Chapter 13

SRO Notices and Disciplinary Proceedings

13.1.1 IDA Amendments to Schedule 12 of Form 1 Relating to the Margin on Commodity Concentrations and Deposits

INVESTMENT DEALERS ASSOCIATION OF CANADA –
AMENDMENTS TO SCHEDULE 12 OF FORM 1 RELATING TO THE MARGIN ON COMMODITY CONCENTRATIONS AND DEPOSITS

I OVERVIEW

A Current Rules

Schedule 12 of Form 1 requires reporting of commodity and commodity derivative positions to determine possible commodity concentration risk. The schedule contains three separate calculations on Lines 1 through 3 – general margin, concentration margin in individual accounts and concentration margin in individual commodities. The Notes and Instructions to Schedule 12 of Form 1 detail the calculation of the amounts to be reported on Lines 1 through 3.

B The Issue

The current Notes and Instructions to Schedule 12 are not clear as to which positions in futures, options on futures and underlying commodity positions are to be reported on Lines 1 through 3 and which offset strategy related positions may be excluded from the positions reported.

C Objective

The objective of the proposed amendments is to clarify the instructions to be used in determining the amounts to be reported on Lines 1 through 3 of Schedule 12. Specifically, the treatment of short options on futures positions has been amended to require that such positions be included in the calculation of the amount reported on Lines 1 through 3, subject to allowing exclusions for positions that are deep out-of-the-money1 and for positions that are part of an acceptable offset strategy.

D Effect of Proposed Rules

It is believed the proposed amendments set out in Attachment #1 will have no impact in terms of capital market structure, member versus non-member level playing field, competition generally, costs of compliance and conformity with other rules.

II DETAILED ANALYSIS

A Present Rules, Relevant History and Proposed Policy

Present Rules

The current Notes and Instructions to Schedule 12 of Form 1 require the reporting of commodity futures and options on futures for concentration purposes. There is a lack of clarity in the notes and instructions as to which positions are to be reported. For example:

- The Notes and Instructions to Line 1 of Schedule 12 specify that the maintenance margin requirement is a reportable item but only with respect to futures contracts and not with respect to futures contracts underlying short options of futures contract positions. The futures contracts underlying short options of futures contract positions should also be reported.

- The Notes and Instructions to Line 1 of Schedule 12 permit the exclusion of certain out-of-the-money short options on futures positions but does not permit the exclusion of certain positions that are part of otherwise valid offset strategies involving the underlying commodity, futures spreads and options on futures spreads. Positions that are part of these offsets should be excluded because they do not contribute to concentration risk, and

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[1] Short option on futures positions that are out-of-the-money by more than two maintenance margin requirements will be considered to be “deep out-of-the-money”.

- The Notes and Instructions to Lines 2 and 3 require that the short futures contract positions reported include futures contracts underlying any short options on futures contract positions. This makes sense where the option contract is call option (especially where the option is in-the-money) but does not make sense from a concentration risk standpoint where the contract is a put option. In the case of a short put option position the underlying futures contracts should be reported as part of any long futures contract position reported.

In addition, the relief granted for deep out-of-the-money short options on futures positions has been determined to be overly complex to calculate.

Proposed Rule Amendments

The amendments seek to clarify and simplify the commodity concentrations on Schedule 12 by requiring/allowing that:

- Short options on futures contracts as well as futures contracts be included in the positions reported on Lines 1 through 3;

- Spreads involving short positions in options on futures contracts be excluded from the positions reported on Lines 1 through 3;

- Short call options on futures contract positions be reported as short futures positions;

- Short put options on futures contracts positions be reported as long futures positions, and

- Members may exclude option positions that are more than two maintenance margins out-of-money

B Issues And Alternatives Considered

No alternatives have been considered.

C Comparison with Similar Provisions

Both the United Kingdom and the United States have concentration rules on commodities futures and options on futures. Since the proposed amendments are technical in nature, a detailed comparison to these rules was considered unnecessary.

D Systems Impact of Rule

The proposed amendments seek to ensure that the concentration calculation continues to focus on significant futures and options exposures in line with the risks associated. It is therefore not believed that this rule proposal will result in significant costs or systems impacts.

