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CIRCULAR 062-15
June 3, 2015

REQUEST FOR COMMENTS

MODIFICATIONS PERTAINING TO RISK MARGINING SYSTEMS

AMENDMENTS TO *ARTICLE 9002 OF RULE NINE OF BOURSE DE MONTRÉAL INC.*

The Rules and Policies Committee of Bourse de Montréal Inc. (the "**Bourse**") has approved amendments to *Article 9002 of Rule Nine of Bourse de Montréal Inc.* (the "**Article**") in order to recognize the role of the Canadian Derivatives Clearing Corporation (CDCC) in establishing the margin intervals used in risk margining systems, and to ensure that a uniform margin interval calculation is used for the calculation of customer margin and clearing house margin..

Comments on the proposed amendments must be submitted within 30 days following the date of publication of this notice, at the latest on **July 6, 2015**. Please submit your comments to:

Me Sabia Chicoine
Legal Counsel, Legal Affairs, Derivatives
Bourse de Montréal Inc.
Tour de la Bourse
P.O. Box 61, 800 Victoria Square
Montréal, Québec H4Z 1A9
E-mail: legal@m-x.ca

A copy of these comments shall also be forwarded to the *Autorité des marchés financiers* (the "**Autorité**") to:

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800 Victoria Square, 22nd Floor
P.O. Box 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3
E-mail: consultation-en-cours@lautorite.qc.ca

Please note that comments received by one of these recipients will be transferred to the other recipient and that the Bourse may publish a summary of such comments as part of the self-certification process concerning this file.

Appendices

For your information, you will find in the appendices an analysis of the proposed amendments as well as the amendments proposed to the Article. The implementation date of the proposed amendments will be determined by the Bourse, in accordance with the self-certification process as determined by the *Derivatives Act* (R.S.Q., chapter I-14.01).

Process for Changes to the Rules

The Bourse is authorized to carry on business as an exchange and is recognized as a self-regulatory organization (SRO) by the Autorité. The Board of Directors of the Bourse has delegated to the Rules and Policies Committee of the Bourse its powers to approve and amend the Rules and Procedures. The Rules of the Bourse are submitted to the Autorité in accordance to the self-certification process as determined by the *Derivatives Act* (R.S.Q., chapter I-14.01).

TMX Montréal Exchange

MODIFICATIONS PERTAINING TO RISK MARGINING SYSTEMS

AMENDMENTS TO ARTICLE 9002

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I. SUMMARY

Bourse de Montréal Inc. (the Bourse) proposes to amend article 9002 of the Rules of the Bourse, "Risk Margining Systems". This article permits the use of risk margining systems for calculating margin requirements for the accounts of approved participants that consist exclusively of Bourse derivatives contracts. This amendment is intended to recognize the role of the Canadian Derivatives Clearing Corporation (CDCC) in establishing the margin intervals used in risk margining systems, and to ensure that a uniform margin interval calculation is used for the calculation of customer margin and clearing house margin.

II. ANALYSIS

a. Nature and Purpose of Proposed Changes

Margin requirements are essential tools for risk management in futures markets. Margin deposits, often referred to as "performance bonds", serve as collateral to cover the potential losses that may result from the default of a party to a trade. Article 14201 of the Rules of the Bourse provides that the margin requirements applicable to all positions in derivative instruments held by an approved participant or on behalf of its clients are determined, from time to time, by the Bourse, in collaboration with the clearing corporation.

Margin requirements as published by the Bourse are a function of (1) a margin interval, (2) the daily settlement price of the contract and (3) the contract multiplier, which is the value of the tick used to calculate the size of the contract. The contract multiplier is a static number for each contract. The daily settlement price for each contract is determined by the Bourse according to a formula that accounts for both transactions and open orders, and is published following the close of trading. The margin interval is a measure of the risk of a contract, and is calculated based on, inter alia, the historical volatility of the contract.

The Bourse has always relied on the CDCC, the central counterparty clearing house for all Bourse-listed derivatives, for the calculation of the margin intervals for its contracts. This is due to the fact that the CDCC, as the central counterparty to every trade on the Bourse, is responsible for managing the risk of default and establishing appropriate margin requirements. As a result of its core responsibilities the CDCC has developed and benefits from the skills, tools and expertise of a Risk Management Department which establishes margin requirements that are calibrated to meet international best practices for risk management.

b. Comparative Analysis

A benchmarking of North American Exchanges demonstrates that the following exchanges also rely on margin rates established by their respective clearinghouses:

