13.1.2 Notice of Request for Comments – Amendments to IDA Regulation 100.12 regarding Optional Use of Value at Risk (VaR) Modeling to Determine Capital Requirements for Member Firm Security Positions

INVESTMENT DEALERS ASSOCIATION OF CANADA

**REGULATION 100.12 –
OPTIONAL USE OF VALUE AT RISK (VAR) MODELING
TO DETERMINE CAPITAL REQUIREMENTS
FOR MEMBER FIRM SECURITY POSITIONS**

NOTICE OF REQUEST FOR COMMENTS

I OVERVIEW

At present, the regulatory capital requirements for Member firm positions in and offsets involving securities (and related derivative instruments) are set out in Regulation 100. These requirements have been developed over a number of decades to conservatively provide for the market risk associated with unhedged security positions[1] as well as to allow capital requirement reductions for a limited number of security offset strategies[2, 3].

A Current Rules

Regulation 100 sets out the capital requirements that address the market risk associated with Member firm positions in and offsets involving securities (and related derivative instruments). Regulation 100 has increased in length over the past decade to approximately 120 pages due largely to the significant increase in the number of new securities products that have been introduced and the continuation of the strategy-based[4] rulemaking approach, which requires that specific rules be developed for each new product (as well as accompanying offset rules).

B The Issue

In spite of recent efforts to rationalize the existing strategy-based rules, the continued exclusive use of such rules is no longer workable as:

- The strategy-based rules have been found to be overly conservative in that the number of permitted offset strategies within an issuer product group is limited and issuer risk diversification is not considered; and

- The rulemaking and compliance burden associated with the strategy-based rules is increasing due to the increasing number and complexity of securities products.

It is for these reasons that the optional use of a more advanced approach to determining the market risk associated with a Member firm's proprietary inventory security positions, specifically value at risk (VaR) modeling, is being proposed.

C Objective(s)

The proposal set out in Attachment #1 seeks to permit the optional use of VaR modeling for determining the capital requirement associated with a Member firm's proprietary inventory security positions, subject to certain conditions being met by the Member firm. The proposal does not seek to replace the existing strategy-based rules which we believe will continue to be necessary for determining the capital and margin requirements for relatively unsophisticated proprietary inventory and customer account security positions.

The objective of the proposal is to grant those Member firms who maintain sophisticated and/or significant proprietary inventories the option of using a VaR modeling approach to determine their capital requirement, the byproduct of which will be

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[1] Examples of the conservatism in the current capital requirements for unhedged security positions include the fixed percentage margin requirements for debt securities and the traded price per share margin requirements for equity securities.

[2] Regulation 100.4 sets out a number of strategy-based offsets which allow for capital requirement reductions for debt offsets, convertible / exchangeable security offsets and swap contract offsets. These offset requirements were most recently amended effective January 1, 2004 through the implementation of amendments to Regulations 100.4F, 100.4G, 100.4H and 100.4I.

[3] Regulation 100.10 sets out a number of strategy-based offsets which allow for capital requirement reductions for offsets involving exchange trade derivatives. These offset requirements were most recently amended effective January 1, 2005.

[4] Strategy-based rules set out capital and margin requirements for a security or derivative position or offset strategy involving two or more security/derivative positions based on the calculated worst-case scenario loss for the position or offset strategy.

capital requirements being provided by the Member firm which are more reflective of the overall market risk of the proprietary inventory. Specifically, the use of VaR modeling will generally[5] result in reduced capital requirements for offsets strategies that are either not addressed in the current strategy-based rules (or are addressed in an overly conservative fashion) as well reduced capital requirements in situations where the modeling recognizes the market risk reduction achieved through portfolio diversification.

D Effect of Proposed Rules

As previously stated, the proposal seeks to permit the optional use of VaR modeling for determining the capital requirement associated with a Member firm's proprietary inventory security positions, subject to certain conditions being met by the Member firm. Adoption of the proposal will make consistent the regulatory capital requirements that address the market risk associated with inventory security positions that are held at either a Canadian bank or a Canadian securities dealer.

The conditions that must be met by those Member firms opting to use VaR modeling are:

- Provision of a higher minimum capital requirement on Statement B, Line 4 of Form 1 than the current $250,000 requirement that applies to a full service dealer. [The proposal sets this requirement at the greater of $10 million and 25% of the capital requirement calculated using the VaR modeling approach.]

