Chapter 13

SRO Notices and Disciplinary Proceedings

13.1.1 Investment Dealers Association – Amendments to IDA Regulation 100.12 – Optional Use of Value at Risk Modeling

INVESTMENT DEALERS ASSOCIATION OF CANADA

AMENDMENTS TO REGULATION 100.12 REGARDING THE OPTIONAL USE OF VALUE AT RISK MODELING TO DETERMINE CAPITAL REQUIREMENTS FOR MEMBER FIRM SECURITY POSITIONS

The following is black-lined to indicate amendments from the version that was published on November 11, 2005 at (2005) 28 OSCB 9204.

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 is amended by the addition of paragraph (i) as follows:

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

   With respect to Member firm security and securities related derivative 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~~.~~;

   and;

   (iii) Applies to and receives permission from the Association in writing to use such approach.

   The modeling approach used by the Member firm must be used consistently and cannot be changed without the prior consent of the Association.

   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 last modified in ~~September 1997 and compliant with~~November 2005 (the Basel Requirements), any subsequent updates to the Basel Requirements and 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 The Notes and Instructions to Line 4 of Statement B of Form 1 are repealed and replaced with the following: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 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~~ 20th day of ~~October 2005~~June 2006, to be effective on a date to be determined by Association staff.

IDA RESPONSES TO COMMENTS RECEIVED ON AMENDMENTS TO IDA REGULATION 100.2 – OPTIONAL USE OF VALUE AT RISK (VAR) MODELING TO DETERMINE CAPITAL REQUIREMENTS FOR MEMBER FIRM SECURITY POSITIONS

On November 11, 2005 a proposed amendment to Regulation 100.12 relating to the optional use of value at risk (VaR) modeling to determine capital requirements for Member firm security positions was published for comment.

The IDA received one comment letter BMO Nesbitt Burns Inc.

SUMMARY OF WRITTEN COMMENTS RECEIVED ON THE PROPOSED REGULATION AMENDMENT

The commenter was generally supportive of IDA efforts to improve how principle trading risks are assessed in the securities dealer regulatory capital formula but had concerns with the proposal that are summarized in the following comments:

Scope of IDA proposal - entity level versus consolidated Value at Risk (VaR) modeling

Comment

The IDA proposal seeks to permit the optional use of value at risk modeling to determine capital requirements for Member firm security positions (entity level VaR modeling). The commenter states that “While this makes sense in terms of the IDA’s jurisdiction, it does not make sense in terms of actual industry practice.” The commenter clarifies that “Canadian entities that have adopted a VaR methodology are using it on a consolidated basis” (consolidated VaR modeling) and in the case of bank-owned dealers, consolidated VaR modeling is the dominant methodology used for internal risk management purposes. As a result, the commenter expresses a concern that the IDA proposal will continue the disconnect between securities dealer regulatory capital requirements and internal risk management methodologies and that this “will introduce considerable confusion.”

IDA Response

We disagree with the inference that the approach to risk assessment should be the same whether performed at either the parent company and subsidiary company levels of a financial institution group.

Parent – Position risks of Parent and all subsidiaries are netted for risk assessment purposes reflecting influence of Parent over Subsidiaries

Subsidiary – Position risks held at other entities are not considered for risk assessment purposes as Subsidiary has no reliable influence over Parent or affiliates

Referring to the above illustration, the exclusive use of consolidated VaR modeling to assess risk at the parent company level makes sense due to the parent company influence over the decision making at its subsidiaries. However, at the subsidiary company level we do not agree that risk assessment should be (or is) exclusively done on a consolidated basis as the subsidiary has no reliable influence over the decision making at its parent or affiliates. Specifically, in addition to actively participating in the management of risk by the financial institution group, we believe that the subsidiary also has an obligation to assess its ability to manage its own entity risks as it cannot necessarily always count on its parent and/or affiliates to provide the necessary risk management and capital support in the event of a significant loss at the subsidiary dealer.

Further, it is our understanding that most financial institution groups perform VaR modeling calculations on an entity level basis (in addition to on a consolidated basis). We believe this is being done largely to assess business unit and/or entity performance; but it is also used to assess the appropriateness of risk levels assumed by each entity within the financial institution group. We therefore do not know why the commenter believes that permitting the optional use of entity VaR modeling "does not make sense in terms of actual industry practice" and "will introduce considerable confusion."

Specific to the IDA jurisdiction issue, as long as the IDA is charged with the responsibility of regulating securities dealer subsidiaries that are part of a financial institution group, the risk assessment we perform must be done on an entity basis. Simply, in the event of significant loss at the subsidiary dealer we can neither count on nor demand capital support from others; nor can the Canadian Investor Protection Fund if the loss makes the dealer insolvent. The proposal to permit the optional use of VaR modeling to determine capital requirements for Member firm security positions is consistent with this reality.

Concerns about specific VaR modeling requirements

Comment

The commenter requests that "to the extent OSFI has signed off on a Bank-owned Dealer's VaR model and data calibration framework, the IDA should consider exempting that Dealer from requirements that impose more stringent model or data calibration requirements on that Dealer." The commenter cites two examples where the proposed IDA requirements would be more stringent than those of OSFI.

IDA Response

It is not the intention of the IDA to impose significantly different model or data calibration requirements on the securities dealer subsidiary than those imposed by OSFI or another recognized regulator in assessing the consolidated risk of the financial group parent. However, there are a number of factors to consider as follows:

- It is our understanding that OSFI sign off is limited to the VaR model that assesses the consolidated risk of the financial group parent;
- The proposals were not designed for the exclusive use of securities dealers that are part of a regulated financial group;
- The proposals were developed taking into consideration not only OSFI requirements but also the requirements of securities regulators in other jurisdictions; and
- The maintenance of a different proprietary trading portfolio mix at the subsidiary dealer level (in comparison to that of the consolidated proprietary trading portfolio) may require the use of different modeling assumptions to properly address the risk.

As a result, while every attempt will be made to harmonize the proposed IDA VaR modeling requirements with those of OSFI, circumstances specific to the individual securities dealer and/or differences in other regulatory requirements that apply to securities dealers (in comparison to other financial institutions) will make a certain number of different requirements necessary.