notice

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Regulation 100.5 and Schedule 2A of Form 1 – Capital Requirements for Underwriting Commitments

This Notice has been prepared to describe the background to and provide details of recent amendments to the capital requirements for underwriting commitments. It should be read in conjunction with IDA Bulletin #3354.

OVERVIEW

In January 1998, after passing a proposal to eliminate the use of standby subordinated debt for regulatory capital purposes, the IDA Board of Directors asked that the Financial Administrators Section examine the continued use of new issue loans. The board had determined that since the new issue loan facility had a similarity to the standby subordinated debt facility, its continued use would also need to be studied. The similarity is that the use of the current new issue loan facility also results in a capital benefit to the Member firm without being drawn. In response to this direction from the board, the FAS Capital Formula Subcommittee established the Bank Loan Working Group to study new issue loans. Rather than address the continued use of the new issue loan on a standalone basis, the working group determined that all aspects of the existing capital rules for underwriting commitments warranted study. As a result, the working group developed recommendations on a number of issues relating to underwriting commitments. These recommendations have now been implemented, effective March 1, 2005, through the making of amendments to Regulation 100.5 and Schedule 2A of Form 1 and through the introduction of the standard form new issue loan agreement.

KEY AMENDMENTS TO EXISTING RULES, MAJOR COMPONENTS OF STANDARD FORM NEW ISSUE LOAN AGREEMENT AND PERMITTED USE OF CAPITAL RENTAL ARRANGEMENTS

A. The key amendments made to Regulation 100.5 are as follows:

1. Introduction of reduced "normal new issue margin" rates [Regulation 100.5(a)(vii)];
2. Formal codification of the required wording to be used for "disaster out" and "market out" clauses [Regulations 100.5(a)(iii) and (iv)];
3. Amendments to the reductions in "normal new issue margin" rates due to presence of disaster out and/or market out clauses [Regulations 100.5(b)];
4. Formal codification of the pricing terms that must be agreed to (in addition to all other non-pricing terms) before a Member firm is considered to have an underwriting commitment [Regulation 100.5(a)(ii)];
5. Introduction of reductions to "normal new issue margin" rates due to the existence of expressions of interest from exempt purchasers that have been verbally affirmed but not yet contracted provided there is "acceptable documentation" retained [Regulation 100.5(a)(i) and (c)];
6. Expansion of the list of parties eligible to issue a new issue loan for which the Member firm will receive a reduction in its underwriting capital requirement [Regulation 100.5(a)(v)]; and
7. Formal codification of minimum required terms to be included in new issue loan agreement [Regulation 100.5(a)(v)].

B. The key amendments made to Schedule 2A of Form 1:

1. Increase in the individual underwriting concentration threshold from 25% to 40% of Net Allowable Assets [Column 4 of detail relating to Line 1 of Schedule 2A of Form 1]; and
2. For each outstanding commitment, inclusion of the portion of the commitment allocated to exempt purchasers as an exposure subject to the individual and overall underwriting concentration requirements [Notes 2 and 4 to Schedule 2A of Form 1].

C. The major components of Standard Form New Issue Loan agreement are as follows:

1. The Member firm has the ability to draw down funds on the strength of the new issue only;
2. The loan issuer ("Lender") agrees up front to advance funds:
   (a) at a stated loan value [a percentage of the new issue price];
   (b) on the draw down date [for any portion not sold prior to draw down];
   (c) at a stated interest rate; and
   (d) for a stated period of time [which must equal or exceed a prescribed minimum period]; and
3. The Lender agrees to waive right of set-off against other assets of the Member firm.

D. Formal permitted use of capital rental arrangements

1. "Capital rental arrangements", a term coined to describe arrangements where one Member firm lends capital to another have always been available to Member firms but the SROs have never officially sanctioned their use. We are now doing that through the issuance of this Member Regulation Notice.

