

CIRCULAR 068-18
May 17th, 2018

REQUEST FOR COMMENTS

AMENDMENTS TO ARTICLE 6380 OF RULE SIX OF BOURSE DE MONTRÉAL INC. TO MODIFY THE MINIMUM VOLUME THRESHOLDS APPLICABLE TO BLOCK TRANSACTIONS ON TWO-YEAR AND 30-YEAR GOVERNMENT OF CANADA BOND FUTURES CONTRACTS (CGZ AND LGB)

The Rules and Policies Committee of Bourse de Montréal Inc. (the “**Bourse**”) has approved amendments to article 6380 of Rule Six of the Bourse to modify the minimum volume threshold applicable to block transactions on two-year and 30-year Government of Canada bond futures contracts (CGZ and LGB).

Comments on the proposed amendments must be submitted at the latest on **June 22nd, 2018**. Please submit your comments to:

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

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Corporate Secretary
Autorité des marchés financiers
800 Victoria Square, 22nd Floor
P.O. Box 246, Tour de la Bourse
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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. Unless specified otherwise, comments will be published anonymously by the Bourse.

Appendices

You will find in the appendices an analysis as well as the text of the proposed amendments. The implementation date of the proposed amendments will be determined by the Bourse, in accordance with the self-certification process as established by the *Derivatives Act* (CQLR, 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 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, the Policies and the Procedures, which are thereafter submitted to the Autorité in accordance with the self-certification process as determined by the *Derivatives Act* (CQLR, chapter I-14.01).



**AMENDMENTS TO ARTICLE 6380 OF RULE SIX OF BOURSE DE MONTRÉAL INC. TO MODIFY THE
MINIMUM VOLUME THRESHOLDS APPLICABLE TO BLOCK TRANSACTIONS ON TWO-YEAR AND
30-YEAR GOVERNMENT OF CANADA BOND FUTURES CONTRACTS (CGZ AND LGB)**

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I. SUMMARY

Bourse de Montréal Inc. (the “Bourse”) hereby proposes to update the minimum volume thresholds for block transactions on Government of Canada (“GoC”) bond futures in order to better reflect market conditions and stimulate more activity on certain contracts. The Bourse considers these thresholds to be important for the success of its development initiatives regarding the GoC bond futures product suite. Given that most of the minimum volume threshold updates were done a long time ago, the Bourse is revisiting those pertaining to products in development phases, with the objective of determining more optimal levels for market participants, in line with existing market dynamics. Consequently, the Bourse proposes to amend the minimum volume thresholds for block transactions on Two-Year GoC Bond Futures (“CGZ”) and Thirty-Year GoC Bond Futures (“LGB”). The proposed modifications are to reduce the minimum volume thresholds (during the regular trading hours) from 500 contracts to 250 contracts for CGZ and from 500 contracts to 100 contracts for LGB. The Bourse believes that the proposed amendments will better serve the needs of market participants and allow to stimulate more activity in these contracts.

II. ANALYSIS

a. Background

Block transactions offer a convenient way for market participants to execute large transactions on a specific contract at a single price. These transactions are privately negotiated between counterparties (usually institutional traders or large commercial firms) and executed away from the central limit order book (“CLOB”). After their off-exchange agreement, block transactions must be submitted to the Bourse within a prescribed time delay for reporting purposes. Block transactions are required to be submitted to the Bourse by telephone for validation and entry into the system and subsequently via the Bourse’s website¹. Note that block transactions done on the Bourse’s products still benefit from the advantages of central clearing at the Canadian Derivatives Clearing Corporation (“CDCC”).

The minimum volume thresholds for block transactions should represent the minimum quantity of an order beyond which a significant market disturbance could be observed if the order was directly sent to the CLOB and executed. These thresholds are determined by the Bourse on the basis of market liquidity conditions. However, block thresholds for GoC bond futures were last updated nearly 10 years ago and the Bourse believes that some of them should better reflect current market conditions and participant needs.

