Bourse de Montréal Inc.

**CIRCULAR**
July 30, 2003

# REQUEST FOR COMMENTS

## CUSTODIAL AGREEMENTS

## AMENDMENTS TO STATEMENT B AND STATEMENT C – POLICY C-3 OF THE BOURSE

### Summary

The Executive Committee of Bourse de Montréal Inc. (the "Bourse") has approved amendments to Statement B and Statement C of Policy C-3 of the Bourse entitled Joint Regulatory Financial Questionnaire and Report ("JRFQ&R"), which relate to the custodial agreements. The objective of the proposed amendments is to modify the capital requirements imposed when an approved participant has failed to enter into a written custodial agreement with an entity that would otherwise qualify as an acceptable securities location, to more closely address the increased risk of loss due to the absence of an agreement.

### Process for Changes to the Rules

Bourse de Montréal Inc. is recognized as a self-regulatory organization ("SRO") by the Commission des valeurs mobilières du Québec (the "Commission"). In accordance with this recognition, the Bourse carries on activities as an exchange and as a SRO in Québec. In its SRO capacity, the Bourse assumes market regulation and broker-dealer regulation responsibilities. The broker-dealers regulated by the Bourse are its approved participants. The responsibility for regulating the market and the approved participants of the Bourse comes under the Regulatory Division of the Bourse (the "Division"). The Division carries on its activities as a distinct business unit separate from the other activities of the Bourse.

Circular no.: 113-2003

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The Division is under the authority of a Special Committee appointed by the Board of Directors of the Bourse. The Special Committee is empowered to recommend to the Board of Directors the approval or amendment of some aspects of the Rules and Policies of the Bourse governing approved participants, among which, the Rules and Policies relating to margin and capital requirements. The Board of Directors has delegated to the Executive Committee of the Bourse its powers to approve or amend these Rules and Policies upon recommendation of the Special Committee. These changes are submitted to the Commission for approval.

Comments on the proposed amendments to Statement B and Statement C of Policy G-3 of the Bourse must be submitted within 30 days following the date of publication of the present notice in the bulletin of the Commission. Please submit your comments to:

*Ms. Joëlle Saint-Arnault*
*Vice-President, Legal Affairs and Secretary*
*Bourse de Montréal Inc.*
*Tour de la Bourse*
*P.O. Box 61, 800 Victoria Square*
*Montréal, Quebec H4Z 1A9*
*E-mail: legal@m-x.ca*

A copy of these comments shall also be forwarded to the Commission to:

*Ms. Denise Brosseau*
*Secretary*
*Commission des valeurs mobilières du Québec*
*800 Victoria Square, 22nd Floor*
*P.O. Box 246, Tour de la Bourse*
*Montréal (Quebec) H4Z 1G3*
*E-mail: consultation-en-cours@cvmq.com*

**Appendices**

For your information, you will find in the appendices an analysis document of the proposed rule amendments as well as the proposed regulatory text. The implementation date of the proposed amendments will be determined, if applicable, with the other Canadian self-regulatory organizations following approval by the Commission des valeurs mobilières du Québec.


## CUSTODIAL AGREEMENTS

## – AMENDMENTS TO STATEMENTS B AND C OF THE "JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT" – POLICY C-3 OF BOURSE DE MONTRÉAL INC.

## I OVERVIEW

### A) Introduction

One of the features of the present capital formula is that all client securities that are held in custody outside of the approved participant firm must be held at an acceptable securities location[1]. One of the requirements to be met for an entity to be considered an acceptable securities location is that the approved participant must execute a written custodial agreement with this entity in a form satisfactory to the Bourse. The purpose of the proposed amendments is to revise the capital requirements that apply when an approved participant fails to enter into a written custodial agreement with an entity that would otherwise satisfy the requirements to qualify as an acceptable securities location.

### B) The Issue

Over the last years, one of the most common financial compliance examination findings has been the situation where approved participants have lodged securities with an outside custodian but have failed to execute a written custodial agreement with the custodian to document the arrangement.