- Certification that the VaR modeling methodology to be used utilizes standards that are compliant with the Basel capital standards recommended standards any additional standards the Association may establish from time to time.

It is not anticipated that the proposed rule will have any market structure impacts. It is believed that the proposed rule will have positive impacts in terms of enabling improved Member firm competitiveness with non-dealer financial institutions without diminishing the effectiveness of the IDA's overall capital adequacy requirements. It is also believed that the proposed higher minimum capital requirements that will apply are an accurate reflection of the additional resources that will be necessary and the incremental operational risk and "tail event" market risk that will be assumed where a Member firm opts to use VaR modeling. As a result, we do not believe that competition among Member firms will be unduly affected under this proposed rule.

II DETAILED ANALYSIS

A Present Rules, Relevant History and Proposed Policy

Present rules and relevant history

Regulation 100 sets out the capital requirements that address the market risk associated with Member firm positions in and offsets involving securities (and related derivative instruments). Regulation 100 has increased in length over the past decade to approximately 120 pages due largely to the significant increase in the number of new security products that have been introduced and the continuation of the strategy-based rulemaking approach, which requires that specific rules be developed for each new product (including accompanying offset rules). Efforts have been made over the past five years to rationalize the existing strategy-based rules through the development of the following rule amendment proposals among others:

- Capital and margin requirements for positions in and offsets involving interest rate and total performance swaps – Regulations 100.2(j), 100.2(k), and 100.4F; implemented effective January 1, 2004

- Capital and margin requirements for offsets involving capital shares and convertible and exercisable securities – Regulations 100.4G, 100.4H and 100.4I; implemented effective January 1, 2004

- Capital and margin requirements for positions in and offsets involving exchange traded derivatives – Regulations 100.9 and 100.10; implemented effective January 1, 2005

- Optional use of TIMS or SPAN for determining the capital requirements for positions in and offsets involving exchange traded derivatives – Regulation 100.10; implemented effective January 1, 2005
- Capital requirements for underwriting commitments – Regulation 100.5; implemented effective March 1, 2005

- Capital and margin requirements for offsets involving Canadian debt securities and related futures contracts – Regulations 100.4C and 100.4K; approved by the Board or Directors at January 2005 meeting and awaiting CSA approval

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[5] Although the use of VaR modeling will generally result in a lower capital requirement than current IDA requirements it may not always result in a lower requirement. There may be instances where a Member firm holding an unhedged portfolio of securities, particularly once the new "basic margin rate" methodology is implemented for equity securities, may calculate a lower requirement under the current strategy-based requirements than under VaR modeling.

- Capital and margin requirements for listed equity securities – Regulation 100.2(f)(i); to be considered at Board of Directors at October 2005 meeting

In spite of these efforts to rationalize the existing strategy-based rules, the continued exclusive use of such rules is no longer workable as:

- The strategy-based rules have been found to be overly conservative in that the number of permitted offset strategies within an issuer product group is limited and issuer risk diversification is not considered; and

- The rulemaking and compliance burden associated with the strategy-based rules is increasing due to the increasing number and complexity of securities products.

It is for these reasons that the optional use of a more advanced approach to determining the market risk associated with a Member firm's proprietary inventory security positions, specifically value at risk (VaR) modeling, is being proposed.

Background to development of proposal

In early 2004, the Association engaged the consulting firm PricewaterhouseCoopers to perform an initial feasibility study of the optional use of value at risk (VaR) modeling for determining the capital requirements for a Member firm's proprietary inventory security positions. The study was undertaken for a number of reasons including:

- The recent initiatives in Europe and the United States to consider the use of the Basel II capital standards (including VaR modeling) by the securities industry requiring that Canadian securities regulators consider the same for capital markets competitiveness reasons;

- The increasing limitations to the use of strategy-based rules for determining the capital requirements for proprietary inventory security positions (as discussed above); and

- The expressed interest by a number of Member firms to use VaR modeling for regulatory purposes.

