CIRCULAR
April 22, 2003

REQUEST FOR COMMENTS

CAPITAL AND MARGIN REQUIREMENTS FOR CONVERTIBLE SECURITIES

AMENDMENTS TO ARTICLE 7213

Summary

The Executive Committee of Bourse de Montréal Inc. (the "Bourse") approved amendments to article 7213 of the Rules of the Bourse dealing with capital and margin requirements for convertible securities. The objective of the proposed amendments is to limit the capital or margin required for a convertible security to the sum of the capital or margin required on the underlying security and the loss that would be realized if conversion were to take place. As a result, these amendments formally recognize that the maximum market risk, and thus the resultant maximum capital or margin required for a convertible security, must be closely related to the requirement for the underlying security.

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.: 050-2003

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 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 article 7213 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.

CAPITAL AND MARGIN REQUIREMENTS FOR CONVERTIBLE SECURITIES

– AMENDMENT TO ARTICLE 7213

I DETAILED ANALYSIS

A) Overview

Rule Seven of Bourse de Montréal Inc. ("the Bourse") sets out the capital and margin requirements for positions in securities held by an approved participant for its customers and for its own account. Included in this Rule are capital and margin requirements relating to convertible securities.

The purpose of the proposed amendments is to limit the capital/margin required for a convertible security to the sum of:

- the capital/margin required on the underlying security; and
- the loss that would be realized if conversion were to take place.

As a result, these proposed amendments formally recognize that the maximum market risk, and thus the resultant maximum capital/margin required for a convertible security, must be closely related to the requirement for the underlying security.

B) The Issue

A convertible security is a security that may be converted into or exchanged for another security (the "underlying security") without the payment of a subscription amount[1]. Common types of convertible securities include convertible debentures and convertible preferred shares but exchange traded funds, index participation units and securities held in combination (i.e., a capital share and a preferred share held in combination) are also considered convertible securities. The appeal of a convertible security is that it has both the capital appreciation potential of the underlying security and income potential (either interest or dividend) of the convertible security. As a result, from a risk standpoint, the economic risk of holding a convertible security should never be appreciably higher[2] than the economic risk of holding the underlying security. The issue is that the current rules do not explicitly recognize this relationship between the economic risk of the convertible security and the economic risk of the underlying security.

There is only one instance where the current rules do recognize the above-described relationship. Specifically, paragraph 3) of article 7213 of the Rules of the Bourse permits securities that are convertible into other securities included in the "List of Securities Eligible for Reduced Margin" which is published quarterly by the Bourse to be margined at a reduced margin rate[3] as well. However, as stated previously, the relationship between a convertible security and its underlying security is not universally recognized in the rules resulting in situations where a common share of an issuer is being margined at 50 percent while a convertible preferred share of the same issuer is being margined at 100 percent.

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[1] Warrants, rights, options, capital shares, installment receipts and other securities where the payment of a subscription amount is required are not considered to be convertible securities.

[2] The economic risk of a convertible security is higher than the economic risk of the underlying security only to the extent that there would be a loss upon conversion.

[3] The reduced margin rate is 25% for approved participant positions and 30% for customer positions.

C) Objective

The objective of the proposed amendments is to tie the capital and margin requirements for a convertible security to the economic risk associated with the underlying security.

D) Effect of Proposed Rules

As stated previously, the proposed amendments seek to limit the capital/margin required for a particular convertible security to the sum of:

- the capital/margin required on the underlying security; and
- the loss that would be realized if conversion were to take place.

As a result, these proposed amendments formally recognize that the maximum market risk and thus the resultant maximum capital/margin required for a convertible security must be closely related to the requirement for the underlying security.

E) Public Interest Objective

The purpose of this proposal, as stated above, is to amend the capital and margin requirements for convertible securities to formally recognize that the maximum market risk and thus the resultant maximum capital/margin required for a convertible security should be closely related to the requirement for the underlying security. As a result, the proposed amendment is considered to be in the public interest.

II COMMENTARIES

A) Effectiveness

As mentioned previously, the purpose of this proposal is to tie the capital and margin requirements for a convertible security to the economic risk associated with the underlying security.

It is believed that the adoption of the above amendments will result in margin requirements for convertible securities that are more reflective of their economic risk.

III REFERENCES

- Rule Seven of Bourse de Montréal Inc.

7213 Exceptions to Margin Rules
(30.11.86, 15.12.86, 01.06.88, 01.01.92, 15.01.93, 10.05.93, 01.04.93, 25.02.94, 12.03.97, 21.12.98, 29.08.01, 00.00.03)

~~The following are e~~Exceptions to the margin rules ~~as set out in this section~~are the following:

~~7) The margin rate required on securities approved by the Floor Committee is 25% of their market value, if maintained in a market-maker's or a specialist's account that has a principal or a temporary appointment on those securities. Securities trading at $2 or more during the preceding three months are eligible to this reduced margin rate. The list of eligible securities mustbe reviewed quarterly by the Floor Committee and only securities mentioned on such list are subject to the reduced margin rate.~~

~~This reduced margin rate is however applicable on a maximum market value of $50,000 per security, per approved participant, if during the preceding three months the total trading volume on all exchanges recognized for margin purposes and on NASDAQ is equal to or lower than 90,000 shares, or $100,000 if during the preceding three months the total trading volume on all exchanges recognized for margin purposes and on NASDAQ exceeds 90,000 shares. The margin required on the excess of those amounts must be calculated as required by articles 7201 and following. The reduction in the amount of margin required, as opposed to the margin required by articles 7201 and following, for the aggregate of all market-maker's and specialist's accounts, must never exceed 15% of the clearing member's net allowable assets.~~

~~8~~7) ~~For the purpose of this section, a "control block" means a sufficient number of any securities of an issuer of securities to affect materially the control of that issuer. In the absence of evidence to the contrary, any holding by any person, company or combination of persons or companies of more than 20% of the outstanding voting securities of an issuer is deemed to affect materially the control of that issuer.~~ Any security which is part of a control block has no loan value for margin calculation purposes, except to the extent that the control block constitutes any or all of the securities which an approved participant has an obligation or commitment to acquire, or has acquired, under a prospectus filing. In such case, the appropriate margin requirement provided for in article 7224 ~~of the Rules~~ applies as long as the criteria in said article have been met. For the purpose of the present paragraph, a "control block" means a sufficient number of any securities of the same issuer which could affect materially the control of that issuer. Without proof of the contrary, any holding by any person, company or combination of persons or companies of more than 20% of the outstanding voting securities of an issuer is deemed to affect materially the control of that issuer.

14) Maximum Margin Required for Convertible Securities

The margin required for a security that is currently convertible or exchangeable into another security (the "underlying security") need not exceed the sum of:

i) the margin required for the underlying security; and

ii) any excess of the market value of the convertible or exchangeable security over the market value of the underlying security.