☒	**Trading – Interest Rate Derivatives**	☒	**Back-office - Options**
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CIRCULAR
January 12, 2005

REQUEST FOR COMMENTS

MARGIN ON FUTURES CONTRACT CONCENTRATION

AMENDMENTS TO THE NOTES AND INSTRUCTIONS OF SCHEDULE 12 OF THE "JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT" – POLICY C-3 OF THE BOURSE

Summary

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) has approved amendments to the Notes and Instructions of Schedule 12 of the "Joint Regulatory Financial Questionnaire and Report" – Policy C-3 of the Bourse, which deal with positions in options on futures contracts that must be included or excluded in the calculation of margins concentration, and with the elimination of the requirement to report only half positions of options on futures contracts.

Process for Changes to the Rules

Bourse de Montréal Inc. is recognized as a self-regulatory organization (SRO) by the Autorité des marchés financiers (the Autorité). 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 supervision responsibilities of 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.: 009-2005

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 Rules and Policies Committee of the Bourse its powers to approve or amend these Rules and Policies with recommendation from the Special Committee. These changes are submitted to the Autorité for approval.

Comments on the proposed amendments to the Notes and Instructions of Schedule 12 of Policy C-3 of the Bourse must be submitted within 30 days following the date of publication of the present notice in the bulletin of the Autorité. 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 Autorité to:

Ms. Anne-Marie Beaudoin
Director – Secretariat of L'Autorité
Autorité des marchés financiers
800 Victoria Square, 22nd Floor
P.O. Box 246, Tour de la Bourse
Montréal (Quebec) H4Z 1G3
E-mail: consultation-en-cours@lautorite.qc.ca

Appendices

For your information, you will find in 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 "Autorité des marchés financiers”.

MARGIN ON FUTURES CONTRACT CONCENTRATION

– AMENDMENTS TO THE NOTES AND INSTRUCTIONS OF SCHEDULE 12 OF THE "JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT" – POLICY C-3 OF THE BOURSE

I DETAILLED ANALYSIS

A) Current Rules

The Notes and Instructions of Schedule 12 – Margin on Commodity Concentrations and Deposits" – of the "Joint Regulatory Financial Questionnaire and Report" (JRFQR), Policy C-3 of Bourse de Montréal Inc. (the Bourse) present the positions and offsets that must be considered (or excluded) for the calculation of margin concentration on futures contracts.

The objective of Schedule 12 of Policy C-3 of the Bourse is to limit approved participants dealings in futures contracts in terms of level of activity by restricting their leveraging ability and to protect the firms from becoming too overweighed in any one futures contract or with any particular client or group of related clients. The capital requirements imposed on approved participants fall under two categories:

- a general provision used to establish a base level of capital to be provided by all firms, which is dependent on the number of contracts currently being held by the firm and its clients; and
- a risk provision intended to identify and require additional capital for situations considered to be of sufficient risk to the approved participant. There are two subcomponents to this provision: concentration in individual accounts and concentration in individual open futures contracts.

Some positions are excluded from the calculation of the general capital provision and the concentration provisions. These positions are, among others:

- positions held by acceptable institutions, acceptable counterparty and regulated entity accounts;
- hedged positions;
- spreads in the same futures contract; and
- short options on futures contracts positions when offset with predetermined other positions.

Also, short options on futures contracts positions can be excluded from the calculation when the options are deep-out-of-the-money[1].

Finally, to calculate the aggregate position of futures contracts, a short call options on futures contract position must be considered as a short futures contract position since they have the same risk profile. On the other hand, a short put options on futures contract position must be considered as a long futures contract position.

B) Issue and Proposed Rules

The Notes and Instructions of Schedule 12 of Policy C-3 of the Bourse do not make it clear which positions are to be reported on Lines 1 to 3 of Schedule 12 (for example, short options on futures contract positions) and which offsets strategy may be excluded from the calculation

[1] Where the option on futures contracts is out-of-the-money by more than two maintenance margin requirements, half of the short option on futures contracts position can be excluded from the calculation. The whole option on futures contracts position can be excluded from the calculation if the option is out-of-the-money by more than three maintenance margin requirements.

