MEMBER REGULATION

notice

INVESTMENT DEALERS ASSOCIATION OF CANADA

ASSOCIATION CANADIENNE DES COURTIERS EN VALEURS MOBILIÈRES

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Offsets involving Capital Shares, Convertible and Exercisable Securities and Offsets involving Takeover or Reorganization Transactions

This notice should be read in conjunction with Bulletin #3226 – Margin and Capital Requirements for Capital Share and Convertible and Exercisable Security Offsets – Regulations 100.4G, 100.4H and 100.4I.

As mentioned in Bulletin #3226, the number of reduced margin offset strategies available to Members and their clients involving capital shares and convertible and exercisable securities have increased. The additional offset strategies recognize that reverse offset strategies – a long position in the underlying securities offset with a short position in the capital shares or convertible securities or exercisable securities – are effective price hedges, even though the long position cannot be converted into the short position.

As a result, this notice, which is an update to Member Regulation Notice MR-027 – Offsets involving Capital Shares, Convertible Securities and Warrants, Rights, Installment Receipts and like instruments and Offsets involving Takeover or Reorganization Transactions – has been prepared to provide general guidance to Members wishing to use these offset strategies. In addition, the notice serves to explain the changes that were made to the previous offset strategies and the risks the regulations are designed to cover.

Members are reminded that the guidance set out in this notice is not a substitute for the performance of proper due diligence when determining the margin or capital requirement for any offset. Members have a duty to ensure that the economic substance of the offset strategy, results in either the extinguishment or minimization of market risk. Normally, proper due diligence will include, but will not be limited to, consulting the relevant prospectus documents of the securities involved in the offset to determine the conversion or exchange features, the appropriate hedge ratios and any penalties associated with those features.

Additional Offset Strategies

Capital Shares [Regulation 100.4G]

- Long common shares and short capital shares [Regulation 100.4G(e)]
- Long common shares, short capital shares and short preferred shares [Regulation 100.4G(f)]

Convertible Securities [Regulation 100.4H]

- Short convertible securities and long underlying securities [Regulation 100.4H(d)]
- Long "Oldco securities" and short "Newco securities" relating to an amalgamation, spin-off or any other securities related reorganization transaction [Regulation 100.4H(e)]

Exercisable Securities (including Warrants, Rights, Installment Receipts, etc.) [Regulation 100.4I]

- Short exercisable securities and long underlying securities [Regulation 100.4I(d)]

Changes Made to Previous Existing Offset Strategies

The major change to the previous existing offset strategies for capital shares, convertible securities and warrants, rights, etc. is to the use of fixed margin, credit and capital rates such as 30%, 130%, 25% and 5%. The fixed rates have been changed to the normal margin rates or a percentage of the normal margin rates of the securities involved, because fixed rates did not adequately cover the market risk of securities whose normal margin and capital rates exceeded 30% and 25%, respectively.

Risks the Offset Requirements are Designed to Cover

The offset requirements are designed to cover any remaining market risk and the work-out risk of the positions in the hedge. Work-out risk is defined as either the buy-in risk or sell-out risk or both associated with liquidating the positions in the offset strategy. The sell-out risk is defined as the market risk associated with selling the securities to liquidate a long position; and the buy-in risk is defined as the market risk associated with buying securities to cover a short position and is also referred to as "short squeeze risk".

In the previous existing offset strategies – a long position in capital shares or convertible securities or exercisable securities and a short position in underlying securities – work-out risk was not always present, because in the worst-case scenario the long position could be converted and used to close out the short position without the account being exposed to buy-in or sell-out risk. However, with the additional offset strategies – a short position in the capital shares or convertible securities or exercisable securities and a long position in the underlying securities – the long position cannot be converted and used to close out of the short position and the Member or the client will always have to sell-out the long position and buy-in the short position in the market to close out the positions. Therefore, the requirements are designed to cover the exposure of the Member or the client to work-out risk by requiring additional margin where work-out risk is present.

"CONVERTIBLE SECURITY OFFSETS" (IDA Reg. 100.4G, H and I)

The basic principle underlying the offset strategies is that the long position held must be currently convertible/exchangeable into the short position held and where this basic principle is not met, additional margin or capital is required.

