



INVESTMENT DEALERS
ASSOCIATION OF CANADA

bulletin



ASSOCIATION CANADIENNE DES
COURTIERS EN VALEURS MOBILIÈRES

Contact:
Jane Tan
Information Analyst, Regulatory Policy
416-943-6979

For distribution to relevant parties within your firm

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By-Laws and Regulations

Margin and Capital Requirements for Positions in and Offsets involving Interest Rate and Total Performance Swaps – Regulations 100.2(j), 100.2(k), and 100.4F

The Board of Directors of the Association has approved amendments to Regulations 100.2(j), 100.2(k), and 100.4F - positions in and offsets involving interest rate and total performance swaps. These changes are effective on January 1, 2004 and are enclosed as Attachment #1.

The current IDA rules only cover interest rate swaps and are of limited use in determining the margin requirements for positions in and offsets involving total performance swaps. These amendments establish formal capital and margin requirements for positions in and offsets involving total performance swaps. The implementation of these amendments makes redundant the previous guidance on equity swaps set out in Compliance Interpretation Bulletin C-109. In addition, a number of conforming changes have been made to the existing rules for interest rate swaps.

Kenneth A. Nason
Association Secretary

INVESTMENT DEALERS ASSOCIATION OF CANADA CAPITAL AND MARGIN REQUIREMENTS FOR SWAPS

THE BOARD OF DIRECTORS of the Investment Dealers Association of Canada hereby makes the following amendments to the By-laws, Regulations, Forms and Policies of the Association:

1. Regulation 100.2(j) is hereby repealed and replaced as follows:

“(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. On interest rate swap agreements where payments are calculated with reference to a notional amount, the obligation to pay and the entitlement to receive shall 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 shall be the margin rate specified in Regulation 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 Regulation 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.

The counterparty to the interest rate swap agreement shall be considered the Member's customer. No margin is required for an interest rate swap entered into with a customer, which is an acceptable institution. The margin requirement for customers, which are acceptable counterparties, shall be any market value deficiency calculated relating to the interest rate swap agreement. The 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.”

2. By adding new Regulation 100.2(k) as follows:

“(k) Total Performance Swaps

On total performance swap agreements, the obligation to pay and the entitlement to receive shall 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 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 Regulation 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.

The counterparty to the total performance swap agreement shall be considered the Member's customer. No margin is required for a total performance swap entered into with a customer, which is an acceptable institution. The margin requirement for customers, which are acceptable counterparties, shall be any market value deficiency calculated relating to the total performance swap agreement. The 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.”

3. Regulation 100.4F is hereby repealed and replaced as follows:

“100.4F. Swap Positions Offsets

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 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 Member:

(i) is a party to an interest rate swap agreement 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 entitling it to receive (or requiring it to pay) a fixed (or floating) interest rate amount calculated with reference to the same 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.

(b) Fixed Interest Rate Swap Component and Securities Position Offset

Where a Member:

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

and

- (ii) holds a long (or short) position in securities described in Regulation 100.2(a)(i) with a principal amount equal to and denominated in the same currency as the notional amount of the interest rate swap and with a term to maturity that is within the same maturity band for margin purposes as the interest rate swap;

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

(c) Floating Interest Rate Swap Component and Securities Position Offset

Where a Member:

- (i) is a party to an interest rate swap agreement requiring it to pay (or entitling it to receive) Canadian dollar or United States dollar floating interest rate amounts calculated with reference to a notional amount;
- (ii) holds a long (or short) position in securities described in Regulations 100.2(a)(i) or 100.2(b), maturing within one year with a principal amount equal to and denominated in the same currency as the notional amount of the swap;

the margin required in respect of the positions in (i) and (ii) may be netted.

(d) Total Performance Swap versus Total Performance Swap Offset

Where a Member:

- (i) is a party to a total performance swap agreement 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 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 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.

(e) Total Performance Swap Component and Securities Position Offset

- (i) **Short Performance Swap Component and Long Underlying Security or Basket of Securities**

Where a Member:

- (A) is a party to a total performance swap agreement requiring it to pay

amounts calculated based on the performance of a stipulated underlying security or basket of securities, with reference to a notional amount;

and

- (B) holds long an equivalent quantity of the same underlying security or basket of securities;

the capital required in respect of the positions described in (A) and (B) shall be either:

- (C) nil, where it can be demonstrated that sell-out risk relating to the offset has been mitigated:
 - (I) through the inclusion of a realization clause in the total performance swap agreement, which allows the Member to close out the swap agreement using the sell-out price(s) for the long position in the underlying security or basket of securities; or
 - (II) since, due to the features inherent in the long position in the underlying security or basket of securities or the market on which the security or basket of securities trades, the realization value of the long position in the underlying security or basket of securities is determinable at the time the total performance swap agreement is to expire and this value will be used as the closeout price for the swap.

or;

- (D) 20% of the normal capital required on the long position in the underlying security or basket of securities where sell-out risk relating to the offset has not been mitigated.

(ii) **Long Performance Swap Component and Short Underlying Security or Basket of Securities**

Where a Member:

- (A) is a party to a total performance swap agreement entitling it to receive amounts calculated based on the performance of a stipulated underlying security or basket of securities, with reference to a notional amount;

and

- (B) holds short an equivalent quantity of the same underlying security or basket of securities;

the capital required in respect of the positions described in (A) and (B) shall be:

- (C) nil, where it can be demonstrated that buy-in risk relating to the offset has been mitigated:
 - (I) through the inclusion of a realization clause in the total performance swap agreement, which allows the Member to close out the swap agreement using the buy-in price(s) for the short position in the underlying security or basket of securities; or

(II) since, due to the features inherent in the short position in the underlying security or basket of securities or the market on which the security or basket of securities trades, the realization value of the short position in the underlying security or basket of securities is determinable at the time the total performance swap agreement is to expire and this value will be used as the closeout price for the swap.

or;

(D) 20% of the normal capital required on the short position in the underlying security or basket of securities where buy-in risk relating to the offset has not been mitigated.”

PASSED AND ENACTED BY THE Board of Directors this 23rd day of October 2002, to be effective on a date to be determined by Association staff.