CIRO Bulletin

Rules Bulletin

Request for Comments

IDPC Rules/Form 1

Rule Connection:
IDPC Rule 5400

23-0095

July 20, 2023

Comments Due By: September 18, 2023

Please distribute internally to:
Credit
Institutional
Legal and Compliance
Operations
Regulatory Accounting
Retail
Senior Management
Trading Desk
Training

Contact:
Member Regulation Policy
Email: memberpolicymailbox@iiroc.ca

Catherine Drennan
Senior Manager, Financial Information, Member Regulation Policy
Telephone: 416-943-6977
e-mail: cdrennan@iiroc.ca

Republication of proposed amendments regarding margin requirements for structured products

Executive Summary

Canadian Investment Regulatory Organization (**CIRO**) is republishing for comment revisions to the previously proposed amendments that would allow qualifying structured products to be margin eligible (**Proposed Amendments**).

In 2021, IIROC published Notice 21-0032 regarding proposed amendments (**2021 proposed amendments**) to the Dealer Member Rules and IIROC Rules that would allow margining of structured products that meet certain eligibility requirements. On January 1, 2023, the Board of Directors of CIRO approved the adoption of the 2021 proposed amendments to the Investment Dealer and Partially Consolidated Rules (**IDPC Rules**).

The main purpose of the Proposed Amendments is to set a margin methodology for structured products which considers the different risk profiles of the two main structured product types.

The Proposed Amendments would:

- require a fixed margin rate of 50% for principal at risk notes and 30% for principal protected notes that meet eligibility criteria
- clarify the requirements for reporting concentration exposures in structured products on Form 1
- maintain the allowance of an alternative component-based margin methodology

How to Submit Comments

Comments on the Proposed Amendments should be in writing and delivered by September 18, 2023 (60 days from the publication date of this notice) to:

Member Regulation Policy
Canadian Investment Regulatory Organization
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: memberpolicymailbox@iiroc.ca

A copy should also be delivered to the Canadian Securities Administrators (**CSA**):

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the CIRO website at www.ciro.ca.

Rules Notice - Table of Contents

1. Background 4
 1.1 Principal protected notes 4
 1.2 Principal at risk notes 4
2. History 4
 2.1 Previously proposed amendments published in 2021 4
 2.2 Comments received 5
 2.3 Republication 5
3. Proposed Amendments 5
 3.1 Proposed margin rate for principal at risk notes 5
 3.2 Proposed margin rate for principal protected notes 6
 3.3 Margin eligibility criteria 7
 3.4 Requirements for reporting concentration exposures 8
4. Impacts of the Proposed Amendments 8
5. Implementation 8
6. Policy Development Process 8
 6.1 Regulatory Purpose 8
 6.2 Regulatory Process 9
7. Appendices 9

1. Background

A structured product is a market-linked investment that is packaged as an alternative to a direct investment in the underlying security or basket of securities. The purpose of the structured product is to reduce risk exposure while utilizing current market trends. Structured products are not typically listed on exchanges. In Canada, Dealer Members distribute structured products issued by their affiliated financial institutions and offer a secondary market to investors wishing to sell the products prior to maturity.

Investors are attracted to these products for their tax and operational efficiencies and customizable features. Structured products are popular with high net worth clients that want a product customized to their specific investment view. In general, structured products, are intended to be held to maturity for investors to benefit from features such as the principal protection component embedded in the product. The majority of structured products have a term to maturity of 5 to 7 years.

There are two main types of structured products:

- Principal protected notes (**PPNs**)
- Principal at risk notes (**PARs**)

1.1 Principal protected notes

PPNs guarantee at least the return of the principal amount invested, as long as the note is held to maturity. A PPN is structured as a zero-coupon bond combined with a payoff option linked to the performance of an underlying asset, index, or benchmark. PPNs are issued by financial institutions in Canada through an information statement or term sheet. PPNs are sold without a prospectus under prospectus exemptions for guaranteed debt or on the basis that they fall outside the scope of provincial securities legislation.

1.2 Principal at risk notes

PARs provide investors the possibility of increased returns through leverage, by putting more of the investment's principal amount at risk. Financial institutions issue these products to investors through a prospectus offering (with the exception of certain institutional investors) as required by securities laws.