Capital Shares (IDA Reg. 100.4G)

General Rules

In the case of capital shares, conversion privileges are usually set out in the security prospectus documents that permit the conversion of the capital share (accompanied by a cash payment), and the capital share and preferred share into the underlying common shares (or their cash equivalent). As a result, there are specific rules set out in IDA Reg. 100.4G that permit the following offsets be granted reduced margin [a matrix of the permitted capital share offsets is also included as Attachment #1]:

- **Long capital shares and short common shares** – since this offset is economically the same as holding a short position in a preferred share, the margin requirement is the lesser of: the capital share conversion loss plus the normal capital required (credit required in the case of a customer account position) on the related preferred shares; and the normal capital required (credit required in the case of a customer account position) on the underlying common shares. However, where the capital shares cannot be tendered to the split share company for conversion into the underlying common shares at the option of the holder, there is now work-out risk and additional capital or margin is required. The additional capital or margin is 20% of the normal capital required (margin required in the case of customer account positions) on the underlying common shares.

  [Note: Certain capital shares have an annual conversion privilege whereby the holder of the capital share can covert into the common share at no penalty. Because this is an annual (rather than an ongoing) conversion privilege this lower margin requirement may only be permitted where a term borrow arrangement (a term arrangement to borrow the common stock) is in place to cover the period of time between the date for which margin is being calculated and the annual conversion privilege date]

- **Long capital shares, long preferred shares and short common shares** – since the combination of a capital share and a preferred share is the same as a common share, the margin requirement is the lesser of: the combined conversion loss; and the normal capital required (margin required in the case of customer account positions) on the underlying common shares. However, where the capital shares and preferred shares cannot be tendered to the split share company for conversion into the underlying common shares at the option of the holder, there is now work-out risk and additional capital or margin is required. The additional capital or margin is 20% of the normal capital required (margin required in the case of customer account positions) on the underlying common shares.

  [Note: Certain capital/preferred share combinations have an annual conversion privilege whereby the holder of the capital and preferred shares can covert into the common shares at no penalty. Because this is an annual (rather than an ongoing) conversion privilege this lower margin requirement may only be permitted where a term borrow arrangement (a term arrangement to borrow the common stock) is in place to cover the period of time between the date for which margin is being calculated and the annual conversion privilege date]

- **Long capital shares and short call option contracts** – the capital or margin required is the capital share conversion loss plus the lesser of: the normal capital required or credit required on the capital shares less the market value of the premium credit on the call options; and any excess of the market value of the underlying common shares over the aggregate exercise value of the call options. However, where the capital shares cannot be tendered to the split share company for conversion into the underlying common shares at the option of the holder, there is now work-out risk and additional capital or margin is required. The additional capital or margin is 20% of the normal capital required (margin required in the case of customer account positions) on the underlying common shares.

- **Long common shares and short capital shares** – since this offset is economically the same as holding a long position in a preferred share, the margin requirement is the lesser of: the capital share conversion loss plus the normal capital required (margin required in the case of a customer account position) on the related preferred shares; and the normal capital required (margin required in the case of a customer account position) on the underlying common shares. However, because the long common shares cannot be used to close-out the short capital shares, additional capital or margin of 40% of the normal capital is required (margin required in the case of customer account positions) on the underlying common shares to address the higher probability of a short squeeze risk.
- **Long common shares, short capital shares and short preferred shares** – since the combination of a capital share and a preferred share is the same as a common share, the margin requirement is the lesser of: the combined conversion loss; and the normal capital required (margin required in the case of customer account positions) on the underlying common shares. However, because the long common shares cannot be used to close-out the short capital shares and short preferred shares, additional capital or margin of 40% of the normal capital is required (margin required in the case of customer account positions) on the underlying common shares to address the higher probability of a short squeeze risk.