As part of the study the risk specific capital requirements that apply to OSFI regulated financial institutions (both current OSFI and proposed Basel II) and IDA Member firms were compared. The following table summarizes this comparison of requirements:

Risk Type	OSFI Requirements		IDA Requirements
	Current OSFI	Proposed Basel II	
Market risk [proprietary inventory positions]	VaR modeling allowing risk requirement reduction through recognizing a virtually unlimited number of position risk reduction strategies and portfolio diversification	VaR modeling allowing risk requirement reduction through recognizing a virtually unlimited number of position risk reduction strategies and portfolio diversification	Unhedged positions subject to fixed percentage margin requirements set out in Regulation 100 Hedged positions granted reduced margin where offset rule is available
Credit risk Institutional clients	Relatively simple standardized approach	Proposed credit rating based approach will result in some reductions for investment grade credit risks and significant increases for less than investment grade credit risks	Relatively simple standardized approach with a number of instances lower credit requirements than under **Current OSFI** (i.e., currently "acceptable institution" exposures attract no capital provision)
Credit risk Retail clients	Relatively simple standardized approach	Proposed credit rating based approach would yield similar results as **IDA Requirements** as would	Same as **Market risk** requirements above

Risk Type	OSFI Requirements		IDA Requirements
	Current OSFI	Proposed Basel II	
		assess value of credit risk collateral	
Operational risk	No current capital requirement	Proposed capital requirement	IDA examination staff assess operational risk as part of Member firm risk assessment and the preparation of the Risk Trend Report, but there is no current capital requirement.

As the table suggests, the current IDA requirements with respect to the assessment of market risk in proprietary trading books are more conservative than the current OSFI and proposed Basel II VaR requirements. However, the current IDA requirements with respect to the assessment of operational risk and institutional account credit risk are generally less conservative than the existing Basel and proposed Basel II capital requirements.

Specific to operational risk, there are no existing IDA capital requirements that apply to Member firms. As a result, if the optional use of VaR modeling is permitted without the making of any other rule changes, the overall IDA capital requirements will be less conservative than those of Basel and proposed Basel II. It is also believed that operational risk will be of greater concern for those dealers who opt to use VaR modeling, because of the sophisticated systems and control structures that will need to be maintained on an ongoing basis. For these reasons, the proposal will require Member firms to provide a higher minimum capital requirement in the determination of their risk adjusted capital.

Proposal details

The proposal itself is relatively straightforward. The proposal seeks to provide Member firms with the option of using VaR modeling for determining the capital requirements of its proprietary inventory security positions, provided two conditions are met: (1) The provision of a higher minimum capital requirement on Statement B, Line 4 of Form 1 than the current $250,000 requirement that applies to a full service dealer and (2) Certification that the VaR modeling methodology to be used utilizes standards and is subject to stress testing and back-testing procedures that are compliant with the Basel II capital standards recommended standards and any additional standards the Association may establish from time to time.

Member firms will be required to apply to the Association to receive permission to exercise its option to use VaR modeling. As part of any application to the Association, the Member firm will be required to submit a description of their internal risk management control system and how that system satisfies the Association requirements, together with a description of the method the Member firm intends to use to calculate its deductions to risk adjusted capital. The Association will review how the firm manages its market risk and its mathematical models to determine if the Member firm has met the Association's VaR modeling requirements. In approving the application, the Association, in its discretion, may impose additional conditions or limitations where necessary or appropriate in the public interest or for the protection of investors.

Higher minimum capital requirement

The proposal will require Member firms to provide a higher minimum capital requirement in the determination of their risk adjusted capital. We believe the higher capital requirement is necessary to address the increased operational risk that will result when a Member firm opts to use VaR modeling. Specifically, while VaR modeling is a more sophisticated market risk measurement approach it is also more resource intensive to support and maintain in comparison to the existing IDA strategy-based rules.

Further, while VaR modeling works well in capturing the probable loss in most markets, it does not always cover "tail events", the rare market moves that cause extreme losses. The limitations of VaR modeling approaches can be addressed by stress tests that can be used to determine a capital cushion over and above the calculated VaR amount to provide for the risk associated with these events. We therefore also believe that a higher minimum capital requirement is necessary to provide for "tail event" market risk.
As a result, to address the incremental operational risks and "tail event" market risks, it is proposed that the minimum capital requirement provided on Line 4 of Statement B of Form 1 by Member firms who opt to use VaR modeling be the greater of:

(i) $10 million (to cover the increased operational risk associated with using VaR modeling); and

(ii) 25% calculated VaR modeling capital requirement.

Establishment and maintenance of a system of internal risk management controls

As a prerequisite to using VaR modeling, Member firms must establish, document, and maintain a system of internal risk management controls to assist it in managing the market risk associated with its proprietary trading inventory. The remainder of this section details the necessary considerations in developing and elements of a system of internal risk management controls.

