

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.1 SROs

13.1.1 IIROC Rules Notice – Request for Comment – Amendment to Dealer Member Rule 100.10(f)(vi) Box Spread

AMENDMENT TO DEALER MEMBER RULE 100.10(F)(VI) BOX SPREAD

Summary of nature and purpose of proposed Rule

On November 23, 2011, the Board of Directors (the Board) of the Investment Industry Regulatory Organization of Canada (IIROC) approved the publication for comment of a proposed amendment (Proposed Amendment) to the Dealer Member Rules (the Rules) that would amend the capital calculation for Dealer Member inventory account positions in a box spread option offset strategy.

The primary objective of the Proposed Amendment is to clarify the capital calculation for box spreads to ensure that the calculated capital requirement accurately reflects the risk of the position.

Issues and specific Proposed Amendments

Current Rule

The current IIROC Dealer Member inventory account minimum capital calculation for a box spread requires clarification to ensure that the calculation results in a minimum capital requirement that is reflective of the position's risk. A box spread is an option strategy that combines a bull spread¹ and a bear spread² having two different exercise prices, which produces a risk-free payoff of the difference in exercise prices. A box spread can either be a long box spread or a short box spread.

The net profit of either a long or short box spread will approximate zero, and can be represented as follows:

- Profit on long box spread = payoff – net premium paid
- Profit on short box spread = net premium received – payoff

In either case, arbitrage profits are possible by locating favourable net option premiums relative to the payoff.

In theory, the capital requirement in current Rule 100.10(f)(vi) is based upon the offsetting risk from the pay off and net premium paid/received as indicated in clauses (I) and (II) of the capital calculation. However, in practice the current rule only captures one side of the “payoff vs. premium” equation, and always generates a negative margin requirement, because the offset asks for the lesser of clauses (I) and (II), and one of the clauses will always be negative.

Proposed Rule

The proposed amendment will change the calculation from requiring the lesser of clauses (I) and (II) to the sum of clauses (I) and (II). Summing clauses (I) and (II) will ensure that the capital calculation accurately reflects the risk of the position, effectively requiring zero capital, subject to minor requirements depending on slight value differences in clause (I) from clause (II) based upon the valuation of the options.

The Board Resolution, the Proposed Amendment and a black-line of the Dealer Member Rule 100.10(f)(vi) are set out in Attachments A, B and C, respectively.

¹ A bull spread is an option strategy that involves buying a call option with a lower exercise price and selling a call option with a higher exercise price. It can also be executed with put options.

² A bear spread is an option strategy that involves selling a put with a lower exercise price and buying a put with a higher exercise price. It can also be executed with call options.

Rule Making Process

The proposed amendment was developed by IIROC staff and recommended for approval by the FAS Capital Formula Subcommittee and the Financial Administrators Section.

Issues and Alternatives Considered

The only other alternative considered was to leave the Dealer Member Rule for inventory account box spreads unchanged. This alternative was dismissed because it is apparent that the calculation methodology used in the current rule does not accurately reflect the risk of the offset.

Comparison with Similar Provisions

The box spread is a well-established option offset strategy that is recognized in the Rules for customer positions and Dealer Member positions under Dealer Member Rules 100.9(f)(iv) and 100.10(f)(iv), respectively. The box spread is recognized in other jurisdictions, including the U.S. under the Chicago Board Options Exchange Rules 12.3(a)(10) and 12.3(c)(5)(C)(8).

The Proposed Amendment clarifies the calculation methodology of the Dealer Member inventory account box spread option offset making it more reflective of the limited risk of these positions. As a result, the Proposed Amendment also brings the Dealer Member inventory account box spread option offset strategy back in-line with the IIROC prescribed customer margin requirements and U.S. margin requirements.

Proposed Rule classification

In deciding to propose these amendments, IIROC identified that there was a need to clarify and amend the calculation methodology used in determining the minimum capital requirement for a Dealer Member inventory account box spread.

This need was assessed as being in the public interest and not detrimental to the best interests of the capital markets. As a result, the Board has determined that the Proposed Amendment is a Public Comment Rule and is not contrary to the public interest.

Effects of the proposed Rule on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance

Statements have been made elsewhere as to the nature and effects of the Proposed Amendment.

The specific purpose of the Proposed Amendment is to amend the calculation for determining the minimum capital requirement for a Dealer Member inventory account box spread in order to ensure that the risk of these positions is accurately covered.

It is believed that the Proposed Amendment will have no impact in terms of capital market structure, competition generally, cost of compliance and conformity with other rules. The Proposed Amendment 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.

Technological implications and implementation plan

It is not anticipated that there will be any system impacts resulting from the implementation of this rule change. Bourse de Montréal (the Bourse) is also in the process of passing the Proposed Amendment. Implementation of the Proposed Amendment is expected to occur once both the Corporation and the Bourse have received approval to do so from their respective recognizing regulators.

Request for public comment

Comments are sought on the Proposed Amendment. Comments should be made in writing. Two copies of each comment letter should be delivered by March 28, 2012 (60 days from the publication date of this notice). One copy should be addressed to the attention of:

Bruce Grossman
Senior Information Analyst, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, Ontario, M5H 3T9

The second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, Ontario, M5H 3S8
marketregulation@osc.gov.on.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received").

Questions may be referred to:

Bruce Grossman
Senior Information Analyst, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
416-943-5782
bgrossman@iiroc.ca

Attachments

- Attachment A – Board Resolution
- Attachment B – Proposed Amendment to Dealer Member Rule
- Attachment C – Black-line of Proposed Amendment

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
AMENDMENT TO DEALER MEMBER RULE 100.10(F)(VI) BOX SPREAD
BOARD RESOLUTION

BE IT RESOLVED ON THE 23RD DAY OF NOVEMBER, 2011, THAT:

1. The English and French versions of the proposed amendment to the Dealer Member Rule regarding the inventory account box spread option offset strategy, in the form presented to the Board of Directors:
 - (a) be approved for publication for public comment for 60 days;
 - (b) be approved for submission to the Recognizing Regulators for review and approval;
 - (c) be determined to be in the public interest; and
 - (d) be approved for implementation if there are no material comments from the public or the Recognizing Regulators.
2. The President be authorized to approve such non-material changes to the proposed amendments prior to publication and/or implementation as the President considers necessary and appropriate.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
AMENDMENT TO DEALER MEMBER RULE 100.10(F)(VI) BOX SPREAD
PROPOSED AMENDMENT

1. Dealer Member Rule 100.10(f)(vi) is amended by replacing the word “lesser” with the word “sum”.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

AMENDMENT TO DEALER MEMBER RULE 100.10(F)(VI) BOX SPREAD

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Dealer Member Rule 100.10(f)(vi) – Amendment #1

vi) Box spread

Where a Dealer Member account contains a box spread combination on the same underlying interest with all options expiring at the same time, such that a Dealer Member holds a long and short call option and a long and short put option and where the long call option and short put option, and short call option and long put option have the same strike price, the minimum capital required shall be the sum ~~lesser~~ of:

- (I) the difference, plus or minus, between the aggregate exercise value of the long call options and the aggregate exercise value of the long put options; and
- (II) the net market value of the options.