

IIROC NOTICE

Rules Notice Request for Comment

Dealer Member Rules

Comments Due By: September 30, 2019

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Internal Audit
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Operations
Regulatory Accounting
Retail
Senior Management
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19-0154
August 29, 2019

Republication of Proposed Amendments to Dealer Member Rules and Form 1 regarding the securities concentration test and designated rating organizations

Executive Summary

IIROC is republishing for comment revisions to the previously published proposed amendments to its Dealer Member Rules (**DMRs**) and Form 1 (collectively, the **Proposed Amendments**). The Proposed Amendments are designed to bring debt securities with a normal margin rate of 10% or less (**debt securities margined at $\leq 10\%$**) into the existing securities concentration test, and also update the use of credit ratings, and references to credit rating agencies, in the DMRs and Form 1.

We developed the Proposed Amendments to address issues raised in the public comment letters that we received in response to IIROC Notice [18-0153](#), published on August 9, 2018 (**2018 proposed amendments**).



The Proposed Amendments retain the same fundamental framework for introducing debt securities margined at $\leq 10\%$ into Schedule 9 (concentration of securities), which is based on a designated rating organization (**DRO**) risk-weighting methodology. The primary differences between the Proposed Amendments and the 2018 proposed amendments relate to changes that recalibrate the DRO risk-weighting adjustment factors and other changes that should reduce operational complexity and related costs.

The Proposed Amendments:

- eliminate the adjusted concentration charge rate methodology described in section 2.6.5 of IIROC Notice [18-0153](#), which now results in a 150% concentration charge rate for all concentration exposures tested
- apply a 2-step concentration test methodology for debt securities margined at $\leq 10\%$ where a Dealer Member will not need to perform the second-step calculation if the first-step calculation does not exceed any concentration thresholds
- apply risk-weightings to all debt securities margined at $\leq 10\%$ with the maximum concentration margin capped at the risk-weighted loan value for long and short debt positions
- extend to client accounts the Dealer Member inventory netting allowances described in proposed Schedule 9B, Note 4
- eliminate the qualification “No DRO has a lower current credit rating” in proposed Schedule 9B, Note 3, qualifications for exclusion from Schedule 9B
- revise the concentration charge reporting requirement from applying to the largest five exposures to the largest three exposures originating from proposed Schedule 9A (also referred to as **General Security Test**) and the largest three exposures originating from proposed Schedule 9B (also referred to as **Debt Security Test**)
- revise the presentation of the table in proposed Schedule 9B, Note 5, to clarify that the 40% adjustment factor applies to minimum DRO short term ratings “above R2, F3, P-3, A-3”.
- add a qualification that Canadian bank paper issued by a Dealer Member’s provider of capital, as defined in Schedule 14, is not an eligible investment for client free credit segregation purposes.



Impacts

The Proposed Amendments reduce:

- conservatism in the DRO risk-weighting methodology
- operational complexity and projected costs for implementation and compliance.

We believe the Proposed Amendments address the potential operational and marketplace impacts identified in our review, without limiting the effectiveness of the proposed securities concentration test.

How to Submit Comments

Comments are sought on the Proposed Amendments, including any matter that they do not specifically address. Comments should be made in writing. Two copies of each comment letter should be delivered by September 30, 2019 (30 days from the publication date of this Notice). One copy should be addressed to the attention of:

Bruce Grossman
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Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
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bgrossman@iiroc.ca

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, ON 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 “Rulebook - IIROC Dealer Member Rules - Proposed Policy”).