In some instances approved participants have been unable to execute these agreements because of the custodian's refusal to be subject to the terms and conditions set out in the standard agreement prescribed by the Bourse. To address this, a legal review of the standard agreement, including a review of comparable international custodial agreements, was undertaken by an outside law firm.

In other instances approved participants have been unable to execute these agreements either because of differences of opinion as to whether a custodial agreement is necessary or not[2], or due to oversight. In such other instances, it continues to be appropriate to require the approved participant to provide capital for the failure to obtain the necessary custodial agreement, but the capital requirement that is levied against an approved participant should be more reflective of the increased risk of loss.

### C) Objective

The objective of the proposed amendments is to modify the capital requirements that are applicable when an approved participant has failed to enter into a written custodial agreement with an entity that would otherwise qualify as an acceptable securities location, in order to more closely address the increased risk of loss due to not having an agreement.

### D) Effect of Proposed Rules

The adoption of the proposed amendments to Policy C-3 of the Bourse will result in capital requirements that more closely address the risk of loss where an approved participant has failed

[1] The defined term "acceptable securities locations" is set out in the General Notes and Definitions to Policy C-3 of the Bourse.

[2] One area of dispute between approved participants and custodians is whether or not a custodial agreement is required for guaranteed investment certificates and like instruments. Generally, the Bank Act considers these instruments to be deposits and the provincial securities acts consider them to be securities. As a result, the issuer banks for these instruments are very hesitant to enter into a custodial agreement covering instruments they consider to be deposits.

to enter into a written custodial agreement with an entity that would otherwise qualify as an acceptable securities location. As a result, it is anticipated that the proposed amendments will have no impact on market structure, competitiveness of approved participants versus non-approved participants and costs of compliance.

## II DETAILED ANALYSIS

### A) Current Rules

As previously stated, under the current capital formula, all client securities that are held in custody outside of the approved participant firm must be held at an acceptable securities location. The defined term "acceptable securities locations" details the conditions to be met for an entity to be considered appropriate to hold customer securities on behalf of an approved participant. One of those conditions is that the entity must enter into a written custody agreement with the entity in a form satisfactory to the Bourse. Under the present rules, failure to enter into a written custodial agreement with an entity otherwise considered to be an acceptable securities location is treated the same way as an entity that doesn't meet any of the conditions to be considered an acceptable securities location. The following table summarizes the current capital requirements for security positions lodged with outside custodians:

| **Custodian Status** | **Capital Requirement** |
|---|---|
| Custodian considered to be an acceptable securities location and with which the approved participant ***has executed*** an acceptable custodial agreement. | Capital requirement limited to any requirement resulting from unreconciled differences. |
| Custodian considered to be an acceptable securities location with which the approved participant ***has not executed*** an acceptable custodial agreement and ***with which the approved participant has no other obligations***. | Capital requirement is the market value of securities held in custody **plus** normal margin on such securities. |
| Custodian considered to be an acceptable securities location with which the approved participant ***has not executed*** an acceptable custodial agreement and ***with which the approved participant has other obligations***. | Capital requirement is the market value of securities held in custody **plus** normal margin on such securities. |
| Custodian ***not considered to be an acceptable securities location***. | Capital requirement is the market value of securities held in custody **plus** normal margin on such securities. |

### B) Proposed Rules

The proposed rules seek to amend the capital requirements for the situation where the approved participant has failed to execute a custodial agreement with an entity that is otherwise considered to be an acceptable location.

There are two main incremental risks associated with not being able to execute a custodial agreement: setoff risk[3] and fraud risk. The following capital requirements have been revised in order to specifically address these incremental risks:

[3] A definition for "setoff risk" was developed as part of this proposal. Pursuant to the proposed revised Notes and Instructions to Statement B of Policy G-3 of the Bourse, "setoff risk" means "the risk exposure that results from the situation where the approved participant has other transactions, balances or positions with the entity, where the resultant obligations of the approved participant might be setoff against the value of the securities held in custody with the entity".