How the General Rules Apply to Certain Splitshare Issues

In general, the above-discussed general rules apply in the same fashion to all splitshare issuances. However, there are instances where capital and preferred shares (also referred to as dividend shares) have been issued:

- on a basket of underlying securities (i.e., 5 Banc Split Inc. which has as an underlying basket of five Canadian chartered banks or Cyclical Split NT Corp. which has as an underlying basket of one Diversified Metals & Mining company, one Financial company, one Industrial company, four Materials companies and one Open-ended Investment Trust;
- on an individual underlying security issue (i.e., B Split II Corp. which has the BCE Inc. common shares issue as an underlying)
- on a portion of a company (i.e. , there are no current examples of this, but a previous example is TeleClone Inc., which had the BCE issue stripped of the investment in Nortel Networks before Nortel was spun-off)

As a result, because the underlying interest for a particular capital share may be different, particular attention should be paid to the exact nature of the underlying before offset relief is granted.

Convertible Securities (IDA Reg. 100.4H)

General Rule

The group of security types referred to as "convertible securities" includes convertible preferred shares, convertible/exchangeable debentures and any other security provided that it contains a feature that may be converted into a stated number of another security at no additional cost to the beneficial owner. In addition, the term "currently convertible" is now formally defined. As a result, there are specific rules set out in IDA Reg. 100.4H that permit reduced margin be granted to the following offsets [a matrix of the permitted convertible security offsets is also included as Attachment #2]:

- **Long convertible securities considered "currently convertible" and short underlying securities –** the capital and margin requirement on this offset is the conversion loss (the excess of the market value of the convertible securities over the market value of the underlying securities). This is because there is no market risk associated with this offset strategy since the long position can be converted at any time to cover the short position. As a result, the only possibility of loss occurs where the market value of the long position is in excess of the market value of the short position. However, where the convertible security cannot be converted directly into the underlying security, at the option of the holder, an additional 20% of the normal capital required (margin required in the case of customer account positions) on the underlying securities is required.

- **Long convertible securities not considered "currently convertible" and short underlying securities** – the capital and margin requirement is the conversion loss plus 20% of the normal capital required (margin required in the case of customer account positions) on the underlying securities, to cover the sell-out risk associated with holding convertible securities not considered to be "currently convertible". Furthermore, where the convertible securities cannot be converted directly into the underlying security, at the option of the holder, 20% of the normal capital required (margin required in the case of customer positions) on the underlying securities is required.
- **Long underlying securities and short convertible securities** – the capital and margin requirement whether or not the convertible securities are currently convertible is the conversion loss plus 40 % of the normal capital required (margin required in the case of customer account positions) on the underlying securities. 40% of the normal capital is required (margin required in the case of customer account positions) on the underlying securities to address the higher probability of a short squeeze risk as the long underlying securities cannot be converted into the short convertible securities and used to close-out that short position.
- **Long "Oldco securities" and short "Newco securities" relating to an amalgamation, acquisition, spin-off or any other securities related reorganization transaction** – the capital and margin requirement is the excess of the combined market value of the long Oldco securities over the combined market value of the short Newco securities.

Convertible Securities with Issuer Cash Payment Feature

In the case of some convertible securities, the issuer has the option when the conversion feature, is exercised of paying either the stated number of underlying securities or the equivalent amount in cash. Most examples of this cash payment option occur with exchangeable debentures. In fact two IDA Compliance Interpretation Bulletins, C-67 and C-95, have been issued previously detailing the appropriate margin requirement for specific exchangeable debenture issues. The following summarizes the appropriate margin requirement for an offset involving a long position in such issues and a short position in the underlying security:

- If the cash payment value is greater than the current market value of the underlying securities, then
  - 100% of the loss on conversion calculated as the excess of the market price of the convertible/exchangeable issue over the current market value of the short underlying securities, plus
  - 20% of the normal capital required on the underlying securities, if the position is in inventory, or 20% of the normal margin required on the underlying securities, if the position is in a client account.
- If the cash payment value is less than the current market value of the underlying securities, then
  - 100% of the loss on conversion calculated as the excess of the market price of the convertible/exchangeable issue over the cash payment value of the short underlying securities, plus
  - 20% of the normal capital required on the underlying securities, if the position is in inventory, or 20% of the normal margin required on the underlying securities, if the position is in a client account.

The 20% of the normal capital or margin required serves to protect against the intra-day market price risk to the firm should the issuer elect to provide any combination of "cash payment" instead of underlying securities at the date of conversion, thereby requiring the firm to go into the market to purchase the equivalent amount of underlying securities being hedged.