¹ Block trade reporting form available at https://www.m-x.ca/rob_formulaire_en.php

Table 1: Last update of GoC bond futures minimum block thresholds

Contract	Minimum Block Threshold (Regular Hours)	Last Update
Two-Year Government of Canada Bond Futures Contracts (CGZ)	500	July 2007
Five-Year Government of Canada Bond Futures Contracts (CGF)	500	April 2009
Ten-Year Government of Canada Bond Futures Contracts (CGB)	1500	July 2010
30-Year Government of Canada Bond Futures Contracts (LGB)	500	November 2007

Source: Montreal Exchange

In light of the current and upcoming initiatives to revitalize the GoC bond futures yield curve, the Bourse would like to offer participants desiring to further increase their participation in GoC bond futures the opportunity to do so without incurring undue market impact costs from current liquidity levels.

b. Description and Analysis of Market Impacts

The Bourse proposes to amend the minimum volume thresholds for block transactions on certain GoC bond futures contracts, as presented in the table below:

Table 2: Proposed changes to two-year and 30-year GoC bond futures minimum block thresholds

Bond Futures	Block - Minimum volume threshold (from 6AM until the end of trading)
Two-Year Government of Canada Bond Futures Contracts (CGZ)	Change from 500 contracts to 250 contracts
30-Year Government of Canada Bond Futures Contracts (LGB)	Change from 500 contracts to 100 contracts

Source: Montreal Exchange

Reducing the minimum block thresholds for targeted GoC bond futures products would allow market participants to engage in transactions which wouldn't have been effectively executed in a higher block threshold environment, for products in liquidity development phases. In that sense, the proposed modifications will support the efforts of the Bourse in revitalizing the CGZ and LGB products. The proposed modifications are based on consultations with market participants and on market practices for similar products on major electronic derivatives exchanges worldwide.

The Bourse believes that the proposed reduction in block thresholds for CGZ and LGB will encourage market participation in these markets in the absence of sustained liquidity being provided in the electronic market. The Bourse often gets feedback from participants indicating

that they would like to be active in these products but the current 500 contracts threshold is deemed too high by participants desiring to enter these markets.

The Bourse is looking to help the product usage and acceptance by market participants. Based on market statistics coming from another product at a development stage, the Five-Year GoC Bond Futures contract (“CGF”), the Bourse does not believe that reducing the minimum volume threshold for block transactions will negatively impact the market dynamics. As shown in Table 3 below, the average volume per trade on CGF is consistently below the new proposed thresholds for CGZ and LGB, and only a handful of block trades have been reported in recent years.

Table 3: CGF - Transactions statistics

CGF Statistics	2014	2015	2016	2017
Average daily volume	1204	705	467	1438
Average volume per trade*	26	19	22	22
# of Block Trades	2	-	-	4 (3 in February)
Block trade average size	750	-	-	715

*Excluding EFP trades. Source: Montreal Exchange

By adapting its minimum quantity thresholds to the current market conditions and client needs, The Bourse considers that the proposed amendments remain consistent with its objective of providing market participants with an efficient mechanism of price discovery and hedging utility.

Impacts on market integrity

Participants in the block market are mainly institutions that need to transact large sizes. When working with large positions, participants often prefer off-exchange transactions facility to ensure they can have all their contracts filled at a single price, with minimum market impact. This is especially relevant for markets where liquidity is challenging, like it is the case for CGZ and LGB. In such situations, participants are often concerned that a large order size may have a negative and disruptive impact on the market by inducing excess volatility and price dislocations. When the order book cannot assimilate sizeable orders in an efficient manner, it creates unnecessary volatility which can disrupt orderly efficient markets and affect investor confidence. Block transactions are therefore an efficient mechanism to help participants deal with large transactions and minimize their impact on the market.

Because block transactions are negotiated away from the prevailing best bid and offer in the CLOB, the price of the block trade must be fair and reasonable in accordance with the prevailing rules. In determining the price, consideration must be given to factors such as the trade size, the trade prices observable in the market as well as bid and ask prices on the same contract at the relevant time period, the volatility and liquidity of the relevant market and general market conditions. Upon request, the approved participant who arranges a block trade must provide

satisfactory evidence that the block trade has been arranged in accordance with the Rules of the Bourse.

Impacts on transparency

The Bourse is committed to promote the use of the CLOB as the main source of price transparency for its contracts. Thus, the Bourse expects that the principal way of trading its products remains on its open and competitive electronic trading platform. Block transactions are allowed by the Bourse for exceptional market conditions, as an accommodation for market participants who find this way of conducting business more convenient. The objective of this mechanism is not to have these types of transactions represent a large part of the market or have them become current practice. The goal is to facilitate the transition from an opaque OTC market to a transparent listed market. The Bourse continuously monitors block transactions and a report showing a summary of trading volumes on each contract resulting from electronic trading and block trades is sent to the *Autorité des marchés financiers* on a monthly basis.

c. Comparative Analysis

An overview of the minimum volume thresholds for block transactions at international derivatives exchanges (for comparable contracts) is provided in table 4 below.