(for example, spreads in the same options on futures contracts).

Therefore, it is proposed to clearly identify in the Notes and Instructions of Lines 1 through 3 of Schedule 12 of Policy C-3 of the Bourse that "short futures contract positions include futures contracts underlying the short call options on futures contracts and long futures contracts positions include futures contracts underlying the short put options on futures contracts". Also, Line 1 of Schedule 12 will clearly state that "spreads in the same options on futures contracts" are excluded from the calculation of the general margin provision.

<u>Deep-Out-of-the-Money Options</u>

As mentioned previously, short options on futures contracts positions that are deep-out-of-the-money can be excluded from margin calculation. As stated on Line 1 and Note 1 of Schedule 12 of Policy C-3 of the Bourse, half of a short option on futures contracts which is out-of-the-money by more than two maintenance margin requirements and a whole short option on futures contracts which is out-of-the-money by more than three maintenance margin requirements are not included in the calculation.

For the last major revision of Schedule 12 of the Policy C-3 of the Bourse in 1996, a Working Group[2] was formed to review the amendments proposed by the Bourse's staff. Regarding the treatment of short options on futures contracts, the Working Group concluded:

" an out-of-the-money option will generally not be exercised at current prices and, therefore, the investor will not end up with a futures contract in his account. For margin purposes, the margin requirement is lower on an out-of-the-money option than an in-the-money option[3]. The capital requirements should also be less onerous if the option is out-of-the-money";

" to this end, the Group believes it is appropriate to sensitize the concentration calculation to consider the likelihood of exercising the option and, consequently, to exclude from the concentration calculation any equivalent short options on futures contract positions that is:

- half of a short option which is out-of-the-money by more than two maintenance margins but less than three;
- a short option which is out-of-the-money by more than three maintenance margins. "

However, the Working Group did not provide any details regarding their criteria selection (two or three maintenance margin requirements) to determine if only half or the whole option can be excluded from the calculation.

It is difficult to quantify the moment where an option is considered as being "deep-out-of-the-money". Definitions are very subjective and generally it is defined as being an option "that is unlikely to go in-the-money prior expiration". The Bourse's staff deems that an option, which is out-the-money by more than two maintenance margin requirements, has a very low probability to be exercised prior expiration.

One objective of the amendments made to Schedule 12 of Policy C-3 of the Bourse in 1996, was to remove some of the complexity and therefore to maintain a simple margin calculation. However, for approved participants, from an operational standpoint, the requirement to post half positions of options on

[2] The Working Group was created at the request of TSE Capital and Margin Committee and was composed of members and TSE (TSX) staff. The report, dated November 1993, was entitled: "*Report of Group on Capital on Futures Contracts of Toronto Stock Exchange/Capital and Margin Committee on Capital Requirements on Futures Contracts*".

[3] The margin required for a short option is equivalent to 100% of the option's market value, plus a percentage of the market value of the underlying interest, *minus the amount by which the option is out-of-the-money*.

futures contracts represents an administrative burden that is not worth the effort.

To improve operational efficiency of approved participants, it is proposed to exclude the whole (instead of half) short options positions which are out-of-the-money by more than two maintenance margin requirements from the margins calculation presented on Schedule 12 of Policy C-3 of the Bourse.

C) Objective

The objective of the proposed amendments to Notes and Instructions of Schedule 12 of Policy C-3 of the Bourse is to clearly identify which options on futures contracts positions must be included or excluded in the calculation of the general margin provision and in the margins on concentration. Also, the proposed amendments eliminate the requirement to report only half a short option on futures contracts where the option is out-of-the-money by more than two maintenance margin requirements but less than three.

D) Effect of Proposed Rules

As mentioned previously, the objective of the proposed amendments is to clarify the calculation for margin on futures contracts concentrations that must be reported on Schedule 12 of Policy C-3 of the Bourse. Also, the requirement to report half-options is removed. From an operational standpoint, it will be easier for approved participants to complete Schedule 12 of Policy C-3 of the Bourse without imposing any significant risk.

