

13.1.4 IDA Regulations 100.11 and 1900.1 – Over-the-counter options and definition of option

INVESTMENT DEALERS ASSOCIATION OF CANADA –

REGULATIONS 100.11 AND 1900.1 – OVER-THE-COUNTER OPTIONS AND DEFINITION OF OPTION

I Overview

A Current Rules

IDA Regulation 100.11 sets out the capital and margin requirements for over-the-counter (OTC) options. The requirements are intended to recognize the difference in risk between exchange traded American expiry options and over-the-counter traded European expiry options. Regulation 100.11 applies to all option positions other than those considered to be exchange-traded options, as set out in the definition of “option” in Regulation 1900.1.

IDA Regulation 1900.1 includes a definition for the term “option” which is referenced by Regulation 100.11.

B The Issue

A review of Regulation 100.11 has identified certain sections that are either redundant or are inconsistent with the recently implemented amendments to Regulation 100.9 and 100.10 with respect to positions in and offsets involving exchange-traded options. It was also determined that the definition for the term “option”, a definition that is referenced by Regulation 100.11, needs to be updated to reflect changes in the names of the derivatives clearing corporations that issue and clear exchange traded options.

C Objective(s)

The objective of these amendments is to make Regulation 100.11 consistent with the recently implemented amendments to Regulation 100.9 and 100.10 with respect to positions in and offsets involving exchange-traded options.

D Effect of Proposed Rules

It is believed that the proposed amendments will have no impact in terms of capital market structure, competition, costs of compliance and conformity with other rules.

II Detailed Analysis

A Present Rules, Relevant History and Proposed Policy

Present Rules

The current rules for positions in and offsets involving OTC options have not been amended for a number of years. The current rules for positions in and offsets involving exchange-traded options have gone through a number of revisions since 1997, the year the IDA took over the administration of these rules from the Toronto Stock Exchange. As a result, a review of current rules for positions in and offsets involving OTC options, as set out Regulation 100.11, has identified certain sections that are now redundant or inconsistent with the margin and capital requirements for exchange traded options.

Redundant sections

Current Regulation 100.11(i) permits margin offsets for the purpose of hedging OTC options in the same manner as set out in Regulation 100.9 and 100.10 making Regulations 100.11(a), (b) and (c) redundant.

The Notes and Instructions to Schedule 4 of IDA Form 1 set out the margin requirements for accounts of customers that qualify as either acceptable institutions or acceptable counterparties, making Regulation 100.11(h) redundant.

Inconsistent sections

The requirements of current Regulations 100.11(a) and 100.11(b), which address the margining of long option and short options respectively, are inconsistent to the current requirements for exchange-traded options.

Definition of “option” needs to be updated

The definition for the term “option”, a definition that is referenced by Regulation 100.11, needs to be updated to reflect changes in the names of the derivatives clearing corporations that issue and clear exchange traded options.

Proposed Policy

The proposed amendments seek to repeal the redundant sections and make the margin and capital requirements for OTC options substantially the same as those set out in Regulation 100.9 for customer account positions and in Regulation 100.10 for Member firm positions. The requirements for OTC and exchange traded options will continue to differ in some respects where one or more of the OTC option offset positions have a European expiry (i.e., the option can only be exercised on the expiry date of the option).

B Issues and Alternatives Considered

No other alternatives were considered.

C Comparison with Similar Provisions

A comparison with similar regulations in the United Kingdom and the United States was not considered necessary due to the nature of the proposed amendments.

D Systems Impact of Rule

It is believed that the proposed amendments 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. The Bourse de Montréal is also in the process of passing this amendment. Implementation of this amendment will therefore take place once both the Association 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 these proposed amendments are 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 this proposal. The purpose of the proposal is to:

- Standardize industry practices where necessary or desirable for investor protection;

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.

The proposal is believed to be public interest as it is intended to modify the capital and margin requirements that apply to OTC option positions to make them consistent with the requirements that apply to exchange traded options.

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 objective of these amendments is to make Regulation 100.11 consistent with the recently implemented amendments to Regulation 100.9 and 100.10 with respect to positions in and offsets involving exchange-traded options. It is believed that the proposal will be effective for this purpose.

C Process

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

IV Sources

References:

- IDA Regulations 100.11 and 1900.1

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 the proposed. 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 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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INVESTMENT DEALERS ASSOCIATION OF CANADA

REGULATIONS 100.11 AND 1900.1 – OVER-THE-COUNTER OPTIONS AND DEFINITION OF OPTION

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. Regulation 100.11 is amended by inserting the following text at the beginning of the section:
 - “(a) For the purposes of this Regulation 100.11:
 - (i) the terms “customer account”, “firm account”, and “underlying interest” mean the same as set out in Regulation 100.9(a).
 - (ii) the term”;
2. Regulation 100.11 is amended by repealing the following text after revised paragraph (a):

“ “underlying interest” means

 - (i) in the case of an equity, participation unit or bond option, the security, or
 - (ii) in the case of an index option, the index that is the subject of the option.”

and by repealing former paragraphs (a) through (c);
3. Regulation 100.11 is amended by adding new paragraphs (b) to (d) as follows:
 - “(b) **Customer accounts - positions in and offsets involving over-the-counter options**

For customer accounts, the margin requirements for positions in and offsets over-the-counter options are the same as the margin requirements for Options set out in Regulations 100.9.(b) through 100.9.(g), subject to the limitations for offsets set out in Regulation 100.11.(d).

