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To: All Chief Financial Officers, IDA Member Firms
Panel Auditors, IDA Jurisdiction Firms

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Joint Regulatory Financial Questionnaire and Report, effective January 1, 1998

This Interpretation Bulletin has been prepared to describe the background to and provide details of the amendments made to Form 1 - Joint Regulatory Financial Questionnaire and Report ("JRFQ&R"), to be effective January 1, 1998. Due to the complexity surrounding the changes made to the definition of "acceptable securities locations", as set out in the General Notes and Definitions of the JRFQ&R, a separate Interpretation Bulletin [IDA Compliance Interpretation Bulletin C-1 17] has been prepared to describe those changes in detail.

Attachment #1 contains a summary of all the changes that have been made to the JRFQ&R. Attachment #2 contains a copy of each of the JRFQ&R pages that have been amended. The remainder of this Interpretation Bulletin provides greater detail on the more significant changes that have been made to the JRFQ&R.

Other Foreign Acceptable Security Locations

Under the existing rules set out in the JRFQ&R there is a category of acceptable security locations known as other foreign acceptable security locations and yet there is no codified framework set out to enable Member firms to determine which other foreign securities locations would be considered acceptable. In order to address this need, IDA Compliance Interpretation Bulletin C-83 set out a framework to be used.

The changes to the definition of acceptable security locations set out in the General Notes and Definitions to the JRFQ&R, codify the framework set out in this Interpretation Bulletin. As a result of the amendments made to the definition, a framework is now set out detailing the prerequisite requirements for other foreign acceptable security locations.

The requirements set out in this amended definition, to be effective January 1, 1998, include:

- (a) the initial and ongoing approval of such "other" foreign security locations by the board of directors of the Member firm and/or other duly constituted and authorized board committee;
- (b) the foreign institution and/or securities dealer meeting a minimum net worth requirement;
- (c) a written custodial agreement setting out the minimum terms of the arrangement; and
- (d) the positive confirmation of securities held at such locations by the Member firm's external auditors during the course of the annual audit. For locations for which a response to a positive confirmation request has not been received, a capital charge equal to the market value plus margin of such securities held must be provided.

Member firms must evidence on an annual basis the continued approval of such previously approved "other" foreign securities locations as documented in the minutes of the Board of Directors and/or other duly constituted board committee meetings.

For year-end JRFQ&R audit filings, a list of approved "other" foreign locations and the market value of securities held at such locations shall be provided as supplementary disclosure to the IDA. This supplementary disclosure requirement is set out in Note 13 of the General Notes and Definitions to the JRFQ&R.

The Member firm shall also indicate "other" foreign locations for which a response to a positive confirmation request has not been received by the auditors at the time of filing and the amount of capital provided. This requirement is set out in the Notes and Instructions to Statement B relating to Line 19.

Tax Recoveries

The capital formula as set out in the JRFQ&R requires a Member firm to provide for contingent losses. These provisions include margin requirements for customer account positions, capital requirements for inventory positions, concentration charges for significant issuer, commodity and foreign exchange exposures and the write-off of assets considered non allowable for regulatory capital purposes.

With the implementation of the new capital formula on April 1, 1993, the concept of Applicable Tax Recoveries, as set on Schedule 6A of the JRFQ&R, was introduced. This concept permitted certain of the above listed provisions to be considered available for tax recovery purposes. If any of these contingent losses were realized, the losses would result in a lower current tax provision for a profitable firm and could permit the application of a loss carryback for an unprofitable firm which had previously paid taxes. For example, a contingent loss resulting from a customer account margin requirement could result in taxes recoverable if actually realized, so a contingent asset, the tax recovery, is permitted. This effectively treats certain provisions for contingent losses on an after tax basis.

To this point a tax recovery for risk adjusted capital purposes has been calculated by taking into consideration contingent losses resulting from customer account margin requirements, inventory position capital requirements, and assets considered non allowable for regulatory capital purposes. With the implementation of the amendments to Schedule 6A, effective January 1, 1998, a tax recovery may also be calculated in the instance where a Member firm incurs a security concentration charge. The security concentration charge is essentially a margin requirement for concentrated combined firm and customer exposures to the securities of individual issuers. Therefore, its inclusion in the calculation of tax recovery for risk adjusted capital purposes is consistent with the existing tax recovery treatment given to other contingent losses.

Securities Concentration Charge

On January 31, 1993, the SROs enacted an amendment to the JRFQ&R relating to margin requirements for concentrations of securities. That amendment, as set out in Schedule 9 of the JRFQ&R, requires that Member firms that maintain significant exposures to the value of the securities of a particular issuer company must provide concentration margin for those exposures. The exposure a Member firm has to a particular issuer company is determined as the largest aggregate Member firm and customer account amount at risk, resulting from either a long or short position. Whether such exposure is considered to be significant is determined by comparing the value of the amount at risk to an exposure threshold based on a percentage of risk adjusted capital. The Member firm must provide for a concentration margin for any exposure determined to be in excess of the exposure threshold.

Although the formula for calculating concentration margin has worked reasonably well for the past four years, the following amendments will be implemented, effective January 1, 1998, to improve the accuracy of the calculation:

- (a) the Notes and Instructions to Schedule 9 have been completely rewritten to provide guidance to Member firms on:
 - (i) the determination of the gross long and gross short client exposure [Note 7];
 - (ii) the determination of the net long or net short firm exposure [Note 8];
 - (iii) the determination of the amount loaned exposure based on the largest combined client/firm long or short exposure [Note 9]; and (iv) the determination of the security concentration charge.
- (b) amendments have been made to the existing security concentration charge calculation in the following areas:
 - (i) the determination of the amount loaned exposure for the securities of a particular issuer must include any security positions used to reduce the customer account margin requirement pursuant to a guarantee agreement. [Note 9(d)(v)]
 - (ii) the concentration margin requirement calculated for any exposure to the value of the long security positions of a particular issuer will be limited to the loan value of these positions. The current requirements set out in the Notes and Instructions to Schedule 9 place no limit on the concentration margin calculated. So, a Member firm may be providing more in capital than it could possibly lose [i.e., the combined normal margin requirement and security concentration charge may be more than the market value of the security issue]; and
 - (iii) limit the number of issuer positions upon which the security concentration charge must be calculated to the largest five issuer positions only. SRO staff have encountered situations in the past few years where Member firms have had operating losses such that they are capital deficient. Under the current rules, a Member firm that is capital deficient would be required to calculate and provide for a security concentration charge for all issuer positions held in firm inventory or used for customer account collateral purposes. It felt that by limiting the number of issuer positions for which a Member firm must provide for a security concentration charge, there would be enough of an indication that a Member firm is in serious financial difficulty, and to continue to calculate this requirement for additional positions would provide no additional information as to the Member firm's capital adequacy.

Any questions regarding this Interpretation Bulletin should be directed to either:

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