Questions may be referred to:

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Rules Notice – Table of Contents

1. Background	5
1.1 2018 proposed amendments	5
1.2 Comments received	5
1.3 Republication	5
2. Discussion of Proposed Amendments	5
2.1 Addressing potential high operational cost and complexity to implement and maintain the 2018 proposed amendments	6
2.2 Addressing the uncertainty on whether Dealer Members are required to use one or multiple DRO ratings and resulting potential high operational cost	6
2.3 Addressing high DRO risk-weightings, and complexity of adjusted concentration charge rates for investment grade debt	7
3. Impacts of the Proposed Amendments	9
3.1 Dealer Member impacts	9
3.2 Marketplace impacts	10
3.3 Other impacts	10
4. Implementation	10
5. Policy Development Process	10
5.1 Regulatory purpose	10
5.2 Regulatory process	11
6. Appendices	11



1. Background

1.1 2018 proposed amendments

We published the 2018 proposed amendments for comment on August 8, 2018 in IIROC Notice [18-0153](#). The primary objective of the 2018 proposed amendments was to prevent undue concentrations in certain debt securities margined at $\leq 10\%$. IIROC Notice [18-0153](#) provides a detailed review of the 2018 proposed amendments, which we have left largely intact for these Proposed Amendments.

1.2 Comments received

We received four public comment letters and comments from the Canadian Securities Administrators (**CSA**). A copy of IIROC staff's response to the public comments received is included as Appendix E. We identified the following three key issues raised in the comment letters:

- potential high operational cost and complexity to implement and maintain the 2018 proposed amendments
- uncertainty on whether Dealer Members are required to use one or multiple DRO ratings and resulting potential high operational cost
- high DRO risk-weightings, and complexity of adjusted concentration charge rates for investment grade debt.

1.3 Republication

In light of these comments we are republishing for comment revisions to the 2018 proposed amendments.

Please refer to Appendix A for a black-line comparison of the Proposed Amendments versus the 2018 proposed amendments.

2. Discussion of Proposed Amendments

We developed the revisions to the 2018 proposed amendments to address the issues raised in the public comments. We detail the primary revisions that address these issues in the sections that follow. We also provide clarification regarding the application of the multiple DRO current credit rating methodology, described in proposed Schedule 9B, Note 5. For further reference, Appendix B provides an overview of current and proposed Schedule 9 requirements, highlighting key features of the proposed treatment of debt securities under the Debt Security Test.



2.1 Addressing potential high operational cost and complexity to implement and maintain the 2018 proposed amendments

The revisions to the 2018 proposed amendments provide operational flexibility in the application of the proposed Debt Security Test, which should reduce complexity, and related costs.

We believe that simplifying the minimum DRO qualification criteria for exclusion from proposed Schedule 9B and eliminating the adjusted concentration charge rate should reduce complexity and ease operational implementation without reducing the effectiveness of the proposed Debt Security Test.

2-step concentration test methodology

Dealer Members may use the proposed 2-step concentration test methodology to calculate (step 1) an aggregated debt issuer exposure according to the highest determined risk-weighting (i.e. lowest DRO rating) for all debt issue exposures it holds for that issuer. Dealer Members can simply apply a fixed risk-weight adjustment factor of 80%. They can also use lower adjustment factors, if their DRO monitoring/risk management approach determines that the lowest DRO rated debt issue exposure within the aggregate debt issuer exposure is investment grade. For example, if a Dealer Member holds only one debt security from an issuer, which they confirm is DRO rated “AAA”, they can apply a 40% adjustment factor. If the risk-weighted amount loaned calculated in step 1 does not exceed any concentration thresholds there is no need to make any additional calculations.

Dealer Members have the option to calculate a weighted average risk-weight adjustment factor (step 2) taking into account the lower risk-weights for higher DRO rated debt. This option is available because any given debt issuer may have many individual issues, with some of these issues unrated, and others with different DRO ratings. As a result, we provide a relatively simple base test under step 1, with the option to apply the full DRO risk-weighting methodology under step 2. The potential complexity of the test increases as the debt issuer exposure increases in relation to the Dealer Member’s risk adjusted capital (**RAC**).