(a) Environmental factors to be considered

In establishing its system of internal risk management controls, a Member firm shall consider all relevant environmental factors when adopting its internal control system guidelines, policies, and procedures including: (i) dealer ownership, governance and management structures, (ii) scope and nature of established risk management guidelines, (iii) scope and nature of permissible proprietary trading activities, (iv) sophistication and experience of relevant proprietary trading, risk management, and internal audit personnel, (v) sophistication and functionality of information and reporting systems, and (vi) scope and frequency of monitoring, reporting, and auditing activities.

(b) Elements of an internal risk management system

Taking these environmental factors into consideration a Member firm's internal risk management control system shall include the following elements: (i) a risk control unit that reports directly to senior management and is independent from the proprietary trading units, (ii) separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records, (iii) periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the Member firm's risk management systems, (iv) definitions of risk, risk monitoring, and risk management, and (v) written guidelines, approved by firm senior management.

(c) Written risk management guidelines

Written risk management guidelines should include/address: (i) quantitative guidelines for managing the firm's overall proprietary trading risk exposure, (ii) the type, scope, and frequency of reporting by management on risk exposures, (iii) the procedures for and the timing of firm Board of Directors periodic review of the risk monitoring and risk management written guidelines, systems, and processes, (iv) the processes for the performance of the risk monitoring and management functions by persons independent from or senior to the proprietary trading units whose activities create the risks, (v) the authority and resources of the groups or persons performing the risk monitoring and risk management functions, (vi) the appropriate response by management when internal risk management guidelines have been exceeded, and (vii) the procedures authorizing specified employees to commit the firm to particular types of transactions.

(d) Management review requirements

Member firm's management must periodically review, in accordance with written procedures, its proprietary trading activities for consistency with risk management guidelines including that: (i) risks arising from the firm's proprietary trading activities are consistent with prescribed guidelines, (ii) risk exposure guidelines for each proprietary trading unit are appropriate for the unit, (iii) the data necessary to conduct the risk monitoring and risk management function as well as the valuation process over the firm's proprietary trading positions is accessible on a timely basis and information systems are available to capture, monitor, analyze, and report relevant data, (iv) procedures are in place to enable management to take action when internal risk management guidelines have been exceeded, (v) procedures are in place to monitor and address the risk that a transaction contract will be unenforceable, (vi) procedures are in place to identify and address any deficiencies in the operating systems and to contain the extent of losses arising from unidentified deficiencies, (vii) procedures are in place to authorize specified employees to commit the firm to particular types of transactions, to specify any quantitative limits on such authority, and to provide for the oversight of their exercise of such authority, (viii) procedures are in place to provide for adequate documentation of the principal terms of transactions and other relevant information regarding such transactions, (ix) personnel resources with appropriate expertise are committed to implementing the risk monitoring and risk management systems and processes; and (x) procedures are in place for the periodic internal and external review of the risk monitoring and risk management functions.

VaR modeling methodology standards

No single approach to VaR modeling best measures the market risk of a portfolio of securities (and any related derivatives positions). Various VaR models produce different results for the same securities portfolio and therefore quantitative and qualitative factors need to be assessed to determine the suitability of any VaR model. To ensure consistency of approaches amongst those Member firms who opt to use VaR modeling we are proposing that the VaR modeling approach used must comply, at a minimum, with the recommended qualitative and quantitative standards set out in the publication entitled

"Amendment to the Capital Accord to Incorporate Market Risks" that was published by the Basel Committee on Banking Supervision in January 1996 and modified in September 1997. The remainder of this section provides specific guidance on how Member firms opting to use VaR modeling are expected to calculate the capital requirement for their proprietary inventory positions.

(a) Computation of the capital requirement for their proprietary inventory positions

Member firms opting to use VaR modeling must determine their current proprietary inventory position exposures and their VaR modeling capital requirements on a daily basis in order to be in compliance with the existing IDA By-law 17.1 requirement for a Member firm "to have and maintain at all times risk adjusted capital greater than zero."