2. History

2.1 Previously proposed amendments published in 2021

The IIROC Board approved the publication of proposed amendments to DMR 100.2 and IIROC Rule 5400 that would allow margining of structured products using either a fixed rate or an alternative component margining methodology (**2021 proposed amendments**). The 2021 proposed amendments were published for comment in Notice 21-0032. The 2021 proposed amendments were designed to allow margin eligibility to structured products at a conservative fixed margin rate to address risks associated with the liquidity and complexity of the products.

The 2021 proposed amendments:

- required a fixed margin rate of 70% for structured products that meet eligibility criteria, and
- allowed an alternative component-based margin methodology for structured products with a principal protection component. (**Component Methodology**)

On January 1, 2023, the Board of Directors of CIRO approved the adoption of the 2021 proposed amendments as proposed amendments to IDPC Rule 5400.

2.2 Comments received

We received two public comment letters in response to the 2021 proposed amendments published in Notice 21-0032. The public commenters raised concerns that the 70% fixed margin rate was overly conservative and the commenters suggested different rates should be considered for the two main structured product types (PPNs and PARs) due to the differences in risks between these product types. We provided a summary of these comments and our response in **Appendix D**.

2.3 Republication

We are republishing for comment revisions to the 2021 proposed amendments to address the issues raised in the public comments. A blackline comparison of the Proposed Amendments to the 2021 proposed amendments is included in **Appendix C.**

3. Proposed Amendments

The Proposed Amendments set margin requirements that consider the differences in risk between PPNs and PARs and the risk profile of the structured products compared to the underlying securities they track. The Proposed Amendments would:

- require a fixed margin rate of 50% for principal at risk notes and 30% for principal protected notes that meet eligibility criteria
- clarify the requirements for reporting concentration exposures in structured products on Form 1
- maintain the allowance of the Component Methodology as an alternative margin calculation

The text of the Proposed Amendments to IDPC Rules and Form 1 is set out in **Appendix B** and a blackline of the changes is set out in **Appendix A**.

3.1 Proposed margin rate for principal at risk notes

A conservative fixed margin rate of 70% was proposed in the 2021 proposed amendments which was based on a 50% margin rate plus a 20% margin rate premium to cover increased liquidity risk. After further analysis, including a review of the underlying securities, we propose a 50% fixed margin rate for PARs based on the following:

- analysis of the underlying securities shows the margin rate for most underlying securities is less than 30%,
- a 50% fixed margin rate is similar to other products with limited or low liquidity such as bonds in default, preferred shares and thinly-traded listed securities over $2, and
- the margin eligibility criteria under proposed subsection 5455(1) are designed to address additional liquidity and credit risk concerns.

3.1.1 Principal at risk notes analysis

We collected data related to the underlying securities for PARs and performed analysis to identify the common types of underlying securities and the associated margin rates. Generally, the underlying securities of structured notes are highly-liquid securities with low levels of volatility which allow the issuer to create structured products

that offer a variety of features to limit upside and downside risks. Highly-volatile and low-capitalized underlying securities are not usually considered for inclusion in structured products as the high volatility creates challenges for the issuer to create a viable structured product that can be sustained for the full term to maturity.
The underlying securities are typically either:

- highly-capitalized securities that are eligible for reduced margin,
  or
- qualifying indices or index participation units eligible for floating index margin rates.

Based on the analysis, the majority of PARs (approx. 91%) issued in the past five years are based on the performance of a portfolio of underlying securities that have a margin rate of 30% or less as shown in Table 1.

Table 1

Type of underlying securities	Highest margin rate within the portfolio of the PAR's underlying securities	Percentage of PARs issued in the past five years
Qualifying indices and index participation units	10-15%	15.1%
Listed securities eligible for reduced margin	30%	76.5%
Listed securities trading over $2 but not eligible for reduced margin	50%	8.2%
Securities not eligible for margin	100%	0.2%
		100%

3.2 Proposed margin rate for principal protected notes

We determined a lower margin rate for PPNs compared to PARs was appropriate to recognize the lower risk associated with PPNs due to the zero-coupon bond component that provides the principal protection. Since the zero coupon bond component of the PPN is a significant portion of the PPN compared to the performance component, PPNs are more akin to a debt instrument than PARs.

