



## **PROCEDURES FOR THE EXECUTION AND REPORTING OF EXCHANGE FOR PHYSICAL (EFP), EXCHANGE FOR RISK (EFR) AND SUBSTITUTION OF OTC DERIVATIVE INSTRUMENTS FOR FUTURES CONTRACTS TRANSACTIONS**

The purpose of the following procedures is to explain as fully as possible: a) the requirements of article 6815 of the Rules of Bourse de Montréal Inc. (the Bourse) relating to the execution of transactions involving the exchange of futures contracts for a corresponding cash position (Exchange for Physical (EFP)) and of transactions involving the exchange of futures contracts for a corresponding over-the-counter derivative instrument (Exchange for Risk (EFR)); and b) of article 6815A of the Rules of the Bourse relating to the execution of transactions involving the substitution of an over-the-counter derivative instrument for futures contracts. Approved participants must ensure that all of their employees who are involved in the execution of this type of transactions are fully aware of these procedures. Any violation of the requirements set forth in articles 6815 and 6815A of the Rules of the Bourse and in these procedures could result in disciplinary action being taken by the Bourse.

### **Exchanges for Physicals (EFP)**

An EFP is a transaction whereby two parties enter into an agreement in which one party purchases a cash market position and simultaneously sells a corresponding futures contract position and the other party sells the cash market position and simultaneously purchases the corresponding futures contract position.

The Bourse permits EFP transactions on the following instruments:

- Interest rate futures contracts**
- Futures contracts on S&P/TSX indices**
- Futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units (MCX)**

### **Exchange for Risk (EFR)**

An EFR is a transaction whereby two parties enter into an agreement in which one party purchases an over-the-counter derivative instrument and simultaneously sells a corresponding futures contract and the other party sells the over-the-counter derivative instrument and simultaneously purchases the corresponding futures contract.

The Bourse permits EFR transactions on the following instruments:

- Interest rate futures contracts**
- Futures contracts on S&P/TSX indices**
- Futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units (MCX)**

### **Substitution of an OTC derivative instrument for futures contracts (Substitution)**

A Substitution is a transaction whereby two parties enter into an agreement to substitute an over-the-counter derivatives position for a corresponding futures contract position. The party who is the buyer of the over-the-counter derivative instrument substitutes this position and buys the corresponding futures contract and the other party who is the seller of the over-the-counter derivative instrument substitutes this position and sells the corresponding futures contract.

The Bourse currently permits Substitution transactions on futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units.

### **Pricing the Cash component of an EFP or the Risk component of an EFR or of a Substitution**

The cash component of an EFP or the risk component of an EFR or of a Substitution is priced at such level that is mutually agreed upon by the two parties to the transaction.

The futures contract leg of an EFP, an EFR or a Substitution must be priced at a fair and reasonable level in light of factors such as, but not limited to, the size of such an EFP, EFR or Substitution transaction, the currently traded prices and bid and ask prices in the same contract at the relevant time, the volatility and liquidity of the relevant market and the general market conditions prevailing at the time the EFP, EFR or Substitution transaction is executed.

The cash component of an EFP or the risk component of an EFR or of a Substitution transaction must be the futures contract underlying interest, a by-product of this underlying interest or a similar product that is reasonably correlated to the futures contract being exchanged.

Also, the number of futures contracts exchanged must be approximately equivalent to the quantity or value of the cash market position being exchanged in an EFP transaction or of the risk component being exchanged in the case of an EFR or substituted in the case of a Substitution. Approved participants that are parties to an EFP, EFR or Substitution transaction may be required to demonstrate such equivalency.

### **Acceptable EFP, EFR and Substitution Transactions**

In order to have an EFP, EFR or Substitution transaction accepted by the Bourse, the transaction must satisfy the following conditions:

- There must be separate but integrally related futures contracts and cash (in the case of an EFP) or risk component (in the case of an EFR or Substitution) transactions.
- The exchange or substitution transaction must be done between two separate accounts that must satisfy at least one of the following criteria:
  - accounts have different beneficial ownership;
  - accounts have the same beneficial ownership but are under separate control; or
  - accounts are under a common control but involve separate legal entities which may or may not have the same beneficial ownership.

If the parties to an EFP, EFR or Substitution transaction involve the same legal entity, same beneficial owner or separate legal entities under common control, the approved participant (or the parties themselves) must be able to demonstrate that the EFP, EFR or Substitution transaction is a legitimate arm's length transaction.

- The cash market instrument leg of the EFP or the risk component leg of an EFR transaction must provide for a transfer of ownership of the cash market instrument of an EFP or of the over-the-counter derivative instrument of the EFR to the buyer of this instrument and the delivery of this instrument must take place within a reasonable period of time (in accordance with cash market or over-the-counter practice).