DETAILED DISCUSSION

A. KEY AMENDMENTS MADE TO REGULATION 100.5

A1. INTRODUCTION OF REDUCED "NORMAL NEW ISSUE MARGIN" RATES

Effective March 1, 2005, "normal new issue margin rates" will be set at levels lower than the current normal margin requirement for listed securities where the market value of the issue being underwritten is $2.00 per share or more. In other words, new issue underwriting commitments with the following current margin rates will be margined at the following reduced margin rates during the period from commitment date until the business day prior to the settlement date of the underwriting:

Current normal margin rates	Reduced "normal new issue margin" rates
25.00%	15.00%
50.00%	40.00%
60.00%	60.00%
80.00%	80.00%
100.00%	100.00%

These reductions are supported by the results of a study of price volatility performed as part of a comprehensive project to develop revised margin rates for equity securities (known as the Equity Margin Project). The study concluded that on average there are significant cushions in the current margin rate structure for 25% and 50% margin rate securities over and above the margin that would be required to cover the actual market risk associated with these securities. Rather than wait to adopt the recommendations of the Equity Margin Project for all listed securities, the amendment to Regulation 100.5 allows for the early adoption of lower margin rates for certain securities the firm is underwriting and for which the firm has an underwriting commitment. These reductions are achieved through the establishment of a new defined term, "normal new issue margin" [IDA Regulation 100.5(a)(vii)].

A2 FORMAL CODIFICATION OF THE REQUIRED WORDING TO BE USED FOR "DISASTER OUT" AND "MARKET OUT" CLAUSES

The definitions of "disaster out clause" and "market out clause" have been amended to formally codify the required wording to be used for domestic underwritings [Regulations 100.5(a)(iii) and 100.5(a)(iv)]. Where a Member firm participates in underwritings with a material foreign tranche other "disaster out clause" or "market out clause" wording may be acceptable, but it must conform to the required wording to be used in the foreign jurisdiction.

A3 AMENDMENTS TO THE REDUCTIONS IN "NORMAL NEW ISSUE MARGIN" RATES DUE TO PRESENCE OF DISASTER OUT OR MARKET OUT CLAUSES

The reductions in the capital required on an underwriting commitment due to the presence of a disaster out or market out clause have also been amended. The amendments made were determined by studying the amount of loss that would generally be borne by a Member firm on a underwriting before an out clause would be exercised. For example, if a Member firm is willing to assume a 5% loss on an underwriting before invoking a market out clause, then the Member firm should accrue for this 5% loss on commitment date even though the market out clause may be in effect.

The amended requirements, which come into effect on March 1, 2005, require the Member firm to set aside a minimum amount of capital to support its underwriting commitments, irrespective of

which out clauses remain unexpired, to cover the loss they would be willing to assume, as described above. The following is a summary of the amended requirements:

Condition(s) met	Underwriting Capital Requirement	
	Existing	**Amended** (effective March 1, 2005)
No out clauses in effect	100% of "normal margin	100% of "normal new issue margin"
Disaster out clause in effect	50% of "normal margin	50% of "normal new issue margin"
New issue loan obtained	10% of "normal margin	10% of "normal new issue margin"
Disaster out clause in effect and new issue loan obtained	5% of "normal margin	10% of "normal new issue margin"
Market out clause in effect	0% of "normal margin	10% of "normal new issue margin"
Market out clause in effect and new issue loan obtained	0% of "normal margin	5% of "normal new issue margin"

So for underwriting commitment with a normal margin rate of 50%, the following will be the capital requirements effective March 1, 2005 during the period from commitment date until the business day prior to the settlement date of the underwriting:

Condition(s) met	Underwriting Capital Requirement	
	Existing	**Amended** (effective March 1, 2005)
No out clauses in effect	50.00%	↓ 40.00%
Disaster out clause in effect	25.00%	↓ 20.00%
New issue loan obtained	5.00%	↓ 4.00%
Disaster out clause in effect and new issue loan obtained	2.50%	↑ 4.00%
Market out clause in effect	0.00%	↑ 4.00%
Market out clause in effect and new issue loan obtained	0.00%	↑ 2.00%

A4 FORMAL CODIFICATION OF THE PRICING TERMS THAT MUST BE AGREED TO (IN ADDITIONAL TO ALL OTHER NON-PRICING TERMS) BEFORE A MEMBER FIRM IS CONSIDERED TO HAVE AN UNDERWRITING COMMITMENT

Several forms of underwriting agreements are in use throughout Canada. For certain agreements it is not readily apparent whether entering into the agreement constitutes an agency offering or a committed offering. Whether or not entering into the underwriting agreement constitutes a committed offering is a question of fact. If a sufficient number of pricing terms (in addition to all other non-pricing terms) are agreed to, the Member firm has entered into a commitment. To assist in determining whether a Member firm has entered into a commitment, a definition of the term "commitment" has been added [IDA Regulation 100.5(a)(ii)].

