MEMBER REGULATION

INVESTMENT DEALERS ASSOCIATION OF CANADA

notice

ASSOCIATION CANADIENNE DES COURTIERS EN VALEURS MOBILIÈRES

Contact:
A. Mian: (416) 943-4656 – amian@ida.ca

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Margin Requirements for Synthetic and Reconstituted Government of Canada Bonds

This notice is a re-issuance of Compliance Interpretation Bulletin C-64. It was originally issued in 1993 to highlight the areas concerning margin calculations for inventory and client synthetic and reconstituted Government of Canada ("GOC") bond positions. This notice is being re-issued with the objective of explaining the process of "GOC" bond stripping and reconstitution, the margining of positions in these products and the offsets available.

1. **What is a "coupon stripping", "zero coupon bond' and "synthetic GOC bond"?**

   Coupon stripping is the act of detaching interest payment coupons from a bond and treating the coupons and body of the bond as separate securities. These separated/stripped coupons are known as zero coupon bonds and the body of the stripped bond is known as a residual. A synthetic GOC bond is a package constituted from GOC stripped coupons and/or GOC residual bonds and/or GOC "plain vanilla" bonds.

   These packages are created through use of the facilities of The Canadian Depository for Securities Limited ("CDS"). Within the CDS Depository Service, a ledger system is used to separate the underlying bonds into the corresponding strip components. In order to identify each of the strip components, generic CUSIP numbers are assigned to all strip components (referred to as "CDS Book-Entry Strip Bonds") having the same issuer, payment date, payment currency and payment type (principal or interest). Thus a $5 coupon payable 15 June 2006 originally stripped from a Government of Canada Bond maturing 15 December 2016 is indistinguishable from $5 coupon also payable on 15 June 2006 which was originally stripped from GOC Bond maturing 15 June 2017. The stripped components can be repackaged in different ways and the package sold as a synthetic bond. The synthetic bond is assigned a unique CUSIP number to specify the specific characteristics of the new synthetic bond. In this way, components stripped from a high coupon bond can be repackaged into low coupon bonds.

The two basic types of packages that are created are:

- "Bond-type" packages which pay interest at regular intervals from a specified date until maturity and have a lump-sum payment at maturity; and

- "Annuity-type" packages which pay fixed amounts at regular intervals from a specified date until maturity but do not have a lump-sum payment at maturity

2. What are the margin requirements for "bond-type" synthetic GOC bonds?

Where a Member firm has created a "bond-type" synthetic GOC bond, the SROs have determined that a margin premium of 25% should apply. This premium is in addition to the margin rate otherwise required based on the issuer and maturity date of the bond. This margin application is similar to the margin required for mortgage-backed securities in IDA Regulation 100.2(h). However, this margin application is only allowed to the extent that the components are based on the same issuer, and that there is an ascertainable market for the product. In addition "bond-type" synthetic GOC bonds must be identified and assigned new and separate CUSIP numbers at CDS, to qualify for the reduced margin requirement and not solely identified as such within a Member firm's inventory.

3. What offsets are permitted in the determination of margin requirement for "bond-type" synthetic GOC bonds?

Margin offsets are allowed for "bond-type" synthetic GOC bonds and other GOC bond positions on a basis consistent with the margin offset rules allowed for mortgage-backed securities in IDA Regulation 100.4D. The margin required is the net margin required for the long and short positions on the basis that the market value of the two positions is equal, and the positions are in the same unhedged margin rate maturity band.

For all other offsets involving "bond-type" synthetic GOC bonds, the applicable margin offset rules are set out in IDA Regulation 100.4C. This is because "bond-type" synthetic GOC bonds are eligible for the same offset treatment as GOC bonds.

As a result Offsets involving long (short) "bond type" synthetic bonds are permitted against the following other types of Securities, provided the provisions in Regulation 100.4C. (i –iv) are met.

Short (/Long) US Treasury Short (/Long) Provincial Bonds Short (/Long) Muncipal Bonds Short (/Long) Corporate Bonds	The margin required in respect of both positions shall be greater of margin required on the long or short position.

4. What are the margin requirements for "annuity-type" synthetic GOC bonds?

Where a Member firm has created an "annuity-type" synthetic GOC bond, the SROs have determined that a margin premium of 25% should apply. This premium is in addition to the margin rate otherwise required based on the issuer and maturity date of the original underlying bond. This margin treatment is similar to that required for the fixed rate payment component of an interest rate swap, as set out in IDA Regulation 100.2(j). However, this margin treatment is only allowed to the extent that the components are based on the same issuer, and that there is an ascertainable market for the product. In addition, synthetic "annuity-type" GOC bonds must be

identified and assigned new and separate CUSIP numbers at CDS, to qualify for the reduced margin requirement and not solely identified as such within a Member firm's inventory.

5. What offsets are permitted in the determination of margin requirement for "annuity-type" synthetic GOC bonds?

Margin offsets are allowed for synthetic "annuity-type" GOC bonds and Fixed rate swaps on a basis consistent with the margin offset rules allowed for fixed rate interest rate swaps in IDA Regulation 100.4F(b).

Where a Member is a party to an interest rate swap agreement providing for the Member to make or receive Canadian dollar or United States dollar payments calculated with reference to a notional amount at a rate which is fixed for the term of the obligation, and holds a long or short position in "annuity-type" synthetic GOC bonds, maturing within one year with a principal amount equal to and denominated in the same currency as the notional amount of the swap, the margin required is the net margin required between the long and short position on the basis that the market value of the two positions equal, and are in the same maturity band.

6. What is a "reconstituted GOC bond"?

Reconstitution refers to the recombining of the stripped coupon and residual components of an underlying bond after they have been stripped on a book basis. A reconstituted GOC bond may be created where a Market Participant acquires all the underlying stripped components of a GOC bond and this is reflected on its book-based security ledger at CDS.

To perform the reconstitution function CDS exchanges the positions in the stripped components for the equivalent position in the original underlying GOC bond within the ledger system. The reconstituted GOC bond then can be traded or held in the CDS' Depository Service

7. What are the margin requirements for "reconstituted GOC bonds"?

Where a Member firm holds a reconstituted GOC bond, the SROs have determined that the margin requirement shall be the same as that required for the original underlying GOC bond on the basis that the security is re-assigned the same CUSIP number as that used for the underlying GOC bond once reconstitution has taken place.

8. Can the margin requirements set out above for "synthetic GOC bonds" and "reconstituted GOC bonds" be used for other packaged bond components?

No. Any other form, combination or permutation of a packaged bond components that **are** not based on the same issuer or does not have a complete stream of coupons attached to the residual bond component requires that the security be margined on a piece-meal basis.