- The relation between the prices of the futures contract and of the cash instrument leg of the EFP or the risk component leg of the EFR or Substitution transaction and the relevant prices in either market must be established.
- If he does not have actual possession of the cash instrument, in the case of an EFP transaction, or of the over-the-counter derivative instrument, in the case of an EFR transaction, before the execution of the transaction, the seller of this cash instrument or over-the-counter derivative instrument must be able to demonstrate his ability to satisfy his delivery obligation.
- The Bourse may request that approved participants involved in an EFP, EFR or a Substitution transaction demonstrate that the related cash position and futures position is reasonably correlated.

### **Acceptable Cash Components for the purpose of an EFP Transaction**

In order to have an EFP transaction accepted by the Bourse, the cash component of the transaction must satisfy the following conditions:

- **For interest rate futures contracts:** fixed income instruments that have a reasonable price correlation, maturities as well as risk characteristics that parallel the instrument underlying the futures contract being exchanged. Such instruments include, but are not necessarily limited to, money market instruments including asset backed commercial paper, Government of Canada and Federal Crown Corporation fixed income instruments, provincials fixed income instruments, investment grade corporates including Maple Bonds and mortgage instruments including collateralized mortgage obligations (CMOs). Fixed income instruments denominated in the currency of a G7 member country that satisfy these conditions are also acceptable.
- **For futures contracts on S&P/TSX indices:** stock baskets must be reasonably correlated to the underlying index with a correlation coefficient (R) of 0.90 or more. Furthermore, these stock baskets must represent a weight of at least 50% of the underlying index or must include at least 50% of the securities of the underlying index. The notional value of the basket must be fairly equal to the value of the futures contract component of the exchange transaction. Exchange-traded funds (iShares™) are also acceptable, provided they mirror the index futures contract against which the EFP transaction is made.
- **For futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units:** The eligible Canadian CO<sub>2</sub>e units are regulated emitters' credits, and / or offset credits

### **Permissible Over-the-Counter Derivative Instruments for the purpose of an EFR Transaction**

A list of permissible over-the-counter derivative instruments for the purpose of effecting an EFR transaction is included in Appendix I.

## **Permissible Over-the-Counter Derivative Instruments for the purpose of a Substitution Transaction**

- **For futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units:** Over-the-counter derivative instruments on carbon dioxide equivalent units that are reasonably correlated (with a correlation coefficient (R) of 0.80 or more) to the futures contract being substituted.

As a guideline, the time period used to calculate the correlation coefficient must be based on daily price data for a period of at least six (6) months or, if weekly price data are used, for a period of at least one (1) year.

## **Reporting an EFP, EFR or Substitution transaction to the Bourse**

EFP, EFR and Substitution transactions must be reported to the Bourse's Market Monitoring Department for approval and subsequent input into the Montréal Automated System (SAM). Approved participants for both the seller and buyer must complete and submit to the Market Monitoring Department the EFP / EFR / Substitution reporting form prescribed by the Bourse. This form is available on the Web sites of the Bourse at [http://www.m-x.ca/efp\\_formulaire\\_en.php](http://www.m-x.ca/efp_formulaire_en.php) and at [http://www.mcx.ca/trading\\_transactionReportForm](http://www.mcx.ca/trading_transactionReportForm) in the case of futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units. If the EFP, EFR or Substitution transaction is executed before the closing of the trading session of the futures contract involved in the transaction, the EFP / EFR / Substitution reporting form must be submitted immediately upon the execution of the transaction. If the EFP, EFR or Substitution transaction is made after the closing of the trading session, the EFP / EFR / Substitution reporting form must be submitted no later than 10:00 a.m. (Montréal time) on the next trading day.

If the EFP / EFR / Substitution reporting form is not accurately filled out with all the relevant information required by the Market Monitoring Department of the Bourse, the transaction will not be approved neither recorded in SAM and the approved participant will have to resubmit a new EFP / EFR / Substitution reporting form correctly completed.

Once correctly completed EFP / EFR / Substitution reporting forms have been received, the Market Monitoring Department will validate the transaction. The Bourse has the discretion to refuse an EFP, EFR or Substitution transaction if it deems that it is not in compliance with the requirements, as the case may be, of articles 6815 or 6815A of the Rules of the Bourse or of these procedures. In case of refusal, the Market Monitoring Department will ensure that the approved participant(s) involved in the EFP, EFR or Substitution transaction are promptly informed of such refusal and of the reasons for it.

Once an EFP, an EFR or Substitution transaction has been validated and has been entered into SAM by the Market Monitoring Department, the following information with respect to this transaction will be disseminated by the Bourse on its Web sites at [http://www.m-x.ca/dailycrosses\\_en.php](http://www.m-x.ca/dailycrosses_en.php) or at [http://www.mcx.ca/trading\\_transactionReport](http://www.mcx.ca/trading_transactionReport) in the case of case of futures contracts on carbon dioxide equivalent (CO<sub>2</sub>e) units:

- Date and time of transaction
- product description (code);
- Contract month(s);
- Volume of the transaction; and
- Transaction price

Trade validation and market dissemination by the Bourse of an EFP, EFR or Substitution transaction will not preclude the Bourse from initiating any investigation and, as the case may be, disciplinary procedures in the event that the transaction is subsequently found to have been made other than in accordance with the requirements of articles 6815 and 6815A of the Rules of the Bourse or of these procedures.