After further analysis, including comparison to the Component Methodology, we are proposing a margin rate of 30% for PPNs based on the following:

- the effective margin rates under the Component Methodology are below 30% under most economic scenarios,
- a fixed margin rate of 30% for PPNs is conservative in comparison to the current margin rate of similar debt instruments such as corporate strip bonds, and

- margin eligibility criteria under proposed subsection 5455(1) are designed to address additional liquidity and credit risk concerns.

3.2.1 Principal protected notes analysis

The proposed alternative Component Methodology allows the debt component to be margined according to IDPC Rule section 5223(1) and the performance-based component to be margined at 100%. Some Dealers are currently applying the Component Methodology based on margin rulings provided to them.

We collected data related to the effective margin rate calculated by Dealers under the Component Methodology. We analyzed the effective margin rates resulting from applying the Component Methodology to PPNs under various economic scenarios based on historic yields and market returns. The analysis showed a fixed margin rate of 30% is generally higher than the resulting Component Methodology margin rate. The effective margin rates under the Component Methodology ranged from 11% to 23% under most economic scenarios.

3.3 Margin eligibility criteria

The 2021 proposed amendments included margin eligibility criteria such as the requirement for an active secondary market. We have kept the active secondary market requirement in the Proposed Amendments to ensure the structured products have sufficient liquidity to be sold to cover client margin deficiencies, if necessary. We have amended the other margin eligibility criteria as follows:

- re-drafted the language to provide more clarity that the structured products must be issued by Canadian financial institutions that qualify as acceptable institutions,
- clarified that the underlying securities must be eligible for a margin rate of 50% or less at the time the structured product is issued, and
- removed the requirement for the structured product to be issued by prospectus.

3.3.1 Issuer of the structured product

Only structured products issued by credit-worthy regulated financial institutions will be eligible for margin. The structured products such as PARs and PPNs that we reviewed for margin eligibility are issued by credit unions and banks in Canada. The Proposed Amendments limit the margin eligibility to these Canadian financial institutions, specifically ones that qualify as an acceptable institution (**AI**).

The 2021 proposed amendments included this margin eligibility criteria but the requirements were partially embedded in the definition of structured product. We have re-drafted the margin eligibility criteria in the Proposed Amendments to provide more clarity that the structured products must be issued by Canadian financial institutions that qualify as AIs.

3.3.2 Margin eligibility of underlying securities

We clarified that the underlying securities must be eligible for a margin rate of 50% or less at the time the structured product is issued. We propose this margin eligibility assessment to be done when the product is issued because:

- the composition of the structured product does not change over the term, and

- most underlying securities are highly-capitalized securities or indices that are unlikely to have significant changes in margin eligibility that would warrant the operational costs of checking margin eligibility throughout the term of the product.

We believe this requirement is necessary to reduce the likelihood of regulatory margin arbitrage where structured products could be created with underlying securities that require margin rates greater than 50%.

3.3.3 Prospectus qualification criteria

We removed the requirement for the structured products to be qualified with a prospectus. We decided to remove this requirement because:

- the structured products can be issued under prospectus exemptions or in the case of PPNs qualify as deposits at a financial institution, and
- the remaining margin eligibility criteria are considered sufficient to address the potential credit and market risks associated with the products.

3.4 Requirements for reporting concentration exposures

We are proposing an amendment to the notes and instructions to Schedule 9A of Form 1 to provide clarification that structured notes should be included in the classes of securities of the issuer. The investor purchasing the structured products has credit risk exposure to the issuer since the obligation to make payments associated with the structured products is the obligation of the issuer. The continued viability of the structured products is dependent on the financial health and creditworthiness of the issuer. When measuring concentration exposures to an issuer, the structured products should be included with other securities issued by that issuer.

4. Impacts of the Proposed Amendments

The Proposed Amendments will benefit Dealers who hold these products in inventory and clients that wish to borrow against these products by providing clarity on the margin requirements. The Proposed Amendments will also improve the consistency and transparency in the Dealer Member's structured product margin treatment.

We believe that the Proposed Amendments will have no material negative impact on investors, issuers, registrants, CIRO, CIPF and the Canadian capital markets generally. There are no regional-specific effects as the margin requirements impact all industry stakeholders trading in structured products across Canada.

5. Implementation

We intend to make the Proposed Amendments effective within 90 days after approval from our recognizing regulators.