We describe the 2-step concentration test methodology in proposed Schedule 9B, Note 7. For further reference, we provide in Appendix C a simplified example demonstrating the calculation of a risk-weighted amount loaned for an aggregate issuer exposure using a weighted average risk-weight adjustment factor.

2.2 Addressing the uncertainty on whether Dealer Members are required to use one or multiple DRO ratings and resulting potential high operational cost

Proposed Schedule 9B, Note 5, multiple DRO current credit ratings, provides a methodology for determining the relevant risk-weighting adjustment factor when there is more than one DRO chosen for the debt security. Comments indicate that this methodology creates complexity and



may be one of the main drivers that is increasing the estimated costs of compliance of the 2018 proposed amendments.

Our interpretation for this methodology is that Dealer Member compliance does not necessarily require a subscription to all DROs that cover a debt security. We believe there must be a relationship between the DRO rating(s) used for risk management purposes and for compliance purposes with proposed Schedule 9B.¹ For example, if an unsophisticated risk management approach does not rely on DRO ratings, then it is acceptable to report no DRO rating for the purposes of Schedule 9B and assign the most conservative risk-weighting (i.e. 80% adjustment factor for low/unrated debt) to the position (even if there are DRO ratings available for the debt). This treatment corresponds to step 1 of the 2-step methodology described above, which does not necessarily require the use of DRO ratings.

Any use of an adjustment factor <80% (i.e. adjustment factors for eligible investment grade debt) must be supported by a DRO rating. In such cases, Dealer Members must follow the multiple DRO methodology if their risk management relies on multiple DRO ratings for that particular debt security.

2.3 Addressing high DRO risk-weightings, and complexity of adjusted concentration charge rates for investment grade debt

The Proposed Amendments apply risk-weightings to all debt securities margined at $\leq 10\%$, with the maximum concentration margin capped at the risk-weighted loan value for long and short debt positions. We detail the revised risk-weighting adjustment factors in Appendix A, proposed Schedule 9B, Note 5.

Exhibit A reproduces the chart we included in section 2.7 of IIROC Notice [18-0153](#). The chart provides financial statement capital multiples, expressing the ratio of the market value of an investment to financial statement capital, where the amount loaned exposure amount equals the 2/3 RAC concentration threshold. The chart shows the maximum financial statement leverage allowed for issuer exposures without incurring a concentration charge.

¹ We sourced this methodology from [Section 3.6.2.2 Multiple assessments, Capital Adequacy Requirements \(CAR\), Chapter 3 – Credit Risk – Standardized Approach, Office of the Superintendent of Financial Institutions \(OSFI\)](#). Our interpretation corresponds to paragraph 126, which requires banks to consistently apply ratings for both risk-weighting and risk management purposes.



Exhibit A – Maximum financial statement capital multiples for equity and risk-weighted debt (amount loaned @2/3 RAC)²