- ICE Futures Canada: As per ICE Article 4E.05[1].
  - c. The following are the minimum rates of margins for outright positions and inter-crop year spread positions for FCM non-Participant clients:
    - (1) Maintenance margins shall be equal to the current Clearinghouse margin; and
    - (2) Initial margins shall be 110% of the maintenance margin level.
  - d. FCMs can, at their discretion, permit non-Participant clients holding hedge-based positions to provide margin at the Clearinghouse margin rate.
  - e. The FCM client minimum margin for non-clearing Participants is equal to the Clearinghouse margin. FCMs are required to collect, at a minimum, the Clearinghouse margin for both the speculative and hedge based positions of the Participants they provide clearing services to.
- CBOT: Rule 930.B of the CBOT Rulebook provides that "Clearing House staff shall determine initial and maintenance performance bond rates used in determining Exchange performance bond requirements." [2]
- ASX 24: Procedure 8600 of the ASX 24 operating Rules and Procedures specifies that "Contract initial margins are governed by the Approved Clearing Facility or the Exchange or both and vary from time to time according to the volatility of the market in question. " [3] Margin rates and SPAN parameters are published by the ASX Clearing Corporation. [4]
- SGX Rule 3.3.12 provides that the minimum Initial Margin and Maintenance Margin required from customer accounts are prescribed by the Clearing House.[5]

c. Proposed Amendments

<u>Removal of the detailed margin interval methodology</u>

The current Article 9002 of the Rules of the Bourse provides for the use of risk-margining systems for the purposes of calculating minimum margin requirements for the proprietary accounts of Approved Participants. The article contains a reference to the methodology used for the establishing the margin interval for futures contracts to be used in these risk-margining systems. The CDCC has proposed to modify this methodology for the purposes of improved risk management consistent with the Principles for Financial Market Infrastructure[6].

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[1] https://www.theice.com/publicdocs/futures_canada/rules/Rule4_Participants.pdf

[2] Chapter 9 – Clearing Members
http://www.cmegroup.com/rulebook/CBOT/I/9/9.pdf

[3] ASX 24 Operating Rules Procedures
http://www.asx.com.au/documents/rules/asx_24_procedures.pdf

[4] AUD Initial Margin Rates & Span Parameters
http://www.asx.com.au/data/clearing/marginrates.pdf

[5]SGX – 3.3.12 Customer Margins
http://rulebook.sgx.com/en/display/display.html?rbid=3271&element_id=2742

[6] See CDCC Member Notice No. 2014-159 (July 29, 2014), http://cdcc.ca/u_avis_en/159-14_en.pdf.

In order for the Rules of the Bourse to be consistent with the proposed CDCC methodology, Article 9002 must be modified to remove the prescribed method for calculating the margin interval.

The Bourse proposes that Article 9002 should be modified so as to remove the reference to a particular methodology for calculating the margin interval, and in order that the risk margining system use the same margin interval and assumptions used by the CDCC in its calculation of margin requirements for accounts at the CDCC. The Bourse believes that the following reasons justify the removal of a specific margin interval methodology from Article 9002:

1. The text of Article 9002 specifies that the margin interval is calculated "using the margin interval and the assumptions used by the CDCC." The Bourse submits that the CDCC is best placed to calculate the risk of any particular contract, and their methodology may evolve with improvements to risk management practices and global standards. Given that the CDCC must comply with very strict regulatory requirements in order to modify any margin interval methodology, the Bourse does not believe that it is necessary to require a rule change when this methodology is changed.
2. The margin interval methodology change must be presented to the Risk Management Advisory Committee (RMAC), prior to be presented to CDCC Board for approval. The RMAC is composed of risk management specialists representing CDCC Clearing Members and of CDCC key risk management staff. The RMAC members can voice their concern on any methodology change presented by CDCC, and if a concern arises from a methodology change, it will be voiced to the CDCC Board of Directors prior to the approval of the methodology. Once the Board has voted on a methodology change, the change as it appears on CDCC risk manual is subject to the self-certification process under the *Quebec Derivatives Act*[7] and the Rule Protocol provided in the Ontario Securities Commission's Recognition Order. There is therefore full transparency and regulatory oversight with respect to any change in the methodology.
3. The margin interval methodology is not specified in any other article of the Rules of the Bourse that relate to margin requirements. Article 14201 makes no reference to any specific methodology, indicating only that margin requirements are determined from time to time in collaboration with the CDCC. The Bourse applies identical margin intervals whether or not those margin intervals are used in risk margining systems or not. There is therefore no particular reason for the margin interval to be defined in the Rules of the Bourse specifically for the purposes of use in risk margining systems.

[7] Chapter I-14.01.

Removal of requirement of Bourse approval for changes in assumptions

Article 9002 also requires that "all changes to the assumptions used by the Canadian Derivatives Clearing Corporation must be approved by the Bourse prior to implementation to ensure that the continued use of SPAN and TIMS methodologies for regulatory purposes is appropriate". The Bourse proposes that this requirement be removed from Article 9002.