 - (c) **Firm accounts - positions in and offsets involving over-the-counter options**

For Member inventory and other firm accounts, the capital requirements for positions in and offsets involving over-the-counter options are the same as the capital requirements for Options set out in Regulations 100.10.(b) through 100.10.(g), subject to the limitations for offsets set out in Regulation 100.11.(d).

 - (d) **Limitations on Offsets**

In the case of spreads involving European exercise over-the-counter options:

 - (i) a margin offset is permitted where the spread consists of a long and short European exercise option and the contracts have the same expiration date; and
 - (ii) a margin offset is permitted where the spread consists of a short European exercise option and long American exercise option; however
 - (iii) a margin offset is not permitted where the spread consists of a long European exercise option and a short American exercise option.”
4. Regulation 100.11 is amended by renumbering former paragraphs (d) through (g) as revised paragraphs (e) through (h).
5. Regulation 100.11 is amended by repealing former paragraphs (h) and (i);
6. Regulation 100.11 is amended by renumbering former paragraphs (j) through (l) as revised paragraphs (i) through (k).

7. Regulation 1900.1 is amended by replacing within the definition of the term “option” the text “Trans Canada Options Inc., Intermarket Services Inc.” with the text “the Canadian Derivatives Clearing Corporation” and the text “Board of Directors” with the word “Association” under the definition of “option”.

PASSED AND ENACTED BY THE Board of Directors this 26th day of June 2005, to be effective on a date to be determined by Association staff.

INVESTMENT DEALERS ASSOCIATION OF CANADA

REGULATIONS 100.11 AND 1900.1 – OVER-THE-COUNTER OPTIONS AND DEFINITION OF OPTION

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Regulation 100.11 – Amendments #1 through #6

100.11. Over-the-Counter Options -

(a) For the purposes of this Regulation 100.11:

(i) the terms “customer account”, “firm account”, and “underlying interest” mean the same as set out in Regulation 100.9(a).

(ii) the term “over-the-counter option” means an option, other than an option described in Regulation 1900.1;¹

“underlying interest” means

(i) In the case of an equity, participation unit or bond option, the security, or

(ii) in the case of an index option, the index that is the subject of the option.

(a) **Client Account** All purchases of over the counter options for client accounts shall be for cash. For the purposes of this Regulation 100.11, a client account is an account in which the Member, a related company of the Member or any partner, director, officer or employee of the Member does not have an interest, direct or indirect, other than an interest in the commission charged.

(b) **Firm Accounts**

(i) The charge to capital for a long call and for a long put where the over the counter option's premium is less than \$1.00 shall be the market value of the option.

(ii) The charge to capital for a long call where the over the counter option's premium is \$1.00 or more, and which is not used to offset capital required on any other position, shall be the market value of the call, less 50% of the excess of the market value of the underlying interest over the exercise price of the call.

(1) The charge to capital for a long put where the over the counter option's premium is \$1.00 or more, and which is not used to offset capital required on any other position, shall be the market value of the put, less 50% of the excess of the exercise price of the put over the market value of the underlying interest.

(c) **Short Positions**

Subject to sub-sections (g) and (h), the minimum margin for short positions in over the counter options shall be as follows:

(i) In the case of a short over the counter option position, other than a futures contract option position, the minimum margin shall be

(A) 100% of the current premium of the short over the counter options;

(B) plus the product of multiplying the margin rate of the underlying interest by the market value of the underlying interest;

(C) less any out of the money amount.

(ii) Notwithstanding paragraph (i), in the case of a short over the counter option position in a client account the minimum margin shall not be less than

(A) 100% of the current premium of the option;

¹ Note: Writing over-the-counter options constitutes distribution of securities for which a prospectus may be required or for which specific or blanket exemptive relief may be necessary under the applicable securities legislation. The writer of over-the-counter options may, in effect, be an issuer distributing securities and so should accordingly ensure that such distribution is in compliance with applicable securities legislation.

~~(B)~~ plus 25% of the product of multiplying the margin rate of the underlying interest by the market value of the underlying interest.

