INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Catherine Drennan
Senior Manager, Member Regulation
Investment Industry Regulatory Organization of Canada
121 King St W #2000
Toronto, ON
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Dear Catherine:

RE: IIROC Notice 21-0032 Proposed Margin Requirements for Structured Products

The IIAC appreciates the opportunity to provide comments on Notice 21-0032 surrounding IIROC's proposed margin requirements for structured products (the "Proposal"). A working group of IIAC members familiar with the distribution and financial reporting of structured products assisted in reviewing the Proposal and formulating our views.

Our members are very supportive of IIROC's plans to amend its Dealer Member Rules ("DMRs") to formally incorporate a defined margining framework specific to structured products – including both Principal-protected notes ("PPNs") and Principal-at-risk notes ("PARs"). We view IIROC's introduction of a fixed-rate margin methodology especially helpful as it will greatly simplify dealers' margin determination while also contributing to their clients' understanding of how structured notes are margined.

The IIAC questions, however, the appropriateness of IIROC's proposed 70% fixed margin rate for structured products. Specifically, we believe the margin premium that IIROC is assigning on structured products is excessive given the construct of these products, the margin rate IIROC currently applies to "like-products", and the margin eligibility criteria that IIROC has established.

For structured products that meet the margin eligibility criteria proposed by IIROC we recommend that IIROC consider: 1) a fixed-margin rate of between 30 - 50% for PARs and 2) a fixed-margin rate of between 15-30% for PPNs.

We recognize that our recommendations are a material departure from the fixed rate proposed by IIROC. The proceeding comments provide rationale for our recommendations.

The Growth in Structured Products Supports the Need for IIROC to Update its DMRs

Though there are no DMRs surrounding the margining of structured products currently, our members have appreciated that IIROC has allowed for qualifying PPNs to be margined using a Component Methodology. However, we concur that the increased popularity of structured products among issuers and investors warrants revision to the DMRs to provide a specified margining framework for these products, including PARs. We also concur that the complexity of the Component Methodology has made it difficult for dealers, or their vendors, to efficiently implement this approach. The Component Methodology has also made it a challenge for clients to understand how margin on their holdings of structured notes is determined. As such, we greatly welcome IIROC's plan to introduce a fixed-rate methodology as part of the proposed new margining framework while still keeping available the Component Methodology for dealers to use.

IIROC's Proposed 70% Fixed Margin Rate for Structured Products is Unwarranted

IIROC is proposing a fixed margin rate of 70% on PPNs and PARs that meet the eligibility criteria – 20% more than the maximum rate for equities, ETFs and mutual funds. IIROC justifies this margin premium on structured products by referencing the complexity and liquidity risk associated with them.

We note, however, that the complexity and liquidity of structured products are generally favourable when compared to some equities, ETFs and mutual funds that IIROC permits 50% loan value. For example, not all listed securities are liquid given that many trade infrequently or quoted at a wide bid – offer spread. Further still, not all mutual funds or ETFs are 'simple' for investors to understand as some are increasingly adopting more complex strategies/construction to generate superior returns. Additionally, none of these referenced securities would typically carry any downside protection in the form of principal guarantee (PPNs) or predefined level of principal exposure (PARs).

We also believe that much of IIROC's concerns surrounding structured products are well mitigated through the criteria it has proposed for margin eligibility. Specifically, liquidity risk is lessened given IIROC's requirement that the structured product be issued by an acceptable institution ("AI") and the dealer or issuer <u>must</u> be providing an active secondary market for the structured product. By deeming foreign-issued structured products and structed products linked to instruments such as derivatives and cryptocurrencies ineligible for margin, IIROC is also addressing some of its complexity concerns.

Lastly, structured products are typically issued or guaranteed by major Canadian financial institutions ("FIs"). Canadian FIs have repeatedly demonstrated their resiliency through periods of market stress, including the financial crisis of 2008 and more recently during the onset of COVID. Furthermore, the reputational harm to a Canadian FI should it fail to meet commitments, or obligations, related to their structured notes also provides some added assurance to investors, and IIROC, against the market for these products fully seizing.

We believe, therefore, the 20% margin premium that IIROC is assigning to structured products is unwarranted.

Differences between PPNs and PARs should be Reflected in the Proposal

IIROC's proposed margining framework does not differentiate between PPNs and PARs (ie. a 70% fixed margin rate is proposed by IIROC for both). However, structurally these two products vary. Most notable, PPNs guarantee the full principal whereas PARs expose a set portion of principal to risk.
In addition to providing full principal protection, PPNs are less complex and have fewer payoff features than PARs. These should be reflected in IIROC's margin treatment.

Specifically, we believe that PARs should carry a fixed margin rate of between 30-50% and PPNs should carry a fixed margin rate of between 15-30%.

A 50% margin rate on PARs would already represent a premium to equity securities that do not offer the benefit of any additional downside protection features offered by PARs. A lower margin rate can, however, be justified given that most PARs issued by Canadian FIs are tied to indices/ETFs or other baskets that are comprised of securities identified by IIROC as eligible for reduced margin of 30%.

Our justification for a fixed-margin rate of 15-30% for PPNs is elaborated below.

Alternative Component Methodology Supports a Substantial Reduction to the Proposed Fixed Margin Rate for PPNs

As IIROC points out, the Component Methodology would typically result in a lower margin rate for PPNs than the proposed fixed rate of 70%. System limitations, valuation challenges and resource constraints, unfortunately, prevents dealers from fully utilizing the Component Methodology. An additional deterrent is that the Component Methodology is complicated for clients to comprehend. There is a clear preference across our members, therefore, to seek a separate fixed margin rate for PPNs that could more easily be applied broadly across the industry and all accounts.

The construct of PPN's (i.e. underlying components), warrants a fixed margin rate for these products that is significantly below that which is contemplated in the Proposal. Specifically, the risk profile and expected performance for a PPN is essentially that of 1) a strip bond of similar term (typically 3-7 years (which are margined at 10.5% under Rule 100)), and (2) a convertible bond (margined at 15% under Rule

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100). These margin rates are materially different than the 70% fixed-rate proposed by IIROC for PPNs. Client expectations are that like products receive similar margin so it would be very difficult for IIAC members to justify to their clients IIROC's proposed margin requirement of 70% for PPNs.

We also fail to understand the policy rationale for assigning a higher loan value under one method (the Component Methodology) but otherwise assign a significantly lower loan value under another methodology (the 70% fixed rate methodology) for identical securities.

Maintaining a punitive fixed margin rate of 70% for PPNs would compel dealers to devote valuable resources to accommodate the Component Methodology or otherwise default to the proposed 70% fixed-rate and deprive considerable loan value to their clients. This could especially disadvantage smaller-sized dealers (and their clients) without the resources/expertise to adopt the Component Methodology.

We recommend, therefore, that the Proposal be amended to reflect a fixed margin rate of between 15-30% for PPNs.

Closing

We thank IIROC for recognizing the need to introduce a dedicated margining framework for structured products – including the introduction of a fixed rate methodology. We believe lowering IIROC's proposed 70% fixed margin rate to between 30 -50% is warranted for PARs. The fixed margin rate on PPNs should be lowered to between 15- 30% to more closely align with the margin requirements determined using the Component Methodology. The Component Methodology should still be kept available to support dealer use on a case-by-case basis.

We would be happy to arrange a meeting with our members to discuss our recommendations.

Sincerely,

Investment Industry Association of Canada

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