E) Public Interest Objective

The objective of the proposed amendments is to make it clear which positions in options on futures contracts must be included or excluded in the calculation of margins concentration and to eliminate the requirement to report only half positions of options on futures contracts. Schedule 12 of Policy C-3 of the Bourse will now be completed by approved participants with more accurate and simplified information. Consequently, the proposed amendments are considered to be in the public interest.

II COMMENTARIES

A) Effectiveness

The proposed amendments should provide clearer instructions regarding which positions must be included in the calculation of the margins concentration and should simplify the report of deep-out-of-the-money options on futures contracts so that Schedule 12 of Policy C-3 of the Bourse is completed efficiently.

B) Process

The first step of the approval process for the regulatory amendments proposed in the present document consists in having the proposed amendments approved by the Special Committee – Regulatory Division of the Bourse. The second step consists in submitting the proposed amendments to the approval of the Rules and Policies Committee of the Bourse. Once the approval of the Rules and Policies Committee obtained, the project is simultaneously published by the Bourse for a 30-day comment period and submitted to the Autorité des marchés financiers for approval, and to the Ontario Securities Commission for information.

III REFERENCES

- Policy C-3 of Bourse de Montréal Inc.;
- Report of Group on Capital on Futures Contracts of Toronto Stock Exchange, Capital & Margin Committee on Capital Requirements on Futures Contracts, November 1993;
- The Canadian Commodity Supervisors Exam Manual, Chapter 8 – Financial Conditions of Registration, CSI.

SCHEDULE 12
NOTES AND INSTRUCTIONS

Line 1 - General margin provision. The margin requirement for futures contracts ~~(FC) shall be calculated as follows:~~ and options on futures contracts shall be 15% of the maintenance margin requirements, as required by the Commodity Futures Exchange on which such futures contracts were entered into, for the greater of the total long or total short futures contracts per commodity or financial futures carried for all client and firm accounts. For the purpose of this general margin provision, short futures contracts positions include futures contracts underlying the short call options on futures contracts and long futures contracts positions include futures contracts underlying the short put options on futures contracts.

The following positions are excluded from this calculation:

(a) positions in Acceptable Institution, Acceptable Counterparty and Regulated Entity accounts;

(b) hedge positions, provided that the underlying interest is held in the client's account at the ~~M~~member firm or that the ~~M~~member firm has a document giving the ~~M~~member firm an irrevocable right to take possession of the underlying interest and deliver it at the location designated by the appropriate clearing corporation. All other hedge positions are treated as speculative positions for the purpose of this calculation;

(c) client and firm spreads in the same futures contract entered into on the same futures exchange. All other spread positions are treated as speculative positions for the purpose of this calculation;

(d) The following options on futures contracts positions:

~~(i) half of a short option which is~~ (i) short options on futures contracts which are out-of-the money by more than two maintenance margin ~~requirements, but less than three;~~requirements; and

~~(ii) a short option which is out-of-the-money by more than three maintenance margin requirements.~~

(ii) spreads in the same options on futures contracts.

Line 2 - Concentration in individual accounts. The ~~M~~member firm must provide for the amount by which~~;~~:

(a) the aggregate of the maintenance margin requirements of the commodity or financial futures or underlying interest of option on futures contracts held both long and short for any client (including without limitation groups of clients or related clients) or in inventory, except for positions mentioned in Note 1 below, less any excess margin provided

exceeds

(b) 15% of the ~~M~~member firm's net allowable assets.

The excess margin must be based on the maintenance margin. However, spread positions in the same product or different product on the same exchange and an inter-exchange or inter-commodity spread could be included using the maintenance margin as set by the exchange, provided that the spread is acceptable for margin purposes by a recognized exchange.

If the excess is not eliminated within three (3) trading days after it first occurs, the ~~M~~member firm's capital shall be charged the lesser of:

(a) the excess calculated when the concentration first occurred; and

(b) the excess, if any, that exists on the close of the third trading day.

For the purpose of ~~this~~the concentration calculation, short futures contracts positions include futures contracts underlying the short call options on futures ~~option~~contracts and long futures contracts positions ~~(FOC).~~include futures contracts underlying the short put options on futures contracts.

