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Contact:

Member Regulation Policy
e-mail: memberpolicymailbox@iiroc.ca

Applying and interpreting the definitions of "hedger" and "institutional client"

1. Executive summary

This guidance relates to the definitions of the terms *"hedger"* and *"institutional client"* set out in Investment Dealer and Partially Consolidated Rules (**IDPC Rules**) Rule subsection 1201(2). Pursuant to paragraph (vii) of the *"institutional client"* definition, a *"hedger"* can be classified as an institutional client for accounts with qualifying hedging activities and hedge positions if it requests and consents to being classified as an institutional client.

This guidance provides further clarification of the IDPC Rule requirements that apply and to outline our expectations when determining:

- whether a client qualifies as a hedger,
- the circumstances under which a qualifying hedger can be classified as an institutional client.

This guidance is effective September 28, 2024.

2. Applicable rules

IDPC Rules this Guidance Note relates to:

- section 1201

3. Previous guidance notes

This Guidance Note replaces the following:

- N/A

4. Related documents

This Guidance Note was published under Bulletin XX-XXXX.

5. Attachment

Attachment A – Applying and interpreting the definitions of "hedger" and "institutional client"

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Concept of hedger
The concept of "*hedger*" is meant to apply to a non-individual, generally a business, that enters into a derivative transaction for the purpose of managing risk inherent in its business activities. It is not intended to apply to speculators.

Qualifying a client as a hedger
To qualify as a hedger, a non-individual must be exposed to one or more risks as a necessary part of its business activities and seek to hedge some or all of the risk by engaging in derivatives transactions where the underlying interest is the same as or materially related to the underlying interest for the risk. Such risks could include supply, credit, exchange and environmental risks as well as risks related to fluctuations in the market value of an asset, liability or position.

The underlying interest of the derivatives used must be the same as or materially related to the risks to which the hedger is exposed as a necessary part of its business activities. As such, cross-hedging could be considered hedging as a derivative may not exist in the precise underlying interest that the hedger may deal in. However, to be materially related the underlying interest of the derivative should show a historical and commercial price relationship with the hedger's underlying business activities and have a reasonable level of basis risk. For example, members that are registered as an investment dealer (**Investment Dealer Members**) can rely on the qualifying criteria for hedge accounting to establish the reasonable level of basis risk.

To hedge, it is necessary for the hedger to intend to forgo the opportunity to realize the full effect of price-level changes in its business activities. Alternatively, a hedger may intend to substitute a risk to one currency for a risk to another currency provided the substitution does not increase its original exposure. Since the intended effect of the transaction is to eliminate or reduce risk, it is possible to hedge only part of an underlying interest or position and still have the transaction regarded as a hedge. However, the transaction should no more than offset price risks incidental to the hedger's exposure as a necessary part of its business activities. What is considered a material offset will depend on the extent to which changes in the value of positions resulting from the transaction offset the value changes in the underlying interest or position being hedged. For example, Investment Dealer Members can use hedge effectiveness evaluation methods to measure the extent of the changes in the value.

Finally, a hedger who requests and consents to being categorized as an institutional client is such only as to qualifying hedging activities and hedge positions.

Categorizing a qualifying hedger as an "institutional client"
Investment Dealer Members should have reasonable basis to classify a hedger as an "*institutional client*". For example, an Investment Dealer Member should review with the client the nature and extent of the risk that is sought to be hedged and ~~to~~ confirm that the transactions are primarily for hedging purposes and not for speculative purposes. This could include obtaining the hedging strategy/program from the client and being able to establish in a conclusive and verifiable manner that the requisite conditions to be categorized as a hedger have been met.

An Investment Dealer Member's books and records should clearly identify all steps taken and documents obtained that are necessary to demonstrate how the Investment Dealer Member determined the client was a hedger.

Investment Dealer Members should periodically verify that a client's trading activities are consistent with the requisite conditions to qualify as a hedger.

Disclosure by Investment Dealer Members
A hedger who requests and consents to being classified as an institutional client, should be clearly informed that the Investment Dealer Member's obligations under the IDPC Rules are different for institutional clients.

Investment Dealer Members should provide clients with a full list of requirements, and also provide clear examples of information they do not have to provide institutional clients.

The following list provides examples of requirements[1] which are either different from those applicable to a retail client or not applicable to an institutional client:

- Know your client and suitability requirements: IDPC Rule clause 3208(1)(iv), IDPC Rule section 3403,
- Relationship disclosure: IDPC Rule subsection 3216(1),
- Fee schedule disclosure: IDPC Rule subsection 3504(3),
- Client complaints handling: IDPC Rule section 3715,
- Trade confirmation: IDPC Rule subclauses 3816(2)(v)(b), 3816(2)(vi)(c) and 3816(2)(vii),
- Client account statements: IDPC Rule clauses 3808(3)(vi) and 3808(3)(viii),
- Performance report: IDPC Rule subsection 3810(1),
- Fee/charge report: IDPC Rule subsection 3811(1), and
- Supervision of account: IDPC Rule sections 3950 and 3951.

[1] These examples do not constitute an exhaustive list of requirements applicable to retail clients or institutional clients.