| Custodian Status | Capital Requirement |
|---|---|
| Custodian considered to be an acceptable securities location and with which the approved participant ***has executed*** an acceptable custodial agreement. | Capital requirement limited to any requirement resulting from unreconciled differences. |
| Custodian considered to be an acceptable securities location with which the approved participant ***has not executed*** an acceptable custodial agreement and ***with which the approved participant has no other obligations***. | Capital requirement is:<br>▪ In determining Risk Adjusted Capital, the capital requirement resulting from any unreconciled difference;<br>▪ In determining Early Warning Reserve, 10% of the market value of securities held in custody. |

| Custodian Status | Capital Requirement |
|---|---|
| Custodian considered to be an acceptable securities location and with which the approved participant ***has not executed*** an acceptable custodial agreement and ***with which the approved participant has other obligations***. | Capital requirement is:<br>▪ In determining Risk Adjusted Capital, the capital requirement resulting from any unreconciled difference; plus the lesser of the setoff risk exposure and the market value of securities held in custody;<br>▪ In determining Early Warning Reserve, 10% of the market value of securities held in custody;<br>▪ The total amount of the requirements above is limited to the market value of the securities held in custody. |
| Custodian ***not considered to be an acceptable securities location***. | Capital requirement is the market value of securities held in custody. |

In the case of setoff risk, the above-revised requirements require that setoff risk be provided for on a dollar for dollar basis in the determination of an approved participant's Risk Adjusted Capital, where an approved participant has been unable to execute a custodial agreement.

In the case of fraud risk, it has been determined that there should be no specific capital requirement to address this risk. The current general regulatory approach with respect to fraud risk is that rather than requiring approved participants to provide capital for the possibility of the occurrence of fraud, the Bourse should continue to examine the systems of controls in place at approved participant firms to ensure that they have adequate preventive and detection controls relating to fraud risk.

Finally, in order to continue to provide a general incentive for approved participants to obtain written custodial agreements, the above revised requirements require that a provision equivalent to 10% of the market value of the securities held in custody without an agreement be provided in the determination of an approved participant's Early Warning Reserve.

## C) Issues and Alternatives Considered

It was considered whether it was necessary to continue to require that written custodial agreements be executed to document custodial agreements. Although reference was made to the fact that obtaining a written custodial agreement was not a requirement in other major jurisdictions such as the United Kingdom and the United States, it has been concluded that it was preferable to continue to require these agreements on the basis that it was always better to have a document on hand when going to court to prove the existence of a custodial arrangement. As a result, the focus was put on amending the capital requirements to more closely address the incremental risks of not having a written custodial agreement.

## D) Comparison with Similar Provisions

### United States

In the United States, there is no specific requirement for a dealer to enter into a written

custodial agreement when securities are held outside the dealer. Rather, the requirements provide that the dealer must be able to demonstrate that securities being held in custody remain under control of the dealer and that their delivery to the broker or dealer does not require the payment of money or value. As a result, there is no capital requirement where a dealer fails to enter into a written custodial agreement with an outside custodian.

**United Kingdom**

As with the United States, in the United Kingdom there is no specific requirement for a dealer to enter into a written custodial agreement when securities are held outside the dealer. Rather, the requirements are more general in nature, requiring the dealer to ensure that there are procedures to safeguard assets, including those for which the firm is accountable. As a result, there is no capital requirement where a dealer fails to enter into a written custodial agreement with an outside custodian.

### E) Public Interest Objective

The purpose of this proposal is to modify the capital requirements that result when an approved participant has failed to enter into a written custodial agreement with an entity that would otherwise qualify as an acceptable securities location, to more closely address the increased risk of loss due to not having an agreement. Consequently, the proposed amendments are considered to be in the public interest.

## III COMMENTARIES

### A) Effectiveness

As stated above, the purpose of the proposal is to better align the capital requirements with the risk associated with the situation where an approved participant has failed to obtain a written custodial agreement for securities held in custody.

### B) Process

The Special Committee – Regulatory Division of the Bourse has reviewed and approved the proposed amendments to Statement B and Statement C of Policy C-3 of the Bourse, dealing with custodial agreements, at its meeting held on July 8, 2003. The proposal was further approved by the Executive Committee of the Bourse on July 28, 2003 and will be forwarded to the "Commission des valeurs mobilières du Québec" for approval.

