

# IIROC NOTICE

## Rules Notice

### Request for Comments

UMIR / Dealer Member Rules [IIROCRules]

**Comments Due By: April 12, 2021**

*Please distribute internally to:*

Institutional  
Legal and Compliance  
Senior Management  
Trading Desk  
Retail

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**21-0032**

**February 25, 2021**

## Proposed margin requirements for structured products

### Executive Summary

IIROC is proposing amendments to Dealer Member Rule (**DMR**) 100.2 and IIROC Rule 5400<sup>1</sup> that would allow margining of structured products using either a fixed rate or an alternative component margining methodology (**Proposed Amendments**).

The main purpose of the Proposed Amendments is to formally recognize a margin methodology for structured products as the current DMR and IIROC Rules do not specifically address margin requirements for these products.

The Proposed Amendments would:

- require a margin rate of 70% for structured products that meet eligibility criteria, and
- allow an alternative component-based margin methodology for structured products with a guarantee component.

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<sup>1</sup> See Notice [19-0144](#) and Notice [20-0079](#) for more information on the IIROC Rules



## How to Submit Comments

Comments are requested on all aspects of the Proposed Amendments, including any matter which they do not specifically address. Comments on the Proposed Amendments should be in writing and delivered by **April 12, 2021** to:

Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
Suite 2000  
121 King Street West  
Toronto, Ontario M5H 3T9  
e-mail: [memberpolicymailbox@iiroc.ca](mailto:memberpolicymailbox@iiroc.ca)

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Market Regulation  
Ontario Securities Commission  
Suite 1903, Box 55  
20 Queen Street West  
Toronto, Ontario M5H 3S8  
e-mail: [marketregulation@osc.gov.on.ca](mailto:marketregulation@osc.gov.on.ca)

**Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at [www.iiroc.ca](http://www.iiroc.ca).**



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## **1. Background and History**

### **1.1 Background**

A structured product is a market-linked investment that is packaged as an alternative to a direct investment in the underlying security or basket of securities. The purpose of the structured product is to reduce risk exposure while utilizing current market trends. Structured products are not typically listed on exchanges. In Canada, Dealer Members (**Dealers**) distribute structured products issued by their affiliate financial institutions through Fundserv and offer a secondary market to investors wishing to sell the products before maturity.

Investors are attracted to these products for their tax and operational efficiencies and customizable features. Structured products are popular with high net worth clients that want a product customized to their specific investment view. In general, structured products, are intended to be held to maturity for investors to benefit from features such as a guarantee component embedded in the product.

There are two main types of structured products:

- Principal-protected notes (**PPNs**)
- Principal-at-risk notes (**PARs**)

Structured products were first introduced in Canada in the 1990s and included only PPNs. In 2007, the structured products expanded to include PARs. The structured product market has experienced rapid growth over the years in both the size and complexity of the products. Currently in Canada, the market is dominated by the largest six Schedule 1 banks which issue both PARs and PPNs.

### **1.2 Principal-protected notes**

PPNs guarantee at least the return of the principal amount invested, as long as the note is held to maturity. A PPN is structured as a zero-coupon bond combined with a payoff option linked to the performance of an underlying asset, index, or benchmark. PPNs are issued by financial institutions in Canada through an information statement or term sheet. PPNs are sold without a prospectus under prospectus exemptions for guaranteed debt or on the basis that they fall outside the scope of provincial securities legislation.

### **1.3 Principal-at-risk notes**

PARs provide investors the possibility of increased returns through leverage, by putting more of the investment's principal amount at risk. Financial institutions issue these products through a prospectus offering. Financial institutions issue these products through a prospectus offering as required by securities laws.

### **1.4 Other jurisdictions**

IIROC did not identify specific margin rules for structured products in other jurisdictions.



## 2. Discussion of Proposed Amendments

### 2.1 Current Rules

Currently, there are no Dealer Member Rules for structured products; however, IIROC has provided rulings that allowed qualifying PPNs to be margined according to their component parts under DMR 100.2(g) - *Units*. Margin rate rulings required that the principal-protected component be margined according to Regulation 100.2(a)(xi) *Stripped coupons and residual debt instruments*, and the performance-based component be margined at 100% (**Component Methodology**)

PARs may or may not have a principal-protected component depending on whether the PAR has a partial-guarantee against the downside risk. IIROC had advised Dealers that PARs were not margin eligible due to the reduced principal-protection features.

### 2.2 Issue

The Component Methodology is difficult to calculate and must be manually calculated by Dealers as the service provider systems cannot easily implement this method. There is widespread interest from Dealers requesting to allow loan value on all structured products including PARs and to set a fixed margin rate to reduce the complexity of margining the individual components.

### 2.3 Risk analysis

Dealers have suggested PARs are similar to bonds in default, ETFs, and mutual funds which have a maximum margin rate of 50%. IIROC staff analyzed the risks and features that are common to most PARs and PPNs and concluded that the two critical differences between structured products and other securities eligible for margined at 50% are liquidity and complexity of the products.

#### 2.3.1 Liquidity

Most structured products are not listed on exchanges. The issuer may provide redemption rights and typically the affiliated Dealer provides a secondary market. There is no guarantee this secondary market will exist especially in times of market volatility. According to most PPN Information sheets and PAR prospectuses, the issuer or dealer reserves the right not to maintain the secondary market. In contrast, mutual fund issuers are required by securities law to redeem units at the investor's request and ETFs are listed on recognized exchanges. Bonds in default may be sold to various willing buyers and bondholders that have a claim on the issuer's assets in the event of a bankruptcy of the issuer.