Member firms shall provide capital for their proprietary trading inventory equal to the sum of: (i) for positions for which the Association has approved the use of VaR modeling, the calculated VaR modeling capital requirement and (ii) for all other positions, the calculated capital requirement pursuant to IDA Regulation 100. In assessing which positions will be eligible for VaR modeling, the Member firm must either demonstrate that the position is readily marketable or that its models adequately capture the material risks (including issuer specific risk) associated with making a market for the position.

Member firms shall use the same model to determine regulatory market risk as the model used to report risk to the Member firm's senior management and the model shall be integrated into the internal risk management system of the firm. The VaR model used shall be reviewed by the Member firm both periodically and annually. The periodic review may be conducted by the Member firm's internal audit staff. The annual review must be conducted by a public accounting firm with risk management expertise. The VaR model used should: (i) use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices for purposes of determining market risk; (ii) use an effective historical observation period of at least 260 trading days in length that includes periods of market stress; and (iii) take into account and incorporate all significant, identifiable market risk factors applicable to the firm's positions. Historical data sets must be updated at least monthly and must be reassessed when position/portfolio volatilities change significantly.

(b) Back testing

Member firms must also ensure through ongoing back testing that the VaR modeling capital requirement calculated continues to cover normal market risk events (i.e., events other than "tail events"). We are therefore also proposing that the back testing procedures used by the Member firm must comply with those recommended in the publication entitled "Amendment to the Capital Accord to Incorporate Market Risks" that was published by the Basel Committee on Banking Supervision in January 1996 and modified in September 1997.

As a result, on a quarterly basis at a minimum, the Member firm must conduct back testing of the model by comparing its actual daily net trading profit or loss for its VaR eligible positions, using a 99 percent one-tailed confidence level, to its calculated VaR modeling capital requirement. The comparison shall be performed at a minimum for each of the most recent 260 trading days. The Member firm must identify the number of days its actual daily net trading loss for its VaR eligible positions exceeds its calculated VaR modeling capital requirement (back testing violation days). Where the violation day percentage (determined by dividing the number of back testing violation days by the number of trading days tested) exceeds 1%, the Member firm shall consider the need to modify its model assumptions, document any assumption changes made or not made and document why assumption changes have been made or not made.

Where the Member firm determines as a result of its back testing or otherwise that there is a material error in its calculated VaR modeling capital requirement or detects a material deficiency in its internal risk management control systems, the Member firm shall notify the Association immediately. In response, the Association may impose additional conditions or limitations on the Member firm's ongoing use of VaR modeling. Should a Member firm fail to comply with these additional conditions / limitations, the Association may withdraw its approval of a Member firm's use of VaR modeling.

(c) Additional reporting requirements

It is likely that additional reporting requirements will be imposed as a condition of permitting a Member firm to use VaR modeling. The exact form and extent of these additional requirements has not been determined at this point as the Association has not yet hired the staff with risk management expertise that would develop the additional reporting requirements.

(d) Recordkeeping requirements

We are not proposing any specific rules with respect to the maintenance books and records relating to the VaR

modeling capital requirement since existing IDA By-law 17.2 requires that "Every Member shall keep at all times a proper system of books and records."

Certification of VaR modeling methodology

The proposal will require Member firms to certify that the VaR modeling methodology they use utilizes standards and is subject to stress testing and back-testing procedures that are compliant with the Basel II capital standards recommended standards and any additional standards the Association may establish from time to time. Certification will be required: (i) at the time the firm applies to the Association to receive permission to exercise its option to use VaR modeling, and (ii) on an annual basis through responding to a specific VaR modeling question which will be added to the Certificate of Partners and Directors included with IDA Form 1.

B Issues and Alternatives Considered

With respect to the use of VaR modeling by our Member firms the following three alternatives were considered:

1. Allow the optional use by Member firms of the entire bank regulatory capital reporting format (i.e., Basel II in 2006).

2. Allow the optional use by Member firms of certain bank regulatory capital reporting format items (i.e., VaR modeling) through an amended IDA capital formula.

3. Do not allow the optional use by Member firms of VaR modeling.

The only alternative seriously considered of the three above was the second one.

The first alternative would only be practical for bank-owned Member firms and, even for those firms, the regulatory reporting efficiencies achieved would be limited, as they would be required to file with the IDA on a non-consolidated basis. Other issues such as the lack of applicability of some of the Basel II proposals to securities dealers and dealer versus dealer level playing field concerns made this alternative less attractive.

The third alternative was also considered but rejected since, as previously stated, the continued exclusive use of strategy-based rules within the IDA capital formula is no longer workable.