### **Audit Trail Requirements for EFP, EFR and Substitution Transactions**

Approved participants who enter into an EFP, EFR or Substitution transaction must maintain all documents relevant to the futures contracts and corresponding cash market or over-the-counter derivative instruments transactions and must be able to promptly provide copies of such documents to the Regulatory Division of the Bourse upon request. Documents that may be requested include, but are not limited to, the following:

- Futures contracts order tickets;
- Futures contracts account statements;
- Documentation customarily generated in accordance with the cash market, over-the-counter or other relevant market practices such as cash account statements, trade confirmation statements, ISDA<sup>®</sup> Master Agreements or other documents of title;
- Third party documentation to support proof of payment or allowing to verify that the ownership title of the related cash market position or, as the case may be, of the related over-the-counter derivative instrument position was transferred from the seller to the buyer. This may include, but is not limited to canceled checks, bank statements; cash account statements and cash instruments clearing corporation documents (e.g.: CDS Depository and Clearing Services Inc.).

All futures contracts order tickets must clearly indicate the time of execution of the EFP, EFR or Substitution transactions.

**APPENDIX 1**  
**Exchange for Risk: List of permissible OTC derivative instruments**

	Bond Futures Contracts	Short-Term Interest Rate Futures Contracts	Stock Index Futures/ Single Stock Futures	Commodities Futures
Vanilla Interest Rate Swaps	√	√		
Equity and Index Swaps			√	
Commodities Swaps or Forwards				√
Forward Rate Agreements - FRAs		√		
OTC Options and Options Strategies	√	√	√	

The following outlines the characteristics of OTC derivative instruments that would be acceptable for EFR transaction purposes.

**Swaps:**

**Interest rate**

- standard plain vanilla OTC swap;
- written under the terms of an ISDA<sup>®</sup> Master Agreement;
- providing for regular fixed rate payments against regular floating rate payments;
- All swap payments must be denominated in the currency of a G7 member country;
- The OTC interest rate swap must be reasonably correlated with an R = 0.90 or greater so that the futures contract is a suitable instrument for hedging the OTC derivative instrument transactions. As a guideline, the time period used to calculate the correlation must be based on daily price data for a period of at least six (6) months or, if weekly price data are used, for a period of at least one (1) year.

**Equities and indices**

- standard plain vanilla OTC swap;
- written under the terms of an ISDA<sup>®</sup> Master Agreement;
- providing for regular fixed rate payments or regular floating rate payments against the positive or negative performance of a basket of securities or a stock index;
- All swap payments must be denominated in the currency of a G7 member country;
- The OTC equity or index swap must be reasonably correlated with an R = 0.90 or greater so that the futures contract is a suitable instrument for hedging the OTC derivative instrument transaction. As a guideline, the time period used to calculate the correlation must be based on daily price data for a period of at least six (6) months or, if weekly price data are used, for a period of at least one (1) year.

**Swaps or Forwards on Commodities:**

- written under the terms of an ISDA<sup>®</sup> Master Agreement;
- The OTC commodities swap or forward must be reasonably correlated with an R = 0.80 or greater so that the futures contract is a suitable instrument for hedging the OTC derivative instrument transaction. As a guideline, the time period used to calculate the

correlation must be based on daily price data for a period of at least six (6) months or, if weekly price data are used, for a period of at least one (1) year.

**Forward Rate Agreements (FRAs):**

- conventional FRA;
- written under the terms of an ISDA® Master Agreement;
- predetermined interest rate;
- agreed start/end date;
- have a defined interest (repo) rate.

**OTC Options and OTC Option Strategies:**

- Any individual or combination of OTC equity or stock index option positions can form the risk transaction component of an EFR transaction against any of the Bourse's stock index or single stock futures contracts.
- Any individual or combination of OTC bond, interest rate swap or FRA options (e.g. caps, floors, collars) can form the risk component of an EFR transaction against any of the Bourse's interest rate futures contracts

**Stock baskets used in an EFR transaction must have the following characteristics:**

- be reasonably correlated to the index underlying the futures contract with an  $R = 0.90$  or greater and the time period used to calculate the correlation must be based on daily price data for a period of at least six (6) months or, if weekly price data is used, for a period of at least one (1) year;
- represent at least 50% of the weight of the index underlying the futures contract or include at least 50% of the stocks comprised in the index underlying the futures contract;
- have a notional value equivalent to the value of the futures contract component of the EFR transaction;
- exchange-traded funds (ETFs) are acceptable provided that they mirror stock index products traded on the Bourse.