## IV REFERENCES


- Policy C-3 of Bourse de Montréal Inc.;
- United Kingdom Financial Services Authority, The Investment Business Interim Prudential Sourcebook, June 2000, Rule 10-13, Systems of internal control;
- U.S. Securities and Exchange Act of 1934, Section 240.15c3-3(C), Control of securities.

STATEMENT B

## PART I
## JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT

_____
(Firm Name)

**STATEMENT OF NET ALLOWABLE ASSETS AND RISK ADJUSTED CAPITAL**
(as at _____ with comparative figures as at _____)

| REFERENCE | | CURRENT YEAR | PREVIOUS YEAR |
|---|---|---|---|
| 1. A-73 | Total financial statement capital | $_ _ _ _ _ _ _ _ | $_ _ _ _ _ _ _ _ |
| 2. A-29 | **Deduct:** Non allowable assets | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 3. | NET ALLOWABLE ASSETS | $_____ | $_____ |
| 4. | **Deduct:** Minimum capital | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 5. | SUBTOTAL | _____ | _____ |
| | **Deduct - amounts required to fully margin:** | | |
| 6. Sch.1 | Loans receivable, securities borrowed and resold | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 7. Sch.2 | Securities owned and sold short | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 8. Sch.2A | Underwriting concentration | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 9. | Syndicate and joint trading accounts *[attach details]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 10. Sch.4 | Clients' accounts | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 11. Sch.5 | Brokers and dealers | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 12. Sch.7 | Loans and repurchases | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 13. | Contingent liabilities *[attach details]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 14. Sch.10 | Financial institution bond deductible *[greatest under any clause]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 15. Sch.11 | Unhedged foreign currencies | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 16. Sch.12 | Commodity futures contracts | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 17. Sch.14 | Provider of capital concentration charge | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 18. | Securities held at non-acceptable securities locations *[see note]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 19. Sch.7A | Acceptable Counterparties Financing Activities Concentration Charge | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 20. | Unresolved differences *[attach details]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 21. | Other *[attach details]* | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 22. | TOTAL MARGIN REQUIRED *[lines 6 through 21]* | _____ | _____ |
| 23. | SUBTOTAL *[line 5 less line 22]* | _____ | _____ |
| 24. Sch.6A | **Add:** Applicable tax recoveries | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |
| 25. | Risk Adjusted Capital before securities concentration charge *[line 23 plus line 24]* | _____ | _____ |
| 26. Sch.9 | **Deduct:** Securities concentration charge of _____ | | |
| Sch.6A | less tax recoveries of _____ | _ _ _ _ _ _ _ _ | _ _ _ _ _ _ _ _ |

*[see notes and instructions]*

| | | | |
|---|---|---|---|
| 27. | RISK ADJUSTED CAPITAL *[line 25 less line 26]*..... | $========== | $========== |

DATE: _____

STATEMENT B
SUPPLEMENTAL

# PART I
# JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT

_____
(Firm Name)

## Statement B – Line 20: Details of Unresolved Differences

| | Reconciled as at Report Date (Yes/No) | Number of items | Debit/Short value (Potential Losses) | Number of items | Credit/Long value (Potential Gains) | Required to margin |
|---|---|---|---|---|---|---|
| (a) Clearing | _____ | _____ | _____ | _____ | _____ | _____ |
| (b) Brokers and dealers | _____ | _____ | _____ | _____ | _____ | _____ |
| (c) Bank accounts | _____ | _____ | _____ | _____ | _____ | _____ |
| (d) Intercompany accounts | _____ | _____ | _____ | _____ | _____ | _____ |
| (e) Mutual Funds | _____ | _____ | _____ | _____ | _____ | _____ |
| (f) Security Counts | _____ | _____ | _____ | _____ | _____ | _____ |
| (g) Other unreconciled differences | _____ | _____ | _____ | _____ | _____ | _____ |
| TOTAL | | | | | | |

Statement B
Line 20

*[see notes and instructions]*

## STATEMENT B
## NOTES AND INSTRUCTIONS

EACH MEMBER SHALL HAVE AND MAINTAIN AT ALL TIMES RISK ADJUSTED CAPITAL IN AN AMOUNT NOT LESS THAN ZERO.