The definition stipulates that two of the following three pricing terms (in addition to all other non-pricing terms) must be agreed to before a Member firm is considered to have entered into an underwriting commitment:

- Issue price

- Number of shares
- Issue commitment amount [issue price x number of shares]

Since issue commitment amount is issue price multiplied by number shares, agreeing to any two of the above three terms will effectively mean the third term has been agreed to as well.

A5 INTRODUCTION OF REDUCTIONS TO "NORMAL NEW ISSUE MARGIN" RATES DUE TO THE EXISTENCE OF EXPRESSIONS OF INTEREST FROM EXEMPT PURCHASERS THAT HAVE BEEN VERBALLY AFFIRMED BUT NOT YET CONTRACTED PROVIDED THERE IS "ACCEPTABLE DOCUMENTATION" RETAINED

One of the most significant amendments relates to when expressions of interest from exempt purchasers are present. The amendments allow for a significant reduction in the capital requirement for that portion of the underwriting commitment where documented expressions of interest have been received from exempt purchasers. The amendments assume that even though expressions of interest received from exempt purchasers are usually recorded as revenue on the date that contracting takes place, the risk associated with the underwriting is lessened on a date prior to contracting. That date occurs when the final allocation has been made to the exempt purchasers and the entire allotment to exempt purchasers has been verbally affirmed. On this date, each exempt purchaser is informed of the number of shares they have been allotted and the expression of interest received from the exempt purchaser is verbally affirmed. It is also on this date and because of the existence of these verbally affirmed expressions of interest that a reduction in the normal new issue margin required will be permitted, effective March 1, 2005, subject to the Member firm and/or the lead manager meeting certain documentation standards and conditions. The standards and conditions as follows:

Documentation standards

As a minimum, the following documentation standards must be met before a member of the banking group takes any capital requirement reduction:

- For that portion of the underwriting commitment that is allocated to be sold to exempt purchasers, the lead manager must keep a record of the final affirmed allocation indicating for each expression of interest:
  - The name of the exempt purchaser
  - The name of the employee of the exempt purchaser accepting the amount allocated
  - The name of the representative of the lead underwriter responsible for affirming the amount allocated to the exempt purchaser, time stamped to indicate date and time of affirmation
- Upon request the lead manager must be required to notify in writing all the banking group participants when the entire allotment to exempt purchasers has been verbally affirmed so that all banking group participants may take advantage of the reduction in the capital requirement; under no circumstances may the lead manager reduce its own capital requirement on an underwriting due to such expressions of interest from exempt purchasers without providing the above notification to the rest of the banking group.

These documentation standards have been codified in the IDA rules through the establishment of a definition for the term "appropriate documentation" [Regulation 100.5(a)(i)].

Conditions to be met

In addition to meeting the above documentation standards, the following conditions must be met

before a Member firm will be permitted to reduce the capital requirement on that portion of the underwriting commitment where expressions of interest have been received from exempt purchasers:

- There is unlikely to be a significant renege rate on the expressions of interest received from exempt purchasers; and
- The Member firm is not significantly leveraging its underwriting activities through the use of the capital requirement reduction provided on that portion of the underwriting commitment where expressions of interest have been received from exempt purchasers.

In order to ensure that these conditions have been met the following specific criteria have been developed:

- The portion of the underwriting commitment that is allotted to exempt purchasers must be finalized [i.e., the percent allocation between exempt and retail customers must be finalized] and the entire allotment to exempt purchasers must have been verbally affirmed
- To qualify for a reduction in the capital requirement to 20% of normal new issue margin, the current market value of the commitment must be at or above 90% of new issue value (90% x issue price x number of shares). Should a subsequent decline in value reduce the current market value of the commitment below 90% of the new issue value, the capital requirement will be increased up to 40% of normal new issue margin. Further, should a subsequent decline in value reduce the current market value of the commitment below 80% of the new issue value, the capital requirement will be increased up to 100% of normal new issue margin
- The entire exempt purchaser allotment for which a capital requirement reduction is taken must be subject to an underwriting commitment concentration charge

Reduction in normal new issue margin to be permitted

In summary, where the documentation standards and the above criteria are met, the Member firm may reduce by either 80% or 60% (i.e., the capital requirement will be 20% or 40% of normal new issue margin) the capital requirement it provides on that portion of the underwriting commitment where expressions of interest have been verbally affirmed by exempt purchasers. The following table summarizes the proposed lower capital requirements where an 80% reduction is taken:

