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Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

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Dealer Member Rules

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Margin requirements for certain cash and security borrowing and lending arrangements - Amendments to Schedules 1, 7 and 7A of Dealer Member Form 1

BACKGROUND AND HISTORY

General IIROC approach to assessing counterparty credit risks

The purpose of IIROC's capital and margin rules is to ensure that investment dealers are adequately capitalized to meet their obligations, including obligations to clients, on demand. As a result, the capital and margin rules focus on the major risks an investment dealer faces; namely market risk and counterparty or credit risk.

Historically, exposure to counterparty or credit risk has been minimal in the securities industry because transactions are generally executed on a "value for value"[1] basis. In other words, cash is exchanged for securities or vice versa, and the investment dealer retains as collateral, either cash or

[1] Transactions performed on a "value for value" basis are those where the market value of the cash or securities received in by the investment dealer is equal to the market value of the cash or securities delivered out by the investment dealer.

securities of equivalent value. Accordingly, the capital requirements focus on market risk and provide for fluctuations in the market value of securities.

Specific exemptions to this general "value for value" approach and current requirements that apply to these exceptions

There are, however, situations in which the use of the "value for value" approach is not practical as follows:

- an investment dealer must be able to leave cash deposits at certain deposit taking institutions on an unsecured basis;
- an investment dealer must be able hold securities at an external custodial location on an unsecured basis; and
- an investment dealer must be able to deliver a modest amount of additional collateral to a counterparty when borrowing either cash or securities from that counterparty, in order to avoid having to post additional collateral during the term of the arrangement, in response to market fluctuations.

To address these situations, IIROC's rules specify that:

- cash deposits may only be held for Dealer Members by a deposit taking institution that qualifies as an "acceptable institution"[2]
- securities may only be held for Dealer Members at an "acceptable securities location" pursuant to a written agreement that specifies that "…no use or disposition of the securities shall be made without the prior written consent of the Dealer Member and the securities can be delivered to the Dealer Member promptly on demand"; and
- where a cash and securities borrowing and lending arrangement is executed between a Dealer Member and a counterparty, that qualifies as either an "acceptable institution" or as an "acceptable counterparty", a modest amount of additional collateral may be delivered to the counterparty, without the Dealer Member being subject to a margin requirement.

Current margin requirements for cash and securities borrowing and lending arrangements

Background on cash/securities loan arrangements

A cash / securities loan is an agreement that is executed between a Dealer Member and another entity (referred to as a "counterparty"). The terms of the loan are governed by a loan agreement,

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[2] The "acceptable institution" category is one of the four categories of counterparties / clients set out in IIROC's capital and margin rules. Refer to Attachment C for a discussion of the four categories of counterparties.

which requires that the borrower provide the lender with collateral, in the form of cash, government issued securities or a letter of credit issued by a Schedule 1 bank, of a value equal to or greater than the loaned cash/securities. Major lenders of securities include investment funds, insurance companies, pension plans and other large investment portfolios. Securities borrowing is an important means of enabling hedge funds and other investment vehicles that follow a "short sale" strategy, to meet their transaction settlement obligations.

Current margin requirements

The current margin requirements for cash / securities loans allow Dealer Members to enter into such loans on:

- an unsecured basis with "acceptable institution"[3] counterparties;
- a modestly over-collateralized basis[4] with "acceptable counterparty"[5] counterparties;
- a "value for value" basis with "regulated entity"[6] counterparties; and
- a "loan value equivalency"[7] basis with "other"[8] counterparties

The effects of these margin requirements are to limit, in the case of a securities borrowing arrangement, the dollar amount of collateral that may be delivered to the borrower to the lending counterparty. The following table illustrates how the current IIROC rules limit the amount of collateral that may be delivered to the lending counterparty, where the Dealer Member is borrowing securities with a market value of $10,000,000:

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[3] See Attachment C for a description of "acceptable institutions".

[4] Transactions that involve a modest amount of over-collateralization are transactions where the market value of the cash or securities provided as loan collateral by investment dealer is slightly in excess of the market value of the cash or securities received in by the investment dealer pursuant to the loan arrangement. Street practice is to require 102% over-collateralization when cash is provided as loan collateral and 105% over-collateralization when securities are provided as loan collateral.

[5] See Attachment C for a description of "acceptable counterparties".

[6] See Attachment C for a description of "regulated entities".

[7] Transactions performed on a "loan value equivalency" basis are those where the loan value of the cash or securities (which is market value less margin) received in by the investment dealer is equal to the loan value of the cash or securities delivered out by the investment dealer.