The Bourse de Montréal is also in the process of passing this amendment. Implementation of this amendment will therefore take place once both the IDA and the Bourse de Montréal have received approval to do so from their respective recognizing regulators.

E Best Interests of the Capital Markets

The Board has determined that this public interest rule is not detrimental to the best interests of the capital markets.

F Public Interest Objective:

According to subparagraph 14(c) of the IDA's order of Recognition as a self-regulatory organization, the IDA shall, where requested, provide in respect of a proposed rule change "a concise statement of its nature, purposes (having regard to paragraph 13 above) and effects, including possible effects on market structure and competition". Statements have been made elsewhere as to the nature and effects of the proposal. The purposes of the proposal are to:

- Facilitate an efficient capital-raising process and fair and open competition in securities transactions by imposing capital and margin requirement in relation to the inherent risks associated with the open commodity futures and options on futures positions, and

- Standardize industry practices and promote operational efficiency by clarifying the reporting requirements for concentration purposes.

The proposal does not permit unfair discrimination among customers, issuers, brokers, dealers, members or others. It does not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes.

III COMMENTARY

A Filing in Other Jurisdictions

These proposed amendments will be filed for approval in Alberta, British Columbia, Ontario and Quebec and will be filed for information in Manitoba, Nova Scotia and Saskatchewan.

B Effectiveness

As indicated in the previous sections, the objectives of the proposal are to ensure that the concentration calculation continues to focus on significant risk exposures and reduce operational inefficiencies. It is believed that this proposal is effective in achieving its objectives.

C Process

These proposed amendments were developed and recommended for approval by the FAS Capital Formula Subcommittee and recommended for approval by the FAS Executive Committee and the Financial Administrators Section.

IV SOURCES

- Form 1, Schedule 12

V OSC REQUIREMENT TO PUBLISH FOR COMMENT

The IDA is required to publish for comment the accompanying amendments.

The Association has determined that the entry into force of the proposed amendments would be in the public interest. Comments are sought on these proposed amendments. Comments should be made in writing. One copy of each comment letter should be delivered within 30 days of the publication of this notice, addressed to the attention of Jane Tan or Arif Mian, Investment Dealers Association of Canada, Suite 1600, 121 King Street West, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of the Manager of Market Regulation, Ontario Securities Commission, 20 Queen Street West, 19th Floor, Box 55, Toronto, Ontario, M5H 3S8.

Questions may be referred to:

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Attachment #1

INVESTMENT DEALERS ASSOCIATION OF CANADA

AMENDMENTS TO SCHEDULE 12 OF FORM 1 RELATING TO THE MARGIN ON COMMODITY CONCENTRATIONS AND DEPOSITS

BOARD RESOLUTION

THE BOARD OF DIRECTORS of the Investment Dealers Association of Canada hereby makes the following amendments to the By-laws, Regulations, Forms and Policies of the Association:

1. Line 1 of the Notes and Definitions of Schedule 12 to Form 1 is amended by:

   in the first paragraph, deleting "(FC) shall be calculated as follows:" and adding "and options on futures contracts shall be 15% of the maintenance margin requirements, as required by the"; adding "futures" before 'contracts' in the third line and adding the following sentences starting the end of the forth line "For the purpose of this general margin provision, short futures contracts positions include futures contracts underlying the short call options on futures contracts and long futures contracts positions include futures contracts underlying the short put options on futures contracts."

   In Line 1 (d), adding "on futures contracts" into the first line. Immediately after Line 1 (d)(i), deleting "half of a short option which is" and adding "short options on futures contracts which are"; at the end of (d)(i), deleting "requirements, but less than three;" and adding "requirements; and". In Line 1 (d)(ii), replacing "a short option which is out of the money by more than three maintenance margin requirements." with "spreads in the same options on futures contracts."

2. Line 2 of the Notes and Definitions of Schedule 12 to Form 1 are amended by

   in Line 2(a), adding "or underlying interest of option on futures" before 'contracts'. In the last paragraph of Line 2, replacing "this" by "the" in the first line, in the second line, adding "call options on" before 'futures', deleting "option" and adding "contracts and long futures" after 'futures', and after 'contracts positions' deleting "(FOC)." and adding "include futures contracts underlying the short put options on futures contracts."

