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BULLETIN # 3140
April 28, 2003

By-Laws and Regulations

Minimum Margin Requirements for Bonds with Embedded Options – By-Law 1 and Regulation 100.2A

The Board of Directors of the Association has approved amendments to By-Law 1 and the establishment of Regulation 100.2A relating to the margin requirements for bonds with embedded options. These changes are effective immediately and are enclosed as Attachment #1.

Background

The affected bonds with embedded options are callable bonds, retractable bonds and extendible bonds. The previous margin requirements for bonds in Regulation 100 did not take into consideration the unique characteristics of bonds with embedded options, and treated them as plain-vanilla bonds. Accordingly, the changes serve to establish minimum margin requirements that better reflect the relative risks associated with bonds with embedded options for both naked and hedged positions.

Regulation 100.2A will allow Member firms, for margin purposes, to use the callable date, retractable date or extendible date associated with the bond, in determining the term to maturity when the price suggests the embedded option will likely be exercised. Furthermore, By-law 1 was amended to provide definitions for the new terms used in Regulation 100.2A.

Kenneth A. Nason
Association Secretary

INVESTMENT DEALERS ASSOCIATION OF CANADA

MARGIN REQUIREMENTS FOR BONDS WITH EMBEDDED OPTIONS

1. By-law 1 is hereby amended by adding the following definitions:

“callable debt security” means a security described in Regulation 100.2A(a), which allows the issuer to redeem the security at a fixed price (the call price), subject to the call protection period;

“call protection period” means the period of time during which the issuer cannot redeem a callable debt security;

“extendible debt security” means a security described in Regulation 100.2A(b), which allows the holder, during a fixed time period, to extend the maturity date of the security to the extension maturity date, and to change the principal amount of the security to a fixed percentage (the extension factor) of the original principal amount;

“extension election period” means the period of time during which the holder may elect to extend the maturity date and change the principal amount of, an extendible debt security;

“extension factor” means, if any, the fixed percentage that should be used to change the original principal amount of the extendible debt security when the maturity date is deemed to be equal to the extension maturity date;

“retractable debt security” means a security described in Regulation 100.2A(c), which allows the holder of the security, during a fixed time period to retract the maturity date of the security to the retraction maturity date, and to change the principal amount of the security to a fixed percentage (the retraction factor), of the original principal amount;

“retraction election period” means the period of time during which the holder may elect to retract the maturity date, and change the principal amount of, a retractable debt security;

“retraction factor” means, if any, the fixed percentage that should be used to change the original principal amount of the retractable debt security when the maturity date is deemed to be equal to the retraction maturity date;”

2. Regulation 100.2A is enacted as follows:

“For purposes of the Regulation 100 and By-law 17.13,

- (a) a callable debt security may, at the Member’s election, be deemed to have a maturity date equal to

- (i) the original maturity date, if the market price of the callable debt security is trading at or below 101% of the call price; or
 - (ii) the first business day after the call protection period, if the market price of the callable debt security is trading above 101% of the call price.
- (b) an extendible debt security may, at the Member's election, be deemed to have a maturity date equal to
- (i) the original maturity date, if the extension election period has not expired and the market value of the extendible debt security is trading at or below the extension factor times the current principal amount;
 - (ii) the extension maturity date, if the extension election period has not expired and the market value of the extendible debt security is trading above the extension factor times the current principal amount; or
 - (iii) the original maturity date, if the extension election period has expired.
- (c) a retractable debt security may, at the Member's election, be deemed to have a maturity date equal to
- (i) the original maturity date, if the retraction election period has not expired and the market value of the retractable debt security is trading at or above the retraction factor multiplied by the current principal amount;
 - (ii) the retraction maturity date, if the retraction election period has not expired and the market value of the retractable debt security is trading below the retraction factor times the current principal amount; and
 - (iii) the original maturity date, if the retraction period has expired.”

PASSED AND ENACTED BY THE Board of Directors this 17th day of January 2002, to be effective on a date to be determined by Association staff.