	Underwriting Capital Requirement where expressions of interest have been received from exempt purchasers*	
"Normal new issue margin" rate	No out clauses in effect†	Disaster out clause in effect†
15.00%	3.00%	3.00%
40.00%	8.00%	8.00%
60.00%	12.00%	12.00%
80.00%	16.00%	16.00%
100.00%	20.00%	20.00%

* Under the new rules the Member firm may only reduce its capital provided due to the presence of expressions of interest affirmed by exempt purchasers where either no out clauses are in effect or a disaster out clause is in effect. This is because when either a market out clause is in effect or a new issue loan has been obtained (or both) the allowable capital requirement is already lower than the 20% or 40% of normal new issue margin.

† The new rules allow to reduce the capital requirement by either 80% or 60%. The table above has been prepared based on a reduction of 80%. So, for the above normal new issue margin rates the permitted capital requirement is:

= 20% x normal new issue margin

So for underwriting commitment with a normal margin rate of 50% and where the market price of the issue is holding at the issue price, the following will be the capital requirements effective March

1, 2005 during the period from commitment date until the business day prior to the settlement date of the underwriting:

Condition(s) met	Underwriting Capital Requirement where expressions of interest have been received from exempt purchasers		
	Existing	Amended (effective March 1, 2005)	
		Exempt purchasers	All other purchasers
No out clauses in effect	50.00%	↓ 8.00%	↓ 40.00%
Disaster out clause in effect	25.00%	↓ 8.00%	↓ 20.00%
New issue loan obtained	5.00%	↓ 4.00%	↓ 4.00%
Disaster out clause in effect and new issue loan obtained	2.50%	↑ 4.00%	↑ 4.00%
Market out clause in effect	0.00%	↑ 4.00%	↑ 4.00%
Market out clause in effect and new issue loan obtained	0.00%	↑ 2.00%	↑ 2.00%

A6 EXPANSION OF THE LIST OF PARTIES ELIGIBLE TO ISSUE A NEW ISSUE LOAN FOR WHICH THE MEMBER FIRM WILL RECEIVE A REDUCTION IN ITS UNDERWRITING CAPITAL REQUIREMENT

Currently, only Canadian chartered banks are permitted to provide new issue loans to Member firms. Under SRO rules, Canadian chartered banks generally qualify as acceptable institutions. Therefore, there is no reason why other acceptable institutions should not be permitted to provide new issue loans [e.g., trust and insurance companies] on the same basis as Canadian chartered banks. To make this change, the wording of the defined term "new issue letter" has been modified to permit all acceptable institutions to advance new issue loans [Regulation 100.5(a)(v)].

A further source of capital to support underwritings are large corporations that, although they are not regulated and thus do not meet the acceptable institution definition, have substantial capital. Under the terms of the new standard form new issue loan agreement, there is no lender risk associated with the facility after the funds have been drawn, so it is necessary to ensure that the lender is capable of advancing the funds on settlement date. This has been addressed by requiring any non-AI lender to place in escrow with an AI high-grade securities, bank issued letters of credit or cash in escrow. The wording of the defined term "new issue letter" has been modified to permit counterparties other than acceptable institutions to advance new issue loans provided collateral is provided (and held in escrow at an AI to secure a future draw on the facility) [Regulation 100.5(a)(v)].

A7. FORMAL CODIFICATION OF MINIMUM REQUIRED TERMS TO BE INCLUDED IN NEW ISSUE LOAN AGREEMENT

In addition to the development of a standard form new issue loan agreement the minimum required standard terms that any new issue letter must include have also been listed as part of the revised definition of the term "new issue letter" [Regulation 100.5(a)(v)]. For further details of these minimum terms refer to section C below.

B. KEY AMENDMENTS MADE TO SCHEDULE 2A OF FORM 1

The main reason the underwriting commitment concentration charge was put in place was to limit a Member firm's ability to take on underwriting risk. Thus, since the use of a new issue loan under existing rules allowed for a 90% reduction in the capital otherwise required on an underwriting, those underwritings where a new issue loan had been obtained, were subject to a concentration limit. Since Member firms will still have the ability to take on additional underwriting risk through the use of the new standard form new issue loan agreement, the underwriting concentration calculation has been retained. Further, since the proposed rules also allow up to an 80% reduction in the capital otherwise required on an underwriting (subject to certain conditions) where expressions of interest from exempt purchasers have been verbally affirmed but not yet contracted, the concentration calculation has been amended to require that these exposures be reported for concentration purposes [Schedule 2A of Form 1].