C Comparison with Similar Provisions

European Union

The Financial Conglomerates Directive was passed by the European Parliament on December 16, 2002. According to the website of Her Majesty's Treasury in the United Kingdom:

> "The Financial Conglomerates Directive introduces specific legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-sectoral activities to foster the stability of the financial system.
>
> The main objectives of the Directive are (I) to ensure that financial conglomerates are adequately capitalized, preventing the same capital being counted twice over and so used simultaneously as a buffer against risk in different entities, (II) to introduce methods for calculating a conglomerate's overall solvency position, and (III) to provide for the establishment of a single lead regulator for financial conglomerates, rather than multiple lead regulators as at present, thereby reducing regulatory duplication."

As a result, once National laws and administrative arrangements are adopted by each of the European Union member countries, European Union securities dealers that are part of a financial conglomerate will be required to make regulatory filings on a consolidated basis (expected to commence mid 2005) and in turn comply with the Basel II capital standards (expected to commence in 2006).

United Kingdom

Recognizing the risk-based margining approach as more efficient than a strategy-based approach, the Financial Services Authority (FSA) in the United Kingdom permits the use of VaR models for calculating Position Risk Requirements. The FSA is also taking steps to facilitate the implementation of the Financial Conglomerates Directive (referred to in the European Union section above) in the United Kingdom.

United States

In August 2004 the SEC implemented new Alternative Net Capital Requirements (ANCRs) based on Basel II. The ANCRs make use of the Basel II capital standards available to U.S. securities dealers provided the dealer maintains tentative net capital of at least USD $1 billion and net capital of at least USD $500 million and, where the dealer is part of a financial conglomerate, grants to the SEC conglomerate-wide regulatory jurisdiction.

It is interesting to note that this rule limits the optional use of VaR modeling to only the largest of U.S. securities dealers, all of which are part of a financial conglomerate. Further, those large dealers that have chosen to be regulated by the SEC under this approach are not be subject to the regulatory oversight of a European securities regulator. Taking these points into account, the high minimum capital requirements under the ANCRs are understandable as it is believed that the SEC, at least at this point, seems only willing to grant the optional use of VaR to those dealers who would otherwise be subject to the requirements of the European Union Financial Conglomerates Directive.

D Systems Impacts of Rule

It is anticipated that should a Member firm decide to use VaR modeling for determining the capital requirements for its proprietary inventory security positions the operations/systems impacts on that firm could be significant. However, it is not believed that these impacts are of concern from a rule implementation standpoint as the use of VaR modeling is proposed to be optional. More concerning is what IDA staffing will be needed to support the use of VaR modeling and how the proposal will be implemented.

IDA staffing needed to support the use of VaR modeling

It had been hoped that for Member firms already using VaR modeling (for the purposes of consolidated bank financial reporting to the Office of the Superintendent of Financial Institutions (OSFI)) the IDA would be able to place significant reliance on the work already being performed by OSFI examination staff. We have determined however that we will be unable to rely on the work of OSFI as they are unable to share bank specific information with other regulators and the VaR modeling they examine is prepared on a consolidated basis. Taking this determination into account, we have engaged PricewaterhouseCoopers to assist us in determining the necessary resources (and associated costs) that will be needed to enable the IDA to effectively regulate those Member firms who will be utilizing VaR modeling. At a minimum, we would need to hire an individual who is proficient in the development, testing and maintenance of VaR models to assist in the Financial Compliance field examinations performed at Member firms utilizing VaR modeling. More individuals may be required depending upon the number of Member firms opting to use VaR modeling and the extent of the field audit procedures that are to be performed.

Proposal implementation approach

Two implementation approaches were considered for this approach: (1) A proportional phased-in approach, whereby an increasing percentage of the VaR calculation is provided over time in combination with a decreasing percentage of the current IDA requirement; and (2) An eligible security phased-in approach, whereby the use of VaR modeling would be implemented for different levels of eligible securities at different times. The latter approach is the implementation approach that was proposed in the SEC's ANCR proposal whereby VaR modeling is to be permitted for the following levels of eligible securities in sequence over an 18-month period:

Level of Eligible Securities	Securities Eligible for VaR
1	US government securities and derivatives on those securities Investment grade corporate debt and derivatives on those securities Highly rated foreign government securities and derivatives on those securities Highly rated short-term asset-backed securities and derivatives on those securities Highly rated municipal securities and derivatives on those securities Derivatives on major market foreign currencies
2	Equities Derivatives on equities
3	Positions for which there is a ready market and for which there is adequate historical data to support a VaR model

Of note, the US Securities and Exchange Commission ultimately rejected the use of an "eligible security phased-in approach" in response to dealer complaints that this implementation approach would "impose unnecessary operational costs and inefficiencies." We have rejected this approach as well for the same reasons.