Table 4: International benchmarking of government bond futures average daily volume (“ADV”) and minimum block thresholds

Government Bond Futures	MX (GoC Bond Futures)	CME* (US Bond Futures)	Eurex (German Bond Futures)	ICE (UK Bond Futures)
2Y ADV (Block threshold)	0 (500 regular, 100 extended)	387k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	337k (4,000)	83 (250 Standard publication, 1000 Delayed publication)
5Y ADV (Block threshold)	1.5k (500 regular, 100 extended)	902k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	530k (3,000)	70 (100 Standard publication, 1000 Delayed publication)
10Y ADV (Block threshold)	96k (1,500 regular, 350 extended)	1.5M (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	767k (2,000)	203k (500 Standard publication, 1500 Delayed publication)
30Y ADV (Block threshold)	0 (500 regular, 100 extended)	134k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	56k (100)	30 (50 Standard publication, 250 Delayed publication)

*RTH = Regular Trading Hours, ETH = European Trading Hours, ATH = Asian Trading Hours
Sources: Contract specifications and exchange websites. ADV represents the average daily volume for 2017.

From this table, we can observe two market practices:

- Lower block thresholds for products in development stages (i.e. small ADV). This is mainly observed at ICE for their 2Y, 5Y and 30Y government bond futures products. This model is similar to the one the Bourse is contemplating with its proposed modifications. Eurex also has a significantly lower threshold for its 30Y bond futures (where the contract’s ADV is the lowest) relative to its other bond futures products.

- Inverse relationship between a contract duration and its minimum volume thresholds. Everything else being equal, there is a positive relationship between the duration and the risk (dollar value of a basis point change) of a fixed income instrument. Therefore, market quality (depth and order sizes) tends to be greater in shorter duration products, facilitating risk offsets for that portion of the yield curve. For example, a 30Y bond futures bears about 20 times more risk than a corresponding 2Y product. Therefore, block thresholds are usually lower for bond futures with longer duration, like LGB.

Based on this international benchmarking, the Bourse considers that the proposed modifications will better align the minimum block thresholds of CGZ and LGB with international practices for comparable products in which liquidity is challenging.

d. Proposed Amendments

The Bourse proposes to amend the table of eligible derivatives and minimum volume thresholds for block trades in article 6380 of the Rules of the Bourse to reduce minimum volume thresholds applicable to CGZ and LGB within the regular trading hours to 250 and 100 contracts respectively - see attached proposed rule changes.

III. AMENDMENT PROCESS

The drafting process was initiated by the need to review the relevance of GoC bond futures minimum block thresholds for products in liquidity development phases. Given the Bourse's current and upcoming initiatives regarding the revitalization of the yield curve, the Bourse believes that more appropriate block thresholds should be set to help generate interest in the CGZ and LGB products and foster activity in these contracts.

IV. IMPACTS ON TECHNOLOGICAL SYSTEMS

The proposed changes should have no impact on the technological systems of the Bourse, its approved participants, independent software vendors, or any other market participants. The Bourse has not identified any impediments, whether technical, operational or other, to the implementation of the proposed amendments.

V. OBJECTIVES OF THE PROPOSED AMENDMENTS

The objective is to strengthen the functioning of the Canadian derivatives market and better serve the interests of market participants. In particular, the Bourse believes that the proposed amendments will:

- Accommodate and attract large order activity that would otherwise be negotiated away from the Bourse (in the OTC market);
- Facilitate greater market efficiency through improved execution quality and price certainty for large transactions;
- Align the Bourse with international best practices of major electronic derivatives exchanges.

This proposal is not expected to diminish the role of the organized electronic market, which will remain the central place for trading the vast majority of the Bourse volume. The intention of the Bourse is to make this facility available for trades that would otherwise be disruptive to the marketplace and not for block volumes to become a significant part of the market. The CLOB is expected to remain intact and the price discovery mechanism associated with the market is expected to be fully respected.