### Line 4 – Minimum capital

"~~m~~Minimum capital" is $250,000 ($75,000 for Type 1 introducing brokers).

### Line 9 – Syndicate and joint trading accounts

This line should include margin requirement for syndicate accounts where the firm is the lead underwriter and joint trading accounts. If the firm has "drawn down" a portion of the new issue positions from the syndicate account to its inventory accounts, those portions should be disclosed as firm's inventory and be included in Schedules 2 and possibly 2B. If the firm is not the lead underwriter but a Banking Group member, margin requirement should be reported on Schedule 2.

If the other syndicate member is a Regulated Entity, a related company of the Member firm, or an Acceptable Institution, then no margin need be provided by the firm. In the case of an Acceptable Counterparty the amount of margin to be provided, **commencing on regular settlement date** (i.e. the contracted settlement date as specified for that issue), shall be the equity deficiency of (a) the net market value of all settlement date security positions in the entity's accounts and (b) the net money balance on a settlement date basis in the same accounts. For all other parties the amount of margin to be provided by the firm, **commencing on regular settlement date,** shall be the margin deficiency, if any, that exists in the account.

### Line 13 – Contingent liabilities

No firm may give, directly or indirectly, by means of a loan, guarantee, the provision of security or of a covenant or otherwise, any financial assistance to an individual and/or corporation unless the amount of the loan, guarantee, provision of security or of the covenant or any other assistance is limited to a fixed or determinable amount and the amount is provided for in computing Risk Adjusted Capital. The margin required shall be the amount of the loan, guarantee, etc. less the loan value of any accessible collateral, calculated in accordance with the rules and regulations of the Joint Regulatory Bodies. A guarantee of payment is not acceptable collateral to reduce margin required.

Details of the margin calculations for contingencies such as guarantees or returned cheques should be provided as an attachment to this Statement.

**(New Line 18 below)**
~~**Line 18** – 100% of the market value of securities plus applicable margin must be provided (less any margin already provided on those securities) in the case where client or inventory securities are held at locations which do not qualify as Acceptable Securities Locations (see General Notes and Definitions).~~

**STATEMENT B**
**NOTES AND INSTRUCTIONS (Cont'd)**

~~Securities~~

~~1. held by an entity with which the Member has not entered into a written custodial agreement as required by the bylaws, rules and regulations of the Joint Regulatory Authorities, or~~

~~2. in respect of which a positive audit confirmation has not been received in respect of a foreign location approved by a Joint Regulatory Authority and not specified in the definition of acceptable securities location,~~

~~shall be considered as being held at non-acceptable securities locations and capital provided for as above.~~

**Line 18 – Securities held at non-acceptable securities locations**

Capital requirements

In general, the capital requirements for securities held in custody at another entity are as follows:

i) where the entity qualifies as an acceptable securities location, there shall be no capital requirement, provided there are no unresolved differences between the amounts reported on the books of the entity acting as custodian and the amounts reported on the books of the member firm. The capital requirements for unresolved differences are discussed separately in the Notes and Instructions for the completion of Statement B, Line 20 below;

ii) where the entity does not qualify as an acceptable securities location, the entity shall be considered a non-acceptable securities location and the member firm shall be required to deduct 100% of the market value of the securities held in custody with the entity in the calculation of its risk adjusted capital.

However, there is one exception to the above general requirements. Where the entity would otherwise qualify as an acceptable securities location except for the fact that the member firm has not entered into a written custodial agreement with the entity, as required by the By-laws, Rules and Regulations of the self-regulatory organizations, the capital requirement shall be determined as follows:

a) where setoff risk with the entity is present, the member firm shall be required to deduct the lesser of:

I) 100% of the setoff risk exposure to the entity; and

II) 100% of the market value of the securities held in custody with the entity,

In the calculation of its risk adjusted capital;

and

b) the member firm shall be required to deduct 10% of the market value of the securities held in custody with

**STATEMENT B**
**NOTES AND INSTRUCTIONS (Cont'd)**

the entity in the calculation of its early warning reserve.

