capital requirement accurately reflects the risk of the offset strategy.

Description of a box spread

A box spread is an option strategy that combines a bull spread[1] and a bear spread[2] that have two different exercise prices and produces a risk-free payoff that is equal to the difference in exercise prices. A box spread can either be a long box spread or a short box spread.

The net profit of either a long or short box spread will approximate zero, and can be represented as follows:

- Profit on long box spread = payoff – net premium paid
- Profit on short box spread = net premium received – payoff

In either case, arbitrage profits are possible by locating favourable net premiums relative to the payoff.

Rationale for the amendment

The capital requirement for a box spread should be based on the offsetting risk from the payoff and the asset or liability represented by the net market value of the options. The current rule (Rule 100.10(f)(vi)) only captures one side of the "payoff vs. asset or liability" equation, and always generates a negative capital requirement because the offset requires the lesser of clauses (I) and (II) of the current rule, and one of the clauses will always be negative. The amendment changes the calculation from requiring the lesser of clauses (I) and (II) to requiring the sum of clauses (I) and (II), as shown in the enclosure. Summing clauses (I) and (II) will ensure that the capital calculation accurately matches the risk of the box spread strategy, effectively requiring capital that reflects any value differences in clause (I) from clause (II), based upon the valuation of the options.

Potential early exercise risk when American style options are used in a box spread strategy

Dealer Members are reminded that box spread option strategies composed of American style options are subject to the risk that an option could be exercised early. If this is the case, the remaining option positions would no longer be considered a box spread and the risk profile of the strategy would have changed. Accordingly, any alternate risk profile created as a result of unraveling an option spread strategy would be subject to other applicable capital requirements under IIROC Dealer Member Rule 100.

1 A "bull spread" is an option strategy that involves buying a call option with a lower exercise price and selling a call option with a higher exercise price. It can also be executed with put options.

2 A "bear spread" is an option strategy that involves selling a put with a lower exercise price and buying a put with a higher exercise price. It can also be executed with calls.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
AMENDMENT TO DEALER MEMBER RULE 100.10(F)(VI) BOX SPREAD

1. Dealer Member Rule 100.10(f)(vi)

(vi) Box spread

Where a Dealer Member account contains a box spread combination on the same underlying interest with all options expiring at the same time, such that a Dealer Member holds a long and short call option and a long and short put option and where the long call option and short put option, and short call option and long put option have the same strike price, the minimum capital required shall be the sum ~~lesser~~ of:

(I) the difference, plus or minus, between the aggregate exercise value of the long call options and the aggregate exercise value of the long put options; and

(II) the net market value of the options.