The following set of examples has been prepared to illustrate how revised Schedule 2A is to be completed:

Details of underwriting commitments with unsold quantities and calculation of underwriting concentration charge

1. Calculation of adjusted normal new issue margin rate (including all adjustments other than those for the SFNIL and for expressions of interest)

	Issue with unsold quantities	**Unadjusted normal new issue margin rate**	**Disaster out clause present and effective**	**Market out clause present and effective**	**Adjusted normal new issue margin rate** (including all adjustments other than those for the SFNIL and for expressions of interest)
1	ABC	40%	Yes	No	20%
2	DEF	40%	No	No	40%
3	GHI	40%	No	Yes	4%
4	JKL	40%	No	Expired	40%

2. Calculation of fully adjusted normal new issue margin rate (including all adjustments)

	Issue with unsold quantities	**Adjusted normal new issue margin rate** (including all adjustments other than those for the SFNIL and for expressions of interest)	**SFNIL present**	**If SFNIL present, number of day underwriting is past settlement date**	**Expressions of interest present and for what portion of the underwriting**	**Adjusted normal new issue margin rate** (including all adjustments)
1	ABC	20%	No	N/A	Yes, 100%	Lessor of: 40% x 50% = 20% 40% x 20% = 8%
2	DEF	40%	Yes	4	No	40% x 10% = 4%
3	GHI	4%	No	N/A	No	4%
4	JKL	40%	Yes	10	No	40% x 25% = 10%

3. Calculation of individual and overall underwriting concentration charges

DATE: SCHEDULE 2A

PART II
JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT
ABC Securities Inc.
(Firm Name)

MARGIN FOR CONCENTRATION IN UNDERWRITING COMMITMENTS

INDIVIDUAL CONCENTRATION:

Description *(see note 3)*	Market Value	Normal Margin[1]	40% of Net allowable assets	Excess	Margin Already Provided[2] *(see note 2)*	Concentration Margin
ABC Co. preferred shares	$13,750,000	$2,750,000	$2,000,000	$750,000	$1,100,000	Nil
DEF Co. common shares	$7,500,000	$3,000,000	$2,000,000	$1,000,000	$300,000	$700,000
JKL Co. common shares	$3,400,000	$1,360,000	$2,000,000	Nil	$340,000	Nil
1. SUBTOTAL						$700,000

OVERALL CONCENTRATION:

Description *(see note 5)*	Total Market Value	Normal Margin	100% of Net allowable assets	Excess	Margin Already Provided *(see note 4)*	Concentration Margin
2. See Above	$24,650,000	$7,110,000	$5,000,000	$2,110,000	$2,440,000	Nil
3. TOTAL CONCENTRATION MARGIN *[lines 1 plus 2]*						$700,000
						B-8

NOTES:

1. This schedule need only be completed for underwriting commitments requiring concentration margin.
2. INDIVIDUAL COMMITMENT CONCENTRATION:
   Where the normal margin required on any one commitment is reduced due to either:
   (a) the use of a new issue letter; or
   (b) qualifying expressions of interest received from exempt purchasers that have been verbally affirmed but not yet contracted [the margin reduction is only permitted once the final allocation has been made to the exempt purchasers and the entire allotment to exempt purchasers has been verbally affirmed]
   and the normal margin on the commitment exceeds 40% of the member firm's net allowable assets, such excess shall be provided as margin. The amount to be added may be reduced by the amount of margin already provided on the individual underwriting position to which such excess relates.
3. Report details by individual commitments.
4. OVERALL COMMITMENT CONCENTRATION:
   Where the normal margin required on some or all commitments is reduced due to either:
   (a) the use of a new issue letter; or
   (b) qualifying expressions of interest received from exempt purchasers that have been verbally affirmed but not yet contracted [the margin reduction is only permitted once the final allocation has been made to the exempt purchasers and the entire allotment to exempt purchasers has been verbally affirmed]
   and the aggregate normal margin on these commitments exceeds 100% of the member firm's net allowable assets, such excess shall be provided as margin. The amount to be added may be reduced by the amount of margin already provided on such commitments and by the amount, if any, already provided for individual concentration.
5. It is not necessary to report details of individual commitments. Report the aggregate totals.