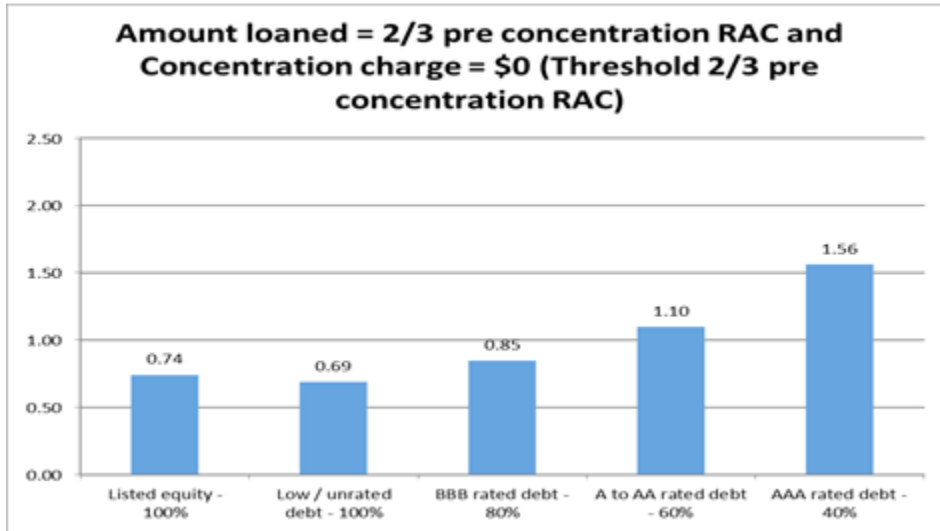
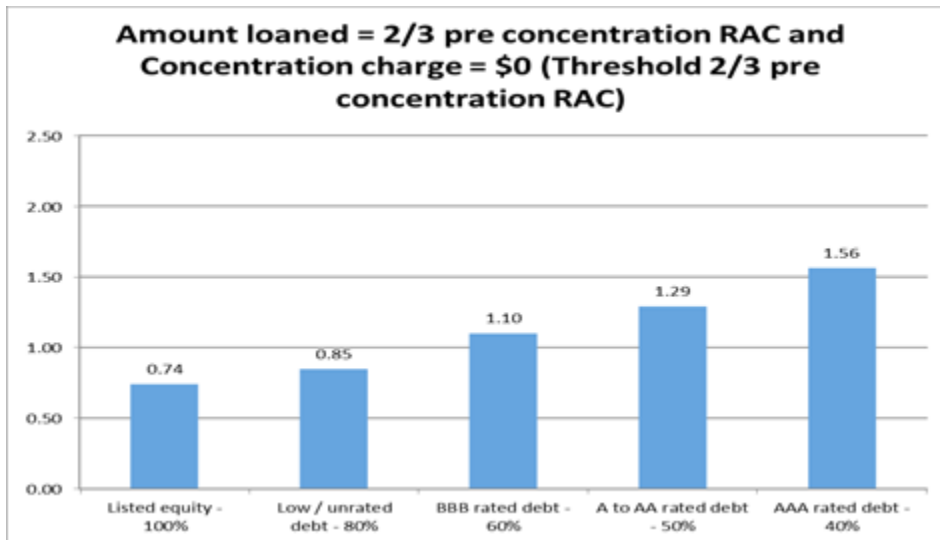


Exhibit B shows the updated maximum financial statement multiples for equity and risk-weighted debt securities, using the revised risk-weighting adjustment factors.

Exhibit B – Updated maximum financial statement capital multiples for equity and risk-weighted debt (amount loaned @2/3 RAC)



² This example provides ratios for a simple capital structure where there is one asset (security) in each case, and the RAC is determined by deducting the security's margin rate. All of the debt securities shown have a margin rate of 10%. The listed equity has a margin rate of 30%.



In addition, we also eliminated the adjusted concentration charge rate, which does not affect the maximum exposure limits in Exhibit B. This revision reduces the rate of increase for concentration charges when an exposure exceeds an established concentration threshold. As a result, any concentration charges will now simply apply at 150% of the calculated exposure in excess of the threshold.

We originally developed the adjusted concentration charge rate to complete the scaling of debt securities into the existing Schedule 9 concentration framework. We believe eliminating this adjustment allows a more appropriate concentration charge rate for risk-weighted debt securities. However, in a corresponding revision, we are revising the Form 1 concentration charge reporting requirement to apply to the largest three exposures originating from proposed Schedule 9A and the largest three exposures originating from proposed Schedule 9B. This revision should allow for a more balanced approach to concentration testing and reporting, without materially impacting the effectiveness of the test for Dealers that will report only on one of Schedule 9A or 9B.³

3. Impacts of the Proposed Amendments

The Proposed Amendments address the potential concentration risk posed by corporate debt and “other” non-commercial debt securities. We conducted extensive advisory committee consultations with the FOAS Capital Formula Subcommittee, which included a review of the Proposed Amendments (**2019 consultation**). We do not expect material impacts to result from the Proposed Amendments.