3. Line 3 of the Notes and Definitions of Schedule 12 to Form 1 are amended by

   in the first line, deleting "futures option contracts" and adding "options on futures contract" before 'positions'. In the last paragraph of Line 3, adding "call options on" before 'futures' and deleting "option" after 'futures' and adding "contracts and long futures" before 'contracts'; deleting "FOC." after 'contracts positions' and adding "include futures contracts underlying the short put options on futures contracts." at the end of Line 3.

4. Line 4 of the Notes and Definitions of Schedule 12 to Form 1 are amended by

   in the first line, deleting "," after 'assets'. In the second last line of the last paragraph, deleting "futures" before 'options' and adding "on futures" after 'options'.

5. Note 1 of the Notes and Definitions of Schedule 12 to Form 1 are amended by:

   in the second line of Note 1, adding "options on" before 'futures contracts', deleting "futures option" and adding "options on futures" after 'short'. In Note 1 1.1 deleting "(AI)". In Note 1 1.3, deleting "Futures Option Contracts Positions (FOC)" and adding "Options on Futures Contracts Positions" after 'short' in the first line. In Note 1 1.3(vi), adding "and" at the end; in (vii), deleting "half of a short" and adding "short" before 'option' in the first line; deleting "requirements but less than three; and" and adding "requirements;" in the second line. Further, deleting the whole Note 1 1.3 (viii) "a short option which is out of the money by more than three maintenance margin requirements."

PASSED AND ENACTED BY THE Board of Directors this 19th day of January 2005, to be effective on a date to be determined by Association staff.

Attachment #2

INVESTMENT DEALERS ASSOCIATION OF CANADA

AMENDMENTS TO SCHEDULE 12 OF FORM 1 RELATING TO THE MARGIN ON COMMODITY CONCENTRATIONS AND DEPOSITS

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SCHEDULE 12
NOTES AND INSTRUCTIONS

Line 1 - General margin provision. The margin requirement for futures contracts ~~(FC) shall be calculated as follows:~~ and options on futures contracts shall be 15% of the maintenance margin requirements, as required by the Commodity Futures Exchange on which such futures contracts were entered into, for the greater of the total long or total short futures contracts per commodity or financial futures carried for all client and firm accounts. For the purpose of this general margin provision, short futures contracts positions include futures contracts underlying the short call options on futures contracts and long futures contracts positions include futures contracts underlying the short put options on futures contracts.

The following positions are excluded from this calculation:

(a) positions in Acceptable Institution, Acceptable Counterparty and Regulated Entity accounts;

(b) client and firm hedge positions, provided that the underlying interest is held in ~~the client's~~an account at the Member or that the Member has a document giving the Member an irrevocable right to take possession of the underlying interest and deliver it at the location designated by the appropriate clearing corporation. All other hedge positions are treated as speculative positions for the purpose of this calculation;

(c) client and firm spreads in the same futures contract entered into on the same futures exchange. All other spread positions are treated as speculative positions for the purpose of this calculation;

(d) The following options on futures contracts positions:

~~(i) half of a short option which is~~(i) short options on futures contracts which are out-of-the money by more than two maintenance margin ~~requirements, but less than three;~~requirements; and

~~(ii) a short option which is out of the money by more than three maintenance margin requirements.~~

(ii) spreads in the same options on futures contracts.

Line 2 - Concentration in individual accounts. The Member must provide for the amount by which;

(a) the aggregate of the maintenance margin requirements of the commodity or financial futures or underlying interest of option on futures contracts held both long and short for any client (including without limitation groups of clients or related clients) or in inventory, except for positions mentioned in Note 1 below, less any excess margin provided

exceeds

(b) 15% of the Member's net allowable assets.

The excess margin must be based on the maintenance margin. However, spread positions in the same product or different product on the same exchange and an inter-exchange or inter- commodity spread could be included using the maintenance margin as set by the exchange, provided that the spread is acceptable for margin purposes by a recognized exchange.

If the excess is not eliminated within three (3) trading days after it first occurs, the Member's capital shall be charged the lesser of:

(a) the excess calculated when the concentration first occurred; and

(b) the excess, if any, that exists on the close of the third trading day.