6. Policy Development Process

6.1 Regulatory Purpose

The purpose of these amendments is to formally recognize a margin methodology for structured notes which considers the different risk profiles of the two main structured product types, as the current IDPC Rules do not specifically address margin requirements for these products. The Proposed Amendments have been determined to be in the public interest because they would:

- foster fair and efficient capital markets and promote market integrity, and
- accommodate innovation and ensure flexibility and responsiveness to the future needs of the evolving capital markets, without compromising investor protection.

6.2 Regulatory Process

The Board of Directors of CIRO (**Board**) has determined the Proposed Amendments to be in the public interest and on June 28, 2023 approved them for public comment.

CIRO developed the Proposed Amendments in consultation with the Financial and Operations Advisory Section (FOAS) Capital Formula Subcommittee. The subcommittee supported the Proposed Amendments.

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

7. Appendices

Appendix A – Blackline copy of Proposed Amendments to IDPC Rules and Form 1

Appendix B – Clean copy of Proposed Amendments to IDPC Rules and Form 1

Appendix C – Blackline copy of the Proposed Amendments to the 2021 proposed amendments

Appendix D – Response to public comments

Appendix B

Canadian Investment Regulatory Organization

Republication of proposed amendments regarding margin requirements for structured products

Clean copy of the proposed amendments to IDPC Rules and Form 1

Amendment #1 - IDPC Rule section 5130 is amended as follows:

5130. Definitions

(1) In Rules 5100 through 5900, unless stated otherwise, any term used that is not defined here or in the Rule where it is used, but is defined or used in Form 1, has the meaning defined or used in Form 1.

(2) For all positions subject to margin, the term:

"underlying interest" or "underlying security" or "underlying basket of securities"	In the case of: (i) a *convertible security,* the security to be received upon invoking the conversion or exchange feature, (ii) an *exercisable security,* the security to be received upon invoking the exercise feature, (iii) an *index participation unit,* the basket of securities to be received upon invoking the conversion or exchange feature, (iv) an *installment receipt*, the security that has been purchased on an installment basis by the holder of the *installment receipt*, (v) residual debt securities and strip debt securities, the *debt security* used to create the residual debt securities and strip debt securities, (vi) currency *options*, the currency referenced by the *option*, (vii) equity, *index participation unit* and debt *options*, the security referenced by the *option*, (viii) *index options*, the *index* referenced by the *option*, (ix) a *total performance swap*, the security or basket of securities on which the swap is based, and (x) a *structured product*, the security or basket of securities on which the performance of the *structured product* is based.

.

.

.

(8) For *structured product* positions, the term:

"structured product"	A financial instrument where the return is linked to the performance of a specified *underlying security* or *underlying basket of securities.* Structured products include:

	(i) *principal at risk notes*, and (ii) *principal protected notes*.
"principal at risk note"	A financial instrument where the return is linked to the performance of a specified *underlying security* or *underlying basket of securities* and the investor carries a risk of losing part or all of the initial amount invested.
"principal protected note"	A financial instrument where the return is linked to the performance of a specified *underlying security* or *underlying basket of securities* and at maturity the investor receives as a minimum, the initial amount invested.

(9) For positions in and offsets involving foreign exchange exposures, the term:

.

.

.

(10) For positions in and offsets involving *derivative* products, the term:

Amendment #2 - IDPC Rule section 5401 is amended as follows:

5401. Introduction

(1) Rule 5400 sets out specific *Dealer Member inventory margin* and *client account margin* requirements for investment products not covered in Rules 5200 or 5300. The order of subjects in Rule 5400 is:

(i) securities subject to redemption call or offer [section 5410],

(ii) units [section 5420],

(iii) precious metal certificates and bullion [section 5430],

(iv) swap contracts [sections 5440 through 5442],

(v) mutual fund positions [section 5450],

(vi) *structured products* [section 5455 through 5456], and

(vii) foreign exchange positions [sections 5460 through 5469].

Amendment #3 - IDPC Rule sections 5455 and 5456 are added as follows:

5451. - 5454. Reserved.

STRUCTURED PRODUCTS

5455. Margin requirements for structured products

(1) A *structured product* is eligible to be margined provided:

(i) the issuer of the *structured product* is a Canadian financial institution as defined in securities laws, which qualifies as an *acceptable institution*,

(ii) at the time of issuance, the *structured product's underlying security* or *underlying basket of securities* are eligible for a margin rate of 50% or less under Rule 5200, 5300 or 5400, and

(iii) the issuer of the *structured product* or its *affiliate* is actively providing a secondary market.