[8] See Attachment C for a description of "other" counterparties.

Counterparty type	Market value of securities borrowed	Market value of collateral that may be delivered to the counterparty without the Dealer Member incurring margin
Acceptable institution	$10,000,000	Dealer Members may deal with "acceptable institutions" on an unsecured basis - Despite this fact, in the case of security borrowing arrangements current street practices are: • $10,200,000 [102%] when cash is provided as collateral; and • $10,500,000 [105%] when securities are provided as collateral.
Acceptable counterparty	$10,000,000	$10,200,000 [102%] to $10,500,000 [105%], depending upon whether cash or securities are provided as collateral
Regulated entity	$10,000,000	"Value for value" or $10,000,000 [100%]
Other counterparty	$10,000,000	"Loan value equivalency", which translates to: • greater than $10,000,000, when a Dealer Member is borrowing higher quality securities from a client in relation to the quality of the securities delivered as collateral • less than $10,000,000, when a Dealer Member is borrowing lower quality securities from a client in relation to the quality of the securities delivered as collateral

Concerns with current margin requirements

There are two concerns with the current margin requirements:

1. The current rules do not set out specific margin requirements for agency cash and security borrowing and lending arrangements; and
2. The current rules do not have the same margin requirements for cash and security borrowing and lending arrangements with "acceptable counterparty" versus "regulated entity" counterparties.

Agency agreements

Within the last year there has been a significant shift away from Dealer Members entering into cash and security borrowing and lending arrangements directly with the arrangement counterparty. Rather, the recent trend is for Dealer Members to execute an agency arrangement, whereby the Dealer Member enters into cash and security borrowing and lending arrangement with a custodian

who is acting as agent for the ultimate counterparty to the arrangement. These agency arrangements have the following features:

- A custodian that qualifies as an "acceptable institution" administers an agency lending program on behalf of its clients;
- Pursuant to the agency lending arrangements that are executed:
    - The agent custodian holds the loan collateral the Dealer Member must deliver under the arrangement without right to re-hypothecate;
    - The agent custodian can only make the collateral available to the ultimate loan counterparty in the event a Dealer Member default event occurs;
    - The agency agreement qualifies as an "Eligible Financial Contract" under Canadian legislation relating to bankruptcy, insolvency and creditor's rights, which means that the contract continues in the event that any party to the contract becomes insolvent.

Given the features of agency arrangements, IIROC staff have concluded that the risk assumed by a Dealer Member when entering into one of these arrangements is no greater than the risk assumed by a Dealer Member when entering directly into an equivalent "principal" arrangement with the same ultimate counterparty. Further, there is an argument to be made that the risk is lower as the Dealer Member:

- will not have its collateral frozen should the ultimate counterparty become insolvent; and
- will be able to quickly access its collateral should the custodian become insolvent, because the agency lending arrangement qualifies as an "Eligible Financial Contract".

The current notes and instructions to Schedules 1 and 7 of Dealer Member Form 1 do not discuss these specific types of agency arrangements, nor do they recognize that the risk of such arrangements is equivalent to comparable "principal" arrangements. The result is that Dealer Members are required, under the current IIROC margin rules, to provide additional margin for such arrangements in amounts that represent as much as 3% of the market value of the loan.

Different margin requirements for arrangements involving "acceptable counterparty" versus "regulated entity" counterparties

As a general rule, IIROC's rules encourage Dealer Members to transact with other regulated dealers on a "value for value" basis. This general rule currently applies to all cash and security borrowing and lending arrangements between a Dealer Member and:

- another Dealer Member; and
- another dealer that qualifies as a "regulated entity", such as a FINRA dealer.

It is now common street practice for Dealer Members to be asked to provide collateral with a value in excess of the amount of the loan when entering into cash and security borrowing and lending

arrangements with foreign dealers, despite the fact that these foreign dealers qualify as a "regulated entity" under IIROC's margin rules.

The current IIROC rules that apply to cash and security borrowing and lending arrangements, where the counterparty is an "acceptable counterparty" allow for delivery of excess collateral representing between 102% and 105% of the amount of the loan without any margin implication. As credit risk exposures to "acceptable counterparties" and "regulated entities" are treated the same way for all other transactions, there is no risk-related reason why a modest amount of excess collateral should not be permitted for cash and security borrowing and lending arrangements where the counterparty is a "regulated entity", without similar margin relief. Without this relief, however, Dealer Members are required under the current IIROC margin rules to provide margin for such arrangements, where a modest amount of over-collateralization is requested, in amounts that represent as much as 5% of the market value of the loan.