For the purpose of ~~this~~the concentration calculation, short futures contracts positions include futures contracts underlying the short call options on futures ~~option~~contracts and long futures contracts positions ~~(FOC).~~include futures contracts underlying the short put options on futures contracts.

Line 3 - Concentration in individual open futures contracts and short ~~futures option contracts~~options on futures contract positions. The Member must provide for the amount by which;

(a) the aggregate of two maintenance margin requirements on the greater of the long or the short commodity or financial futures contracts position held for clients and in inventory, except for positions mentioned in Note 1 below,

exceeds

(b) 40% of the Member's net allowable assets.

There may be deducted from this difference, on a per client basis, the excess margin available in all accounts of the client up to two maintenance margin requirements of the client's positions in the futures contracts.

The excess margin must be based on the maintenance margin. However, spread positions in the same product or different product on the same exchange and in inter-exchange or inter commodity spread could be included in both the long and short side using maintenance margin as set by the exchange, provided that the spread is acceptable for margin purpose by a recognized exchange.

If the excess is not eliminated within three (3) trading days after it first occurs, the Member's capital shall be charged the lesser of:

(a) the excess calculated when the concentration first occurred; and

(b) the excess, if any, that exists on the close of the third trading day.

For the purpose of the concentration calculation, short futures contracts positions include futures contracts underlying the short call options on futures ~~option~~contracts and long futures contracts positions ~~(FOC).~~include futures contracts underlying the short put options on futures contracts.

Line 4 - Where assets~~,~~ including cash, open trade equity and securities owing to a Member from a Commodity Futures Correspondent Broker exceeds 50% of the Member's net allowable assets, any excess over this amount shall be provided as a charge in computing the Member's margin required.

Where the net worth of the Commodity Futures Correspondent Broker, as determined from its latest published audited financial statements, exceeds $50,000,000, no margin is required under this rule.

Where the net worth of the Commodity Futures Correspondent Broker, as determined from its latest published financial statements, is less than $50,000,000, the Member may use a confirmed unconditional and irrevocable letter of credit issued by a US bank qualifying as an Acceptable Institution on behalf of the Commodity Futures Correspondent Broker to offset any margin requirement calculated above. The amount of the offset is limited to the amount of the letter of credit.

No exemption from this requirement is permitted for Members who operate their commodity futures contracts and commodity ~~futures~~ options on futures contracts business on a fully disclosed basis with a correspondent broker.

Note 1: For the purpose of the calculation of the concentration margin on individual client accounts (Line 2) and for open options on futures contracts and short ~~futures option~~options on futures contracts positions (Line 3), the following positions are excluded:

1.1 positions held in Acceptable Institution~~(AI)~~, Acceptable Counterparty and Regulated Entity accounts;

1.2 hedge positions provided that the underlying interest is held in the client's account at the Member or that the Member has a document giving the Member an irrevocable right to take possession of the underlying interest and deliver it at the location designated by the appropriate clearing corporation. All other hedge positions are treated as speculative positions and are thereby not excluded;

1.3 the following short ~~Futures Option Contracts Positions (FOC):~~Options on Futures Contracts Positions:

(i) either the short call or the short put where a client or firm account is short a call and short a put on the same futures contract with the same exercise price and same expiration month;

(ii) a futures contract paired with an in-the-money option provided that this pairing is acceptable for margin purposes by a recognized exchange;

(iii) a short option paired with a long in-the-money option provided that this pairing is acceptable for margin purposes by a recognized exchange;

(iv) a short option paired with a futures contract provided that this pairing is acceptable for margin purposes by a recognized exchange;

(v) an out-of-the-money short call option paired with an out-of-the-money long call option, where the strike price of the short call exceeds the strike price of the long call, provided that this pairing is acceptable for margin purposes by a recognized exchange;

(vi) an out-of-the-money short put option paired with an out-of-the-money long put option provided that this pairing is acceptable for margin purposes by a recognized exchange; and

~~(vii) half of a short~~(vii) short option which is out-of-the-money by more than two maintenance margin ~~requirements but less than three; and~~requirements;

~~(viii) a short option which is out of the money by more than three maintenance margin requirements.~~