The "proportional phased-in approach" was successfully used recently by CDS in rolling out its new risk model (completed in October 2004). We are recommending using this approach for Member firms who opt to use VaR modeling for determining the capital requirements for their proprietary inventory security positions. We are suggesting a one-year phase-in period from the date the Association has approved the Member firm's use of VaR modeling.

The Bourse de Montreal is also in the process of passing these amendments. Implementation of these amendments will therefore take place once both the Association and the Bourse de Montreal have received approval to do so from their respective recognizing regulators.

E Best Interests of the Capital Markets

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

F Public Interest Objective

According to 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 and effects, including possible effects on market structure and competition". Statements have been made elsewhere as to the nature and effects of the proposals with respect to the proposed optional use of VaR modeling for determining the capital requirement associated with a Member firm's proprietary inventory security positions. The purpose of the proposal is to "facilitate fair and open competition in securities transactions generally."

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 has been determined to be in the public interest due to the likely material impact that usage of VaR modeling will have on the capital provided by a Member firm for the market risk associated with its proprietary inventory security positions.

III COMMENTARY

A Filing in Other Jurisdictions

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

B Effectiveness

An assessment of the effectiveness of the proposed rules in addressing the issues discussed above.

C Process

This proposal has been developed by IDA staff in consultation with the FAS Capital Formula Subcommittee at the request of the IDA Board of Directors.

IV SOURCES

References:

- IDA Regulation 100
- Equity Margin Project Discussion Paper – Draft #14, May 11, 2005
- OSFI Capital Adequacy Model (based on Basel I)
- Amendment to the Capital Accord to Incorporate Market Risks - Basel Committee on Banking Supervision, published in January 1996 and modified in September 1997
- Consultative Document, The New Capital Accord - Basel Committee on Banking Supervision, published in April 2003

- FSA Interim Prudential Sourcebook: Investment Businesses – Chapter 10, Rule 10-80 – Position Risk Requirement

- SEC Alternative Net Capital Requirements (ANCR), Securities Exchange Act of 1934, Rule 15c3-1e (Appendix E to 17 CFR 240.15c3-1), August 20, 2004,

- Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council

V OSC REQUIREMENT TO PUBLISH FOR COMMENT

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

The Association has determined that the entry into force of the proposed regulation would be in the public interest. Comments are sought on the proposed regulation. 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 Richard Corner, Vice President, Regulatory Policy, 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:

Richard Corner
Vice President, Regulatory Policy
Investment Dealers Association of Canada
(416) 943-6908
rcorner@ida.ca

INVESTMENT DEALERS ASSOCIATION OF CANADA

REGULATION 100.12 – OPTIONAL USE OF VALUE AT RISK (VAR) MODELING TO DETERMINE CAPITAL REQUIREMENTS FOR MEMBER FIRM SECURITY POSITIONS

ATTACHMENT #1

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 100.12[6] is amended by the addition of paragraph (i) as follows:

   "**Optional use of value at risk modeling**

   With respect to Member firm security and related derivatives positions, the capital requirement provided may be calculated using an approved value at risk modeling approach, provided the Member firm:

   (i) Reports as its minimum capital requirement on Line 4 of Statement B of Form 1 the greater of:

   (A) $10 million; and

   (B) 25% of the capital requirement calculated using the approved value at risk modeling approach;

   and;

   (ii) Certifies it is using an approved value at risk modeling approach whose standards are subject to regular stress testing and back-testing to ensure ongoing model standard appropriateness.

   For the purposes of this section "an approved value at risk modeling approach" is one which utilizes standards that are compliant with the recommended qualitative and quantitative standards set out in the publication entitled "Amendment to the Capital Accord to Incorporate Market Risks" that was published by the Basel Committee on Banking Supervision in January 1996 and modified in September 1997 and compliant with any additional standards the Association may establish from time to time."