DETAILED DESCRIPTION OF PROPOSED AMENDMENTS

Objective of the proposed Amendments

The objective of the proposed Amendments is to allow a Dealer Member to deliver a modest amount of excess collateral to the arrangement counterparty (or their agent) ***without having to provide margin***, when they enter into a cash and security borrowing and lending arrangement with either an "acceptable counterparty" or a "regulated entity" - where such excess collateral or over-collateralization does not exceed:

- 102% of the loan when the collateral provided is cash; and
- 105% of the loan when the collateral provided is securities.

Description of the Amendments

To achieve this objective it is proposed that the Notes and Instructions to Schedules 1 and 7 and Schedule 7A of Dealer Member Form 1 be amended as follows:

- Amend the definition of "excess collateral deficiency" that appears in Note 2 of the Notes and Instructions to Schedules 1 and 7, such that margin only applies when the collateral provided is in excess of:
    - 102% of the loan when the collateral provided is cash; and
    - 105% of the loan when the collateral provided is securities.
- Introduce new note 5(b) to the Notes and Instructions to Schedules 1 and 7 to specify that the margin requirement is the same for certain qualifying agency cash and securities borrowing and lending arrangements as for the equivalent principal arrangement.

- Amend note 6(b) to the Notes and Instructions to Schedules 1 and 7 to set "market value deficiency" as the standard margin requirement for resale and repurchase agreements involving "acceptable counterparties" and "regulated entities" – while the current rules do allow over-collateralization for certain resale and repurchase agreements involving "acceptable counterparties", IIROC staff recommends that this margin requirement be revised from "excess collateral deficiency" to "market value deficiency" since:
    - overcollateralization is not a common practice for repurchase and resale agreements; and
    - allowing continued overcollateralization for repurchase and resale agreements would run counter to the Bank of Canada's proposal to introduce "haircuts" for these agreements in the near future.

Revise Schedule 7A to extend the existing overcollateralization concentration test, that currently only applies to overcollateralization exposures to "acceptable counterparties", to overcollateralization exposures to both "acceptable counterparties" and "regulated entities".

ISSUES AND ALTERNATIVES CONSIDERED

No other alternatives to the proposed Amendments were considered.

COMPARISON WITH SIMILAR PROVISIONS

Canada

Office of the Superintendent of Financial Institutions Canada

OSFI Guideline B-4 requires that lenders "should at all times hold adequate collateral to protect themselves against the risk associated with securities lending." When the guideline was issued in September 1996 it stipulated that the level of collateral would be considered adequate if collateral of at least 105% of the market value of the securities lent was obtained. This requirement was changed in April 2007 to "at least 102 per cent" to accommodate situations where a borrower provides cash as collateral.

Canadian Securities Administrators

Section 2.12 of National Instrument 81-102, requires that mutual funds obtain collateral that represents "at least 102 percent" of the market value of the securities lent when lending securities. This requirement was based on the equivalent OSFI requirement set out in OSFI Guideline B-4.

United States

Rule 15c3-1(c)(2)(iv)(B)/09 of the Securities Exchange Act of 1934 requires that securities loan deficits exceeding 5% (equates to 105% over-collateralization) must be provided for in computing a dealers regulatory net capital. The rule does not distinguish between situations where the dealer

has provides cash as loan collateral and situations where the dealer provides securities as loan collateral.

EFFECTS OF PROPOSED AMENDMENTS ON MARKET STRUCTURE, DEALER MEMBERS, NON-MEMBERS, COMPETITION AND COSTS OF COMPLIANCE

With the Proposed Amendments, Dealer Members will benefit from enhanced clarity and certainty in the Schedule and the required concentration calculations.

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.

CLASSIFICATION OF RULES AND AMENDMENTS AND FILING IN OTHER JURISDICTIONS

IIROC has determined that the proposed Amendments are Public Comment Rules and they will therefore be published for comment.

The proposed Amendments will be filed with each of IIROC's Recognizing Regulators, in accordance with s.3 of the Joint Rule Review Protocol contained in the IIROC Recognition Order.

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 June 11, 2014 (90 days from the publication date of this notice).

One copy should be addressed to the attention of:

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A 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

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 – Proposed Policy").

Attachments

Attachment A - Proposed amendments to Schedules 1, 7 and 7A [and related Notes and Instructions] of Dealer Member Form 1;

Attachment B - Proposed amendments to Schedules 1, 7 and 7A [and related Notes and Instructions] of Dealer Member Form 1 – BLACK-LINE VERSION; and

Attachment C - Discussion of four types of counterparties defined within IIROC's capital and margin rules.