(2) Where a *structured product* is eligible to be margined pursuant to 5455(1), the minimum *Dealer Member inventory margin* and *client account margin* requirements are as follows:

Type of structured product	Minimum margin required
principal protected note	30% of the *market value* of the *principal protected note* position
principal at risk note	50% of the *market value* of the *principal at risk note* position

5456. Alternative calculation approach for structured products

(1) For *structured products* with protection of all or a portion of the investment principal, where the performance component can be separated from the debt instrument component, the minimum *Dealer Member inventory margin* and *client account margin* requirements may be calculated as the sum of the separate components as follows:

(i) For the performance component linked to an *underlying interest*, 100% of the *market value* of the performance component; and

(ii) For the debt instrument component, the margin rate percentage specified in subsection 5223(1), multiplied by the *market value* of the debt instrument component,

provided the conditions in section 5455(1) are met.

5457. - 5459. Reserved.

Amendment #4 – The notes and instructions to Schedule 9A of Form 1 are amended as follows:

Form 1, Part II – Schedule 9A
Notes and instructions

General Security Test

(1) *Dealer Members* must disclose the largest ten issuer positions and precious metal positions subject to the General Security Test, whether or not a concentration charge applies. If there are more than ten issuer positions and precious metal positions where a concentration exposure exists, then all such positions must be listed.

(2) An issuer position must include all classes of securities for an issuer (i.e. all long and short positions in equity, convertibles, debt, structured products, or other securities of an issuer other than *debt securities* cited in note 3). Precious metal positions are also tested using the General Security Test methodology, and must include all certificates and bullion of the particular precious metal (gold, platinum or silver).

(3) Exclude all:

  (i) *debt securities* with a normal margin requirement of 10% or less, and

  (ii) stripped coupons and residuals if they are held on a book based system and are in respect of federal and provincial debt instruments.

(4) An amount loaned exposure to *broad based index* positions may be treated as an amount loaned exposure to each of the individual securities comprising the index basket. These amount loaned exposures may be reported by breaking down the *broad based index* position into its constituent security positions and adding these constituent security positions to other amount loaned exposures for the same issuer to arrive at the combined amount loaned exposure.

To calculate the combined amount loaned exposure for each index constituent security position held, sum:

  (i) the individual security positions held, and

  (ii) the constituent security position held.

(For example, if ABC security has a 7.3% weighting in a *broad based index*, the number of securities that represents 7.3% of the value of the *broad based index* position shall be reported as the constituent security position.)

Comments received in response to Rules Notice 21-0032 – Rules Notice – Request for Comments – Proposed margin requirements for structured products

On February 25, 2021, we issued Notice 21-0032 requesting comments on the proposed margin requirements for structured products. CIRO received two comment letters from the following commenters:

CIBC World Markets Inc.
Investment Industry Association of Canada (IIAC)

A copy of these comment letters is publicly available on IIROC's website (www.iiroc.ca). The comments we received and our responses to them are summarized in the table below.

Summary of Comment	New SRO Response
The commenters suggested the proposed margin rate of 70% was excessive for structured products and suggested the margining framework should differentiate between the two main types of structured products (principal at risk notes and principal protected notes)	We performed further analysis of the structured products and engaged in further consultation with the FOAS Capital Formula Subcommittee on the margining framework. The Proposed Amendments set separate margin rates for principal at risk notes and principal protected notes which are less than the original proposed margin rate of 70%.
One commenter requested clarification on how the margin eligibility criteria of underlying securities applies to broad based indices, portfolios of shares, exchange traded funds etc.	The Proposed Amendments require that the structured product's underlying securities must be eligible for a margin rate of 50% or less at the time the structured product is issued. Where the structured product is based on the performance of an index, (a) the index must be a qualifying index under the IDPC Rules, or (b) the underlying securities of the index must all be eligible for a margin rate of 50% or less under IDPC Rules. Where the structured product is based on the performance of a portfolio of securities, all the securities in the portfolio must all be eligible for a margin rate of 50% or less under IDPC Rules. Where the structured product is based on the performance of an exchange traded fund (**ETF**), the ETF itself must be eligible for a margin rate of 50% or less under IDPC Rules.

Summary of Comment	New SRO Response
	ETFs are margined as listed securities under the IDPC Rules and not margined based on the ETF’s underlying securities.