(b) Customer Accounts - Positions in and Offsets involving Over-the-Counter Options

For customer accounts, the margin requirements for positions in and offsets over-the-counter options are the same as the margin requirements for Options set out in Regulations 100.9.(b) through 100.9.(g), subject to the limitations for offsets set out in Regulation 100.11.(d).

(c) Firm Accounts - Positions in and Offsets involving Over-the-Counter Options

For Member inventory and other firm accounts, the capital requirements for positions in and offsets involving over-the-counter options are the same as the capital requirements for Options set out in Regulations 100.10.(b) through 100.10.(g), subject to the limitations for offsets set out in Regulation 100.11.(d).

(d) Limitations on Offsets

In the case of spreads involving European exercise over-the-counter options:

- (i) a margin offset is permitted where the spread consists of a long and short European exercise option and the contracts have the same expiration date; and
- (ii) a margin offset is permitted where the spread consists of a short European exercise option and long American exercise option; however
- (iii) a margin offset is not permitted where the spread consists of a long European exercise option and a short American exercise option.

~~(d)~~(e) Over-the-counter option positions in inventory or in a client account shall be marked to the market daily by calculating the value on a basis consistent with the valuation benchmark or mathematical model used in determining the premium at the time the contract was initially entered.

~~(e)~~(f) Where the Member is a party to an over-the-counter option, the counter-party to the option shall be considered a client of the Member.

~~(f)~~(g) All opening short transactions in over-the-counter options must be carried in a margin account.

- ~~(g)~~(h)
- (i) The following constitute adequate margin for over-the-counter options:
 - (A) a specific deposit of the underlying interest in negotiable form in the client's margin account with the Member, or
 - (B) the deposit with the Member in an escrow receipt, as defined in subsection (ii), in respect of the underlying interest.
 - (ii) Evidence of a deposit of an over-the-counter option's underlying interest shall be deemed an escrow receipt for the purposes hereof if the underlying interest is held pursuant to an escrow agreement by a custodian that is a depository, both of which are acceptable to the Vice-President, Financial Compliance.
 - (iii) The requirements of this subsection apply, regardless of any otherwise available margin reduction or margin offset, in the following circumstance:
 - (A) where an over-the-counter option is written by a client that is not an Acceptable Institution, Acceptable Counter-party or Regulated Entity (as defined in Form 1),
 - (B) where the terms of the over-the-counter option require settlement by physical delivery of the underlying interest, and
 - (C) where a margin rate less than 100% for the underlying interest has not been established under the Regulations.

~~(h)~~ **Financial Institutions**

- ~~(i)~~ No margin is required for over the counter options entered into by a client that is an Acceptable institution (as defined in Form 1)
- ~~(ii)~~ Where the client is an Acceptable Counter party or Regulated Entity (as defined in Form 1), the required margin shall be the market value deficiency calculated in respect of the option position on an item by item basis.

~~(i)~~ **Margin Offsets**

- ~~(i)~~ Except as otherwise provided in this subsection, clients, as defined in subsection (e), and Members are permitted margin offsets for the purpose of hedging over the counter options in the same manner as set out in Regulations 100.9 and 100.10, provided that the underlying interest is the same.
- ~~(ii)~~ In the case of spreads involving European exercise over the counter options,
 - ~~(A)~~ a margin offset is permitted where the spread consists of a long and short European exercise option and the contracts have the same expiration date; and
 - ~~(B)~~ a margin offset is permitted where the spread consists of a short European exercise option and long American exercise option; however
 - ~~(C)~~ a margin offset is not permitted where the spread consists of a long European exercise option and a short American exercise option.

~~(j)(i)~~ Consistent with listed options, Members are permitted to apply the premium credit generated on over-the-counter options against the margin required pursuant to this Regulation.

~~(k)(i)~~ **Margin Agreements**

Members writing and issuing or guaranteeing over-the-counter options on behalf of a customer shall have and maintain with each customer a margin agreement in writing defining the rights and obligations between them in regard to over-the-counter options or have and maintain supplementary over-the-counter option agreements with customers selling such options.

~~(k)~~ **Confirmation, Delivery and Exercise**

- (i) Every over-the-counter option shall be confirmed in writing as between the parties, such confirmation to be mailed or delivered on the day of the transaction.
- (ii) Payment for an over-the-counter option, settlement, exercise and delivery shall be made in accordance with the terms of the over-the-counter contract.

Regulation 1900.1 – Amendment #7

1900.1. For the purposes of this Regulation 1900, unless the subject matter or content otherwise requires:

“**option**” means a call option or put option issued by ~~Trans Canada Options Inc., Intermarket Services Inc., the Canadian Derivatives Clearing Corporation,~~ the Options Clearing Corporation, ~~Intermarket Clearing Corporation, International Options Clearing Corporation~~ or any other corporation or organization recognized by the ~~Board of Directors~~ Association for the purposes of this Regulation but “option” does not include a futures contract or futures contract option as defined in Regulation 1800.1.