#### 2.3.2 Complexity

Structured products can be customized and therefore the risk profile for each structure product is different. The customization of the structured products makes these products uniquely different from traditional equities, bonds and mutual funds.

The features of a structured product that can be customized include:

- term to maturity,



- underlying security, currency or asset,
- minimum amount of principal to be returned, and
- upside participation.

Further, the design of the upside participation may include barriers, buffers, and floors to limit the upside or downside risks. Also, the upside potential may be limited by issuer autocallability features.

## **2.4 Proposed Amendments**

The Proposed Amendments allow structured products to be margined using a fixed margin rate of 70%, while including a Component Methodology as an alternative margin calculation for structured products that have a guarantee component. This Component Methodology may require additional operational resources to calculate but it would result in a lower margin rate than the proposed fixed rate.

The fixed margin rate of 70% is based on the following:

- (a) a 50% margin rate (which is the maximum rate for equities, bonds in default, ETFs, mutual funds)  
plus
- (b) a 20% additional margin rate requirement to cover any increased liquidity risk associated with the structured product.

We believe a conservative fixed margin rate is necessary to address product liquidity limitations and the uniqueness and variability of the product design.

We also propose that margin eligibility will only apply if the structured product:

- is issued by an acceptable institution.
- is qualified by prospectus for sale in any province in Canada or is guaranteed by a Canadian financial institution as defined in securities laws - this will limit the margin eligibility to Canadian issued structured products. Foreign-issued structured products will not be eligible for margin.
- has an active secondary market - if the issuer or Dealer is not providing a secondary market, the structured products would not be eligible for margin.
- is linked to an underlying asset that is already eligible for margin under IIROC Rules - for example, structured products linked to bitcoins or complex derivatives would not be eligible for margin.

The blackline of the Proposed Amendments to DMR is set out in Appendix A and the text of the changes is set out in Appendix C. The blackline of the Proposed Amendments to the IIROC Rules is set out in Appendix B and the text of the changes is set out in Appendix D.

## **3. Alternatives considered**

The following alternatives were considered:

- (a) Status quo



(b) Fixed margin rate of 50%

### **3.1 Status quo**

The status quo was not chosen because of the increasing demand from Dealers for specific margin requirements due to the rapid growth in use of these products. Also it is impractical for IIROC staff to assess and provide margin rulings on a product-by-product basis.

### **3.2 Fixed margin rate of 50%**

We also considered an approach that would require a fixed margin rate of 50% for structured products as suggested by Dealers. IIROC considered a conservative approach to be more appropriate given the additional complexities with structured products and the limited secondary market for such products. A more conservative fixed rate of 70% was chosen but the Proposed Amendments also include an alternative Component Methodology which may result in a lower overall margin rate and aligns with our previous rulings.

## **4. Impacts of the Proposed Amendments**

We do not believe that the Proposed Amendments will have a material impact on investors, the capital market structure, competition generally, the cost of compliance, constraints on innovation and conformity with other rules. The Proposed Amendments do not permit unfair discrimination among customers, issuers, brokers, Dealers or others.

### **4.1 Economic Impact Assessment**

We need to consider undertaking an economic impact assessment of the anticipated costs and benefits of our rule proposals as part of our regulatory process. We determined it was not necessary to perform an economic impact assessment of the Proposed Amendments as the proposed margin rate changes:

- codify existing minimum margin requirements for qualifying PPNs
- grant margin eligibility for qualifying PARs at a 70% rate
- result in margin rate levels that adequately address:
  - o the market risks associated with holding PPN and PAR positions in Dealer inventory
  - o the credit risks associated with margining client account PPN and PAR positions

## **5. Implementation**

We intend to make the Proposed Amendments effective within 90 days after approval from our Recognizing Regulators.

## **6. Policy Development Process**

### **6.1 Regulatory Purpose**



The Proposed Amendments would:

- establish and maintain rules that are appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity,
- promote consistency in the margin treatment

## **6.2 Regulatory Process**

The Board of Directors of IIROC has determined the Proposed Amendments to be in the public interest and on January 27, 2021 approved them for public comment.

IIROC developed the Proposed Amendments in consultation with the Financial and Operations Advisory Section (FOAS) Capital Formula Subcommittee and FOAS Executive Committee. The committees support the Proposed Amendments.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend that revisions be made to the applicable Proposed Amendments. If the revisions and comments received are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the Proposed Amendments as revised will be subject to approval by the Recognizing Regulators. If the revisions or comments are material, the proposed amendments including any revisions will be submitted to the Board for approval for republication or implementation as applicable.

## **7. Appendices**

- [Appendix A](#) - Blackline copy of the Proposed Amendments to Dealer Member Rules
- [Appendix B](#) - Blackline copy of the Proposed Amendments to IIROC Rules (Effective December 31, 2021)
- [Appendix C](#) - Clean copy of the Proposed Amendments (Dealer Member Rules)
- [Appendix D](#) - Clean copy of the Proposed Amendments (IIROC Rules – Effective December 31, 2021)