[1] Determined by multiplying to market value of the unsold portion of the underwriting commitment by the adjusted normal new issue margin rate (including all adjustments other than those for the SFNIL and for expressions of interest) as calculated in step 1 above.

[2] Determined by multiplying to market value of the unsold portion of the underwriting commitment by the fully adjusted normal new issue margin rate (including all adjustments) as calculated in step 2 above.

C. THE MAJOR COMPONENTS OF STANDARD FORM NEW ISSUE LOAN AGREEMENT

The primary concern with the existing new issue letter facility is that it grants Member firms a significant reduction in their capital requirements without shifting a significant portion of the underwriting risk to the letter issuer. The new standard form new issue loan (SFNIL) agreement was developed to create a risk transference agreement that also took into account the fact that funds made available by the facility would only be needed on the settlement date of the relevant underwriting. Under the new SFNIL agreement:

1. The Member firm has the ability to draw down funds on the strength of the new issue only;
2. The loan issuer ("Lender") agrees up front to advance funds:
   (a) at a stated loan value [a percentage of the new issue price];
   (b) on the draw down date [for any portion not sold prior to draw down];
   (c) at a stated interest rate; and
   (d) for a stated period of time [which must equal or exceed a prescribed minimum period]; and
3. The Lender agrees to waive right of set-off against other assets of the Member firm.

Collateral available to the Lender

As stated above, under the SFNIL agreement the loan issuer will agree to provide to the Member firm an irrevocable commitment to advance funds on the strength of the new issue only. As such is the case, the loan issuer will receive, as collateral on draw down date, [the facility must be drawn on settlement date to the extent there is a remaining unsold position] the unsold portion of the underwriting.

Further, under no circumstances would the loan issuer have any right of set-off and therefore have no recourse to use other cash and securities collateral lodged by the Member firm to recover any loss incurred on the SFNIL agreement.

However, there are certain assets that are currently considered non allowable assets that are not included as part of a Member firm's regulatory capital. Member firms may be permitted to pledge these assets under the SFNIL agreement provided they do not represent the other side of an obligation to a customer [e.g., dividends and interest receivable]. Such assets could include capital assets such as furniture and fixtures, certain types of unsecured loans in existence at the date of the SFNIL agreement [to prevent the creation of unsecured loans after the fact], investments and advances in subsidiaries and affiliates [keeping in mind that such investments would be included in the customer pool fund on bankruptcy - but that they could also be in a holding company and thus customers would not be able to obtain such value and it could be pledged to support SFNIL agreement borrowing in such cases], real estate, commissions receivable, etc.

Specific repayment terms

Generally, funds will only be drawn under a SFNIL agreement where a portion of the underwriting remains unsold as at the underwriting settlement date. When funds are drawn, the Member firm will provide the Lender as collateral the unsold portion of the underwriting commitment. As sales of the new issue are made, the Member firm will pay the funds to the Lender for the release of the securities required to make delivery to purchasers or to meet segregation requirements. In the event that the price of the new issue declines, the Member firm will immediately record a mark-to-market adjustment to recognize the loss on the unsold portion of the issue [a continuous process as the price fluctuates]. Payments for the release of securities held by the Lender as collateral would have to be based on either:

(i) The original issue price or the stated loan value per share [terms to be negotiated between loan issuer and Member firm] where the Member firm has sufficient regulatory capital; or

(ii) The proceeds per share realized where the Member firm has insufficient regulatory capital.

Ongoing Member firm obligation to the Lender should repayments be insufficient

In the event that the Lender ultimately realizes less than the amount of the loan, the Lender will become, under the terms of the SFNIL agreement, a general unsecured creditor for the balance owing with, as noted above, absolutely no right of set-off. The Member firm will be permitted to pay down the balance of such loan only to the extent that such payment would not result in the firm having a capital deficiency.

The only exception to the above requirement that "under no circumstances would the loan issuer have any right of set-off " will be in the event that a Member firm defaulted on one or more SFNIL agreements held by the Lender. It would be reasonable under this circumstance to allow the Lender to combine all of the outstanding SFNILs so that an excess on one SFNIL could offset the loss on another.

Rights of Lender in the event of Member firm bankruptcy

In the event of the bankruptcy of the Member firm, the loan issuer will be a general creditor and it will share in the general fund based on the amount of the loss [or unsecured portion of the loan if the entire new issue had not yet been sold]. It will not have any access to the customer pool fund [that would contain all cash, all securities including inventory, equity in subsidiaries, etc.]. This will correct the abuses and dangers that are inherent in the current new issue loan process. Thus, loan issuer lending officers will be forced to apply prudent credit policies in granting SFNIL agreements and in addition to assessing the quality of the new/secondary issue, it will be necessary for them to evaluate the adequacy and quality of the borrower's balance sheet.