Exercisable securities (including warrants, rights, instalment receipts and other cash payment convertible securities) (IDA Reg. 100.4I)

General Rule

Exercisable securities, which includes warrants, rights, instalment receipts and like instruments (referred to as "cash payment convertible securities") are similar to the securities referred to as "convertible securities" above with the exception that to convert these securities into another, a cash payment must be made by the holder. As a result, the exercisable securities offset rules set out in IDA Reg. 100.4I are similar to the "convertible securities" offset rules set out in IDA Reg. 100.4H, which permit reduced margin for the offsets below. However, because of the required cash payment to convert these securities, the capital required for a Member position and the margin required for a customer position is different, because only in the case of a customer position is the exercise or subscription payment required.

Another difference between the exercisable securities rules and the convertible securities rules is in the definition of exercise loss. The exercise loss means the excess of the combined sum of the market value of the exercisable securities <u>plus</u> the exercise or subscription payment over the market value of the underlying security. The permitted reduced margin offsets for exercisable securities are as follows [a matrix of the permitted exercisable security offsets is also included as Attachment #3]:

- **Long exercisable securities considered "currently exercisable" and short underlying securities** – the capital and margin requirement is the exercise or subscription payment (for customer account positions only) plus the exercise loss. However, if the exercisable security cannot be exercised directly into the underlying security, at the option of the holder, an additional 20% of the normal capital required (margin required in the case of customer account positions) on the underlying securities is required.
- **Long exercisable securities not considered "currently exercisable" and short underlying securities** – the capital and margin requirement is the exercise or subscription payment (for customer account positions only) plus the exercise loss and 20% of the normal capital or margin required on the underlying securities to cover the sell-out risk associated with holding exercisable securities that are not considered to be "currently exercisable. However, if the exercisable security cannot be exercised directly into the underlying security, at the option of the holder, an additional 20% of the normal capital required (margin required in the case of customer account positions) on the underlying securities is required.
- **Long underlying securities and short exercisable securities** – the capital and margin requirement is the exercise or subscription payment (for customer account positions only) plus the exercise loss and 40% of the normal capital or margin required on the underlying securities to cover the higher probability of work-out risk as the long position cannot be exercised to close-out the short position.

Capital Shares – Offset Matrix [Regulation 100.4G]

	Short capital shares	**Short capital share and short preferred share**	**Short common shares**	**Short call option contracts**
Long capital shares	No margin required, if offsetting positions in same security		**Reg. 100.4G(b)**	**Reg. 100.4G(d)**
Long capital shares and long preferred shares		No margin required, if offsetting positions in same security	**Reg. 100.4G(c)**	
Long common shares	**Reg. 100.4G(e)**	**Reg. 100.4G(f)**	No margin required, if offsetting positions in same security	

Convertible Securities – Offset Matrix [Regulation 100.4H]

	Short convertible securities considered "currently convertible"	**Short convertible securities <u>not</u> considered "currently convertible"**	**Short underlying securities**	**Short "Newco securities"**
Long convertible securities considered "currently convertible"	No margin required, if offsetting positions in same security		**Reg. 100.4H(b)**	
Long convertible securities <u>not</u> considered "currently convertible"		No margin required, if offsetting positions in same security	**Reg. 100.4H(c)**	
Long underlying securities	**Reg. 100.4H(d)**	**Reg. 100.4H(d)**	No margin required, if offsetting positions in same security	
Long "Oldco securities"				**Reg. 100.4H(e)**

Exercisable Securities (including warrants, rights, instalment receipts, etc.) – Offset Matrix [Regulation 100.4I]

	Short exercisable securities considered "currently exercisable"	**Short exercisable securities not considered "currently exercisable"**	**Short underlying securities**
Long exercisable securities considered "currently exercisable"	No margin required, if offsetting positions in same security		**Reg. 100.4I(b)**
Long exercisable securities not considered "currently exercisable"		No margin required, if offsetting positions in same security	**Reg. 100.4I(c)**
Long underlying securities	**Reg. 100.4I(d)**	**Reg. 100.4I(d)**	No margin required, if offsetting positions in same security