The sum of the requirements calculated in paragraphs a) and b) above shall be no greater than 100% of the market value of the securities held in custody with the entity. Where the sum amounts initially calculated in paragraphs a) and b) above are greater than 100%, the capital required under paragraph b) and the amount reported as a deduction in the calculation of the early warning reserve shall be reduced accordingly.

For the purposes of the determining the capital requirement detailed in paragraph a) above, the term "setoff risk", shall mean the risk exposure that results from the situation where the member firm has other transactions, balances or positions with the entity, where the resultant obligations of the member firm might be setoff against the value of the securities held in custody with the entity.

Client Waiver

Where the laws and circumstances prevailing in a foreign jurisdiction may restrict the transfer of securities from the jurisdiction and the Member is unable to arrange for the holding of client securities in the jurisdiction at an acceptable securities location, the Member may hold such securities at a location in that jurisdiction if (a) the Member has entered into a written custodial agreement with the location as required hereunder and (b) the client has consented to the arrangement, acknowledged the risks and waived any claims it may have against the Member, in a form approved by the Joint Regulatory Authority. Such a consent and waiver must be obtained on a transaction by transaction basis.

**Line 20 – Unresolved Differences**

Items are considered unresolved unless:

(i) a written acknowledgement from the counterparty of a valid claim has been received, and

(ii) a journal entry to resolve the difference has been processed as of the Due Date of the questionnaire.

This does not include journal entries writing off the difference to profit or loss in the period subsequent to the date of the questionnaire.

Provision should be made for the market value and margin requirements at the questionnaire date on out of balance short securities and other adverse unresolved differences (e.g. with banks, trust companies, brokers, clearing corporations), still unresolved as at a date one month subsequent to the questionnaire date or other applicable Due Date of the questionnaire.

The margin rate to be used is the one that is appropriate for inventory positions. For instance, if the calculation is for securities eligible for reduced margin, the margin rate is 25%, rather than 30%.

**STATEMENT B**
**NOTES AND INSTRUCTIONS (Cont'd)**

A separate schedule, in a form approved by the ~~Joint Regulatory Authority~~self-regulatory organization, must be prepared detailing all unresolved differences as at the report date.

The following guidelines should be followed when calculating the required to margin amount on unresolved items:

| ***Type of Unresolved Difference*** | ***Amount Required to Margin*** |
|---|---|
| Money balance — credit (potential gains)<br>— debit (potential losses) | None<br>Money balance |
| Unresolved Long with Money on the Member's Book | [(Money Balance on the trade minus market value of the security)* plus the applicable inventory margin] |
| Unresolved Long without Money on the Member's Books | None |
| Unresolved Short with Money on the Member's Books | [(Market value of the security minus money balance on the trade)* plus the applicable inventory margin] |
| Unresolved Long/Short on the Other Broker's Books | None |
| Short Security Break (e.g. Mutual Funds, Stock Dividends) or Unresolved Short without Money on the Member's Books | [Market value of the security plus the applicable inventory margin] |

* also referred to as the Mark to Market Adjustment.

Where mutual fund positions are not reconciled on a monthly basis, margin shall be provided equal to a percentage of the market value of such mutual funds held on behalf of clients. Where no transactions in the mutual fund, other than redemptions and transfers, have occurred for at least six months and no loan value has been associated with the mutual fund, the percentage shall be 10%. In all other cases, the percentage shall be 100%.

**Unresolved Differences in Accounts:** Report all differences determined on or before the report date that have not been resolved as of the due date.

~~**July 31**~~**Month End** ~~**August 31**~~**Month End + 20 Business Days**

(Report date) (Due date)

**Include** differences determined on or before the report date that have not been resolved as of the due date.

¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ®

**Do not include** differences as of the report date that have been resolved on or before the due date.

¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ¾ ®

For each account listed, set out the number of unresolved differences and the money value of both the debit and credit differences. The Debit/Short value column includes money differences and market value of security differences, which represent a potential loss. The Credit/Long value column includes money differences and market value of security differences, which represent a potential gain. In determining the potential gain or loss, the money balance and the security position market value of the same transaction should be netted. Debit/short and credit/long balances of different transactions cannot be netted.