D. FORMAL PERMITTED USE OF CAPITAL RENTAL ARRANGEMENTS

Arrangements, referred to as "capital rental arrangements, where one Member firm lends capital to another have always been available to Member firms but the SROs have never officially sanctioned their use. We are now officially sanctioning their use through the issuance of this Member Regulation Notice.

Capital rental contract terms

A capital rental arrangement is in essence the same as an over the counter put option contract where the Member firm willing to lend capital (Lender) writes a put option to the Member firm wishing to borrow capital (Borrower). As with any over the counter option contract, the two parties must agree to the following minimum terms:

1. ***Type of option contract*** – in this case is would be a put option
2. ***Contract premium*** – the premium would generally be determined in relation to the fees to be earned associated with the underwriting
3. ***Contract exercise price*** – to transfer all risk to the Lender, the exercise price would be set at the underwriting issue price; where an exercise price lower than the issue price is set, both the Borrower and the Lender will be providing capital on the underwriting
4. ***Contract size*** – the number of shares of the underwriting
5. ***Contract expiry date*** – negotiable; reduced capital requirement

Capital requirements where capital rental agreement has been executed

Provided the above terms are stipulated, the capital requirements that apply to the Lender and the Borrower, where the Borrower also has an underwriting commitment for the underlying security referred to the capital rental agreement, are as follows:

Lender – capital requirement is the same for a short put option position and the capital requirement shall be calculated pursuant to IDA Regulations 100.9(b) and 100.10(a)(ii)

Borrower – capital requirement is the same as for a long put option versus long underlying security position offset and capital requirement shall be calculated pursuant to IDA Regulation 100.10(c)(ii)(B).

OVERALL EFFECT OF AMENDMENTS

Because the amendments are numerous, their impact on a particular underwriting commitment may be difficult to determine. In order to assist in making an impact assessment the following table, which compares the existing requirements to the new requirements that come into effect on March 1, 2005, has been prepared:

Comparison of New (effective March 1, 2005) with Existing (in brackets) Capital Requirements for Underwriting Commitments							
Without documented expressions of interest from exempt purchasers		***With documented expressions of interest from exempt purchasers***		***With or without documented expressions of interest from exempt purchasers***			
Margin rate with no out clauses or SFNIL in effect	***Margin rate with disaster out clause***	***Margin rate with no out clauses or SFNIL in effect***	***Margin rate with disaster out clause***	***Margin rate with SFNIL only***	***Margin rate with disaster out clause and SFNIL***	***Margin rate with market out clause***	***Margin rate with market out clause and SFNIL***
15.00% *[25.00%]*	***7.50%*** *[12.50%]*	***3.00%*** *[25.00%]*	***3.00%*** *[12.50%]*	***1.50%*** *[2.50%]*	***1.50%*** *[1.25%]*	***1.50%*** *[Nil]*	***0.75%*** *[Nil]*
40.00% *[50.00%]*	***20.00%*** *[25.00%]*	***8.00%*** *[50.00%]*	***8.00%*** *[25.00%]*	***4.00%*** *[5.00%]*	***4.00%*** *[2.50%]*	***4.00%*** *[Nil]*	***2.00%*** *[Nil]*
60.00% *[60.00%]*	***30.00%*** *[30.00%]*	***12.00%*** *[60.00%]*	***12.00%*** *[30.00%]*	***6.00%*** *[6.00%]*	***6.00%*** *[3.00%]*	***6.00%*** *[Nil]*	***3.00%*** *[Nil]*
80.00% *[80.00%]*	***40.00%*** *[40.00%]*	***16.00%*** *[80.00%]*	***16.00%*** *[40.00%]*	***8.00%*** *[8.00%]*	***8.00%*** *[4.00%]*	***8.00%*** *[Nil]*	***4.00%*** *[Nil]*
100.00% *[100.00%]*	***50.00%*** *[50.00%]*	***20.00%*** *[100.00%]*	***20.00%*** *[50.00%]*	***10.00%*** *[10.00%]*	***10.00%*** *[5.00%]*	***10.00%*** *[Nil]*	***5.00%*** *[Nil]*