Line 3 - Concentration in individual open futures contracts and short ~~futures option contracts~~ option on futures contract positions. The ~~M~~member firm must provide for the amount by which~~;~~:

(a) the aggregate of two maintenance margin requirements on the greater of the long or the short commodity or financial futures contracts position held for clients and in inventory, except for positions mentioned in Note 1 below,

exceeds

SCHEDULE 12
NOTES AND INSTRUCTIONS (Cont'd)

(b) 40% of the ~~M~~member firm's net allowable assets.

There may be deducted from this difference, on a per client basis, the excess margin available in all accounts of the client up to two maintenance margin requirements of the client's positions in the futures contracts.

The excess margin must be based on the maintenance margin. However, spread positions in the same product or different product on the same exchange and in inter-exchange or inter commodity spread could be included in both the long and short side using maintenance margin as set by the exchange, provided that the spread is acceptable for margin purpose by a recognized exchange.

If the excess is not eliminated within three (3) trading days after it first occurs, the ~~M~~member firm's capital shall be charged the lesser of:

(a) the excess calculated when the concentration first occurred; and

(b) the excess, if any, that exists on the close of the third trading day.

For the purpose of the concentration calculation, short futures contracts positions include futures contracts underlying the short call options on futures ~~option~~contracts and long futures contracts positions ~~(FOC).~~include futures contracts underlying the short put options on futures contracts.

Line 4 - Where assets~~,~~ including cash, open trade equity and securities owing to a ~~M~~member firm from a Commodity Futures Correspondent Broker exceeds 50% of the ~~M~~member firm's net allowable assets, any excess over this amount shall be provided as a charge in computing the ~~M~~member firm's margin required.

Where the net worth of the Commodity Futures Correspondent Broker, as determined from its latest published audited financial statements, exceeds $50,000,000, no margin is required under this rule.

Where the net worth of the Commodity Futures Correspondent Broker, as determined from its latest published financial statements, is less than $50,000,000, the ~~M~~member firm may use a confirmed unconditional and irrevocable letter of credit issued by a US bank qualifying as an Acceptable Institution on behalf of the Commodity Futures Correspondent Broker to offset any margin requirement calculated above. The amount of the offset is limited to the amount of the letter of credit.

No exemption from this requirement is permitted for ~~M~~member firms who operate their commodity futures contracts and commodity~~futures~~ option on futures contracts business on a fully disclosed basis with a correspondent broker.

Note 1: For the purpose of the calculation of the concentration margin on individual client accounts (Line 2) and for open futures contracts and short ~~futures option~~options on futures contracts positions (Line 3), the following positions are excluded:

1.1 positions held in Acceptable Institution ~~(AI)~~, Acceptable Counterparty and Regulated Entity accounts;

1.2 hedge positions provided that the underlying interest is held in the client's account at the ~~M~~member firm or that the ~~M~~member firm has a document giving the ~~M~~member firm an irrevocable right to take possession of the underlying interest and deliver it at the location designated by the appropriate clearing corporation. All other hedge positions are treated as speculative positions and are thereby not excluded;

1.3 the following short ~~Futures Option Contracts Positions (FOC):~~Options on Futures Contracts Positions:

(i) either the short call or the short put where a client or firm account is short a call and short a put on the same futures contract with the same exercise price and same expiration month;

(ii) a futures contract paired with an in-the-money option provided that this pairing is acceptable for margin purposes by a recognized exchange;

(iii) a short option paired with a long in-the-money option provided that this pairing is acceptable for margin purposes by a recognized exchange;

(iv) a short option paired with a futures contract provided that this pairing is acceptable for margin purposes by a recognized exchange;

(v) an out-of-the-money short call option paired with an out-of-the-money long call option, where the strike price of the short call exceeds the strike price of the long call, provided that this pairing is acceptable for margin purposes by a recognized exchange;

SCHEDULE 12
NOTES AND INSTRUCTIONS (Cont'd)

(vi) an out-of-the-money short put option paired with an out-of-the-money long put option provided that this pairing is acceptable for margin purposes by a recognized exchange; and

~~(vii) half of a short~~(vii) a short option which is out-of-the-money by more than two maintenance margin ~~requirements but less than three; and~~requirements.

~~(viii) a short option which is out-of-the-money by more than three maintenance margin requirements.~~