2. The Notes and Instructions to Line 4 of Statement B of Form 1 are repealed and replaced with the following:

   "**Line 4 - Minimum capital**

   "Minimum capital" is:

   - For Type 1 introducing brokers, $75,000
   - For firms that use value at risk modeling to determine the capital requirements on their proprietary inventory positions, the greater of:

     (A) $10 million; and

     (B) 25% of the capital requirement calculated using the approved value at risk modeling approach;
   - For all other firms, $250,000."

3. The Certificate of Partners and Directors included with Form 1 is repealed and replaced with the certificate included as Attachment #2.

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

[6] Note: There are other proposed amendments pending which seek to amend IDA Regulation 100.12 to implement the proposed methodology for margining equity securities. These above proposed amendments assume the passage of these pending amendments.

INVESTMENT DEALERS ASSOCIATION OF CANADA

REGULATION 100.12
OPTIONAL USE OF VALUE AT RISK (VAR) MODELING
TO DETERMINE CAPITAL REQUIREMENTS
FOR MEMBER FIRM SECURITY POSITIONS

ATTACHMENT #2

JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT
CERTIFICATE OF PARTNERS OR DIRECTORS

____
(Firm Name)

I/We have examined the attached statements and schedules and certify that, to the best of my/our knowledge, they present fairly the financial position and capital of the firm at ____________________ and the results of operations for the period then ended, and are in agreement with the books of the firm.

I/We certify that the following information is true and correct to the best of my/our knowledge for the period from the last audit to the date of the attached statements which have been prepared in accordance with the current requirements of the applicable Joint Regulatory Body and Canadian Investor Protection Fund.

ANSWERS

1. Do the attached statements fully disclose all assets and liabilities including the following:
   - (a) All future purchase and sales commitments? ……………………………………………………………
   - (b) Outstanding puts, calls or other options?...……………………………………………………… ....
   - (c) Participation in any underwriting or other agreement subject to future demands? …………………
   - (d) Writs issued against the firm or partners or corporation or any other litigation pending? ....
   - (e) Income tax arrears of partners or corporation? …………………………………………………………
   - (f) Other contingent liabilities, guarantees, accommodation endorsements or commitments affecting the financial position of the firm? …………………………………………………………………………

~~2. Are all Exchange seats which are operated by the firm owned outright and clear of encumbrance by the firm? ....~~

~~3~~2. Does the firm promptly segregate clients' securities in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? ....

~~4~~3. Does the firm determine on a regular basis its free credit segregation amount and act promptly to segregate assets as appropriate in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? ....

~~5~~4. Does the firm carry insurance of the type and in the amount required by the rules and regulations of the appropriate Joint Regulatory Body? ....

~~6~~5. Have all "concentrations of securities", as described in the rules, regulations and policies of the appropriate Joint Regulatory Body, been identified on Schedule 9? ....

~~7~~6. Has the "most stringent rule" requirement *[as described in the general instructions]* been adhered to in the preparation of these statements and schedules? ....

~~8~~7. Does the firm monitor on a regular basis its adherence to early warning requirements in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? ....

~~9~~8. Does the firm have adequate internal controls in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? ....

~~10~~ 9. Does the firm maintain adequate books and records in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? ....

~~11~~ 10. Does the firm follow the minimum required firm policies and procedures relating to security counts as prescribed by the appropriate Joint Regulatory Body? ....

11. Where the firm uses value at risk modeling to determine its capital requirements on its proprietary inventory security positions, does the firm use an approved value at risk modeling approach whose standards are subject to regular stress testing and back-testing to ensure ongoing model standard appropriateness in accordance with the rules and regulations prescribed by the appropriate Joint Regulatory Body? .... ________

____
[date]

Name and Title - Please type	**Signature**
______________________________	______________________________
______________________________	______________________________
______________________________	______________________________
______________________________	______________________________

CERTIFICATE OF PARTNERS OR DIRECTORS
NOTES AND INSTRUCTIONS

1. Details must be given for any “no” answers.

2. To be signed by:

   (a) chief executive officer/partner

   (b) chief financial officer

   ~~(c) member seatholder [if applicable]~~

   (~~d~~c) chief accountant

   (~~e~~d) at least two directors/partners if not included in (a) to (~~c~~b) above.

3. Copies with original signatures must be provided to the Joint Regulatory Body with prime audit jurisdiction.