3.1 Dealer Member impacts

In our discussion of the 2018 proposed amendments, we noted that the potential regulatory capital impacts, if any, would be limited to a small number of Dealer Members. We conducted Dealer Member debt concentration surveys that support this assessment, including the 2016 survey, which we referenced in IIROC Notice [18-0153](#). The Proposed Amendments recalibrate the proposed risk-weighting adjustment factors and introduce lower maximum concentration charges for debt securities margined at $\leq 10\%$.

As noted above, Dealer Members expressed concerns regarding the potential operational impacts of the 2018 proposed amendments. In particular, smaller Dealer Members, with immaterial debt security exposures, were concerned that they would incur a material operational expense to comply with requirements that would not affect their regulatory capital reporting. We

³ The requirement limiting the number of issuer positions for which the securities concentration charge must be calculated to the largest five issuer positions was introduced in 1998. The IDA introduced the limit to avoid scenarios where capital deficient Dealers would need to calculate and provide concentration charges for all issuer positions held in inventory or used for customer account collateral purposes. It was determined that limiting the reporting requirement provided sufficient insight into a Dealer Member’s financial condition. We believe that revising the capital charge reporting limit to a maximum of three issuers from each sub-schedule (maximum of six issuers in total) is appropriate and consistent with the rationale provided for introducing the current limit in [IDA Compliance Interpretation Bulletin C-116 \(December 29, 1997\)](#).



believe the Proposed Amendments, including the 2-step debt concentration testing methodology, address these concerns and reduce the potential operational and compliance costs.

3.2 Marketplace impacts

The Proposed Amendments reduce conservatism in the DRO risk-weighting methodology, which should ensure the ability of Dealer Members to continue to conduct their core debt market business without any material impact. The Proposed Amendments will also enhance our ability to monitor and analyze Dealer Member debt security exposures.

3.3 Other impacts

We believe the Proposed Amendments address the potential operational and marketplace impacts identified in our review, without limiting the effectiveness of the proposed securities concentration test.

4. Implementation

The Proposed Amendments build upon the existing Schedule 9 framework for securities concentration testing, which should ease the implementation process. They will require Dealer Member and/or service-provider expense to ensure that existing compliance systems capture the new debt security exposures, and provide satisfactory DRO monitoring.

In the 2019 consultation, we received positive feedback regarding implementation, including one estimate indicating material reductions in the projected cost and implementation timeline. However, Dealer Members will need to co-ordinate with their service providers to determine revised implementation costs and timelines to implement the full DRO risk-weighting methodology.

We will implement the Proposed Amendments upon approval by the recognizing regulators within a one year period.

5. Policy Development Process

5.1 Regulatory purpose

We intend the Proposed Amendments to:

- establish and maintain rules that are necessary or appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity
- promote the protection of investors.



5.2 Regulatory process

The Board of Directors of IIROC (**Board**) has determined the Proposed Amendments to be in the public interest and on June 25, 2019 approved them for public comment.

We developed the Proposed Amendments, and IIROC policy advisory committees (the FOAS Capital Formula Subcommittee and the FOAS) supported them.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend revisions to the applicable Proposed Amendments. If the revisions and comments received are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the Proposed Amendments as revised will be subject to approval by the Recognizing Regulators. If the revisions or comments are material, we will submit the Proposed Amendments including any revisions to the Board for approval for republication or implementation as applicable.

6. Appendices

[Appendix A](#) - Black-line comparison of the Proposed Amendments to the 2018 proposed amendments

[Appendix B](#) - Overview of Schedule 9 requirements – current and proposed

[Appendix C](#) - Simplified Example – Calculation of a weighted average risk-weight adjustment factor

[Appendix D](#) - Black-line comparison of the plain language version of the Proposed Amendments to the most recently published proposed plain language rules.

[Appendix E](#) - IIROC staffs' response to public comments on the 2018 proposed amendments