The Bourse intends to rely on the margin interval calculated by the CDCC in all cases. The Bourse currently relies on CDCC margin intervals for the calculation of margin requirements for all positions, and a single set of margin intervals is used for risk margining systems, individual product margin requirements and strategy margin requirements. The Bourse is also represented on both the CDCC RMAC and the CDCC Board. Given the robust governance around the modifications to margin intervals by the CDCC and the Bourse representation on governance bodies, the Bourse does not believe that a formal Bourse approval of changes to the margin methodology is required.

Removal of reference to TIMS

Article 9002 makes reference to the use of the Theoretical Intermarket Margining System (TIMS) methodology in order to calculate capital requirements for approved participant accounts constituted exclusively of positions in derivative instruments listed on the Bourse. The TIMS methodology is no longer in use, and the Bourse therefore proposes to remove these reference from the Rule. Finally, Article 9002 also requires that "the selected methodology (either SPAN or TIMS) must be used consistently and cannot be changed without the prior consent of the Bourse." This requirement will no longer be relevant with the removal of the TIMS methodology from the Article and the Bourse therefore proposes that it be removed.

Replacement of "capital requirements" with "margin requirements"

Article 9002 suggests that the applied methodology is used to calculate "capital requirements". From a terminology standpoint, it would be more appropriate to indicate that the calculation actually serves to determine "margin requirements". The Bourse only calculates and disseminates margin requirements.

III. AMENDMENT PROCESS

The proposed amendments are motivated by the change in the CDCC methodology for calculating margin intervals, and the Bourse's requirement to ensure consistency with CDCC margin intervals.

IV. IMPACTS ON TECHNOLOGICAL SYSTEMS

The intended impacts on technological systems of both the Bourse and approved participants are considered to be minimal. Participants will not have to make any changes to their technological infrastructure.

V. OBJECTIVES OF THE PROPOSED AMENDMENTS

The objectives of the proposed amendments are:

1. to clarify the role of the CDCC in establishing the margin intervals used in risk margining systems as permitted by the Rules of the Bourse;
2. to ensure coherence between the margin intervals used for risk margining systems and for outright and strategy margin calculations and to allow the CDCC to modify the margin interval methodology in order to comply with global best practices and international standards.

VI. PUBLIC INTEREST

The proposed amendments are in the public interest since:

1. The clarification of the role of the CDCC in establishing the margin interval methodology will align the Bourse with other global futures exchanges;
2. Relying on the CDCC to establish margin methodologies without resorting to a rule change will allow the evolution of methodologies to comply with global best practices and international standards.
3. Governance around the establishment and modification of margin methodologies is robust and subject to regulatory oversight and public comment.

VII. PROCESS

The proposed amendments are being submitted to the Bourse's Rules and Policies Committee for approval. They will also be submitted to the Autorité des marchés financiers in accordance with the self-certification process and to the Ontario Securities Commission for information purposes.

VIII. ATTACHED DOCUMENT

- Article 9002 of *Rule Nine* of Bourse de Montréal Inc.

RULE NINE
MARGIN AND CAPITAL REQUIREMENTS
FOR OPTIONS, FUTURES CONTRACTS AND
OTHER DERIVATIVE INSTRUMENTS

Section 9001 – 9100
General Provisions

9002 Risk Margining Systems
(01.01.05, 00.00.00)

a) With respect to an approved participant account constituted exclusively of positions in derivative instruments listed on the Bourse, the ~~capital~~ margin required may be the one calculated~~, as the case may be,~~ by the Standard Portfolio Analysis (SPAN) methodology ~~or by the Theoretical Intermarket Margin System (TIMS) methodology,~~ using the margin interval calculated and the assumptions used by the Canadian Derivatives Clearing Corporation. ~~All changes to the assumptions used by the Canadian Derivatives Clearing Corporation must be approved by the Bourse prior to implementation to ensure that the continued use of SPAN and TIMS methodologies for regulatory purposes is appropriate.~~

~~The selected methodology (either SPAN or TIMS) must be used consistently and cannot be changed without the prior consent of the Bourse.~~ If the approved participant selects the SPAN methodology ~~or the TIMS methodology,~~ the ~~capital~~ margin requirements calculated under th~~ose~~is methodolog~~ies~~y will supersede the provisions stipulated in the Rules.

~~For the purpose of the present article, "margin interval" means the product of the three following elements:~~

~~i) the maximum standard deviation of percentage fluctuations in daily settlement values over the most recent 20, 90 and 260 business days; multiplied by~~

~~ii) 3 (for a 99% confidence interval); and multiplied by~~

~~iii) the square root of 2 (for two days coverage).~~

b) With respect to a client account, it is prohibited to use SPAN methodology ~~or TIMS methodology~~ to determine margin requirements.