**STATEMENT B**
**NOTES AND INSTRUCTIONS (Cont'd)**

All reconciliation must be properly documented and made available for review by the ~~Vice-President, Financial Compliance~~self-regulatory organization having audit jurisdiction over the member and Member's Auditor.

**Unresolved differences in Security Counts:** Report all security count differences determined on or before the report date that have not been resolved as of due date.

The amount required to margin is the market value of short security differences plus the applicable inventory margin.

**Line 21 – Other**

This item should include all margin requirements not mentioned above as outlined in the bylaws, rules and regulations of the ~~Joint Regulatory Bodies~~self-regulatory organizations and the Canadian Investor Protection Fund.

DATE:_____ STATEMENT C

# PART I
# JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT

_____
(Firm Name)

## STATEMENT OF EARLY WARNING EXCESS AND EARLY WARNING RESERVE

| REFERENCE | | CURRENT YEAR |
|---|---|---|
| 1. B-27 | RISK ADJUSTED CAPITAL | $========== |
| 2. | LIQUIDITY ITEMS - | |
| | **DEDUCT:** | |
| A-19 | (a) Other allowable assets | _ _ _ _ _ _ _ _ |
| Sch.6A | (b) Tax recoveries | _ _ _ _ _ _ _ _ |
| B-18 | (c) Securities held at non-acceptable securities locations | |
| | **ADD:** | |
| A-66 | (~~c~~d) Long term liabilities | _ _ _ _ _ _ _ _ |
| Sch.6A | (~~d~~e) Tax recoveries - income accruals | _ _ _ _ _ _ _ _ |
| 3. | EARLY WARNING EXCESS | $========== |
| 4. | **DEDUCT:** CAPITAL CUSHION - | |
| B-22 | Total margin required $_ _ _ _ _ _ _ _ multiplied by 5% | $_ _ _ _ _ _ _ _ |
| 5. | EARLY WARNING RESERVE *[line 3 less line 4]* | $========== |

## NOTES:

The Early Warning system is designed to provide advance warning of a ~~M~~member firm encountering financial difficulties. It will anticipate capital shortages and/or liquidity problems and encourage firms to build a capital cushion.

**Line 1 -** If Risk Adjusted Capital of the firm is less than:

(a) 5% of total margin required (line 4 above), then the firm is designated as being in Early Warning category **Level 1**, or

(b) 2% of total margin required (line 4 above), then the firm is designated as being in Early Warning category **Level 2**,

and the applicable sanctions outlined in the bylaws, rules and regulations of the Joint Regulatory Bodies and the Canadian Investor Protection Fund will apply.

**Lines 2(a) and (b) -** These items are deducted from RAC because they are illiquid or the receipt is either out of the firm's control or contingent.

**Line 2(c) –** Pursuant to the Notes and Instructions for the completion of Statement B, Line 18, where the entity would otherwise qualify as an acceptable securities location except for the fact that the member firm has not entered into a written custodial agreement with the entity, as required by the By-Laws, Rules and Regulations of the self-regulatory organizations, the member firm will be required to deduct an amount up to 10% of the market value of the securities held in custody with the entity, in the calculation of its early warning reserve. Please refer to the detailed calculation formula set out in the Notes and Instructions for the completion of Statement B, Line 18, to determine the capital requirement to be reported on Line 2(c).

**Line 2(e~~d~~) -** Long term liabilities are added back to RAC as they are not current obligations of the firm and can be used as financing.

**Line 2(~~d~~e) -** This addback ensures that the firm is not penalized at the Early Warning level for accruing income. The net result is that the firm is in the same position as if the revenue were treated on a cash basis.

**Line 3 -** If Early Warning Excess is negative, the firm is designated as being in Early Warning category **Level 2** and the sanctions outlined in the applicable bylaws, rules and regulations of the Joint Regulatory Bodies and the Canadian Investor Protection Fund will apply.

**Line 5 -** If the Early Warning Reserve is negative, the firm is designated as being in Early Warning category **Level 1** and the sanctions outlined in the applicable bylaws, rules and regulations of the Joint Regulatory Bodies and the Canadian Investor Protection Fund will apply.