VI. PUBLIC INTEREST

The Bourse considers these amendments to be in the interest of the public as they will allow for better trading and hedging practices for market participants. Block transactions offer both clients and approved participants the convenience of privately negotiating a trade with a selected counterparty and the ability to execute a large transaction at a fair and reasonable single price. Furthermore, block trade data provides a useful means for the market to analyze and value a security.

VII. EFFICIENCY

The Bourse's proposal should attract additional trading volume by offering market participants certainty of price and immediacy of execution in the transaction of large orders, as well as the benefits of central clearing. As such, block trades on CGZ and LGB should result in greater market efficiency through improved execution quality.

VIII. PROCESS

The proposed amendments, including this analysis, must be approved by the Bourse's Rules and Policies Committee and submitted to the Autorité des marchés financiers, in accordance with the self-certification process, and to the Ontario Securities Commission for information purposes.

IX. ATTACHED DOCUMENTS

Proposed amendments to the Rules of the Bourse.

RULE SIX

TRADING

A. GENERAL FRAMEWORK AND PROCEDURES

[...]

Section 6365- 6401

Electronic Trading of Derivatives Instruments Traded on the Bourse

[...]

6380 Transactions Required on Bourse Facilities

(25.09.00, 24.09.01, 29.10.01, 31.01.05, 10.11.08, 29.01.10, 09.06.14, 21.01.16, 17.01.18, 09.02.18)

All trading in Listed Products must occur on or through the electronic trading system or in accordance with the rules of the Bourse.

[...]

6380d. Block Trades

- 1) **In general.** Approved Participants of the Bourse may negotiate and execute a transaction off of the electronic trading system pursuant to the following conditions:
 - i) A block trade transaction may be arranged and executed only during trading hours on the Bourse for the eligible derivative.
 - ii) Block trades are only permitted in the derivative instruments and for a quantity which meets or exceeds the minimum volume thresholds as follows:

ELIGIBLE DERIVATIVES	MINIMUM VOLUME THRESHOLD
30-Day Overnight Repo Rate Futures Contracts (ONX)	1,000 contracts
Overnight Index Swap Futures Contracts (OIS)	200 contracts
Ten-Year Government of Canada Bond Futures Contracts (CGB)	1,500 contracts
Two-Year Government of Canada Bond Futures Contracts (CGZ)	500 <u>250</u> contracts
30-Year Government of Canada Bond Futures Contracts (LGB)	1 <u>500</u> contracts
Five-Year Government of Canada Bond Futures Contracts (CGF)	500 contracts

ELIGIBLE DERIVATIVES	MINIMUM VOLUME THRESHOLD
Options on Three-Month Canadian Bankers Acceptance Futures Contracts	2,000 contracts
Canadian Crude Oil Futures Contracts	100 contracts
Futures contracts on the FTSE Emerging Markets Index	100 contracts
Bankers' Acceptance Futures Contracts quarterlies five through eight (BAX Reds)	1,000 contracts
Three-Month Canadian Bankers' Acceptance Futures Contracts quarterlies nine through twelve (BAX Greens)	500 contracts

- iii) Where a block strategy involves the trading of different derivative instruments, or different contract months or premiums of the same instrument, each of derivatives of the strategy need meet only the lowest applicable threshold.
- iv) Approved Participants may not aggregate separate orders in order to meet the minimum volume thresholds.
- v) Each party to a block trade must be an accredited counterparty as defined in section 3 of the Quebec Derivatives Act, CQLR c I-14.01.
- vi) The price at which a block trade is arranged must be “fair and reasonable” in light of (a) the size of the block trade; (b) currently traded prices and bid and ask prices in the same derivative instrument; (c) the underlying markets; and (d) general market conditions, all at the relevant time. The fairness and reasonableness of the price of a block trade priced at a basis to an index as permitted under paragraph 2 of this article may also take into account the following additional considerations: (e) financing rates, (f) expected dividend income, and (g) time remaining until the index futures contract expiration, all at the relevant time. Although there is no requirement for a block trade to be executed within the daily high and low prices, execution outside of that price range may result in a request by the Regulatory Division for additional information about the transaction.
- vii) Block trades shall not trigger special terms orders or otherwise affect orders on the electronic trading system.
- viii) A block trade on a contract roll strategy is not permitted, except for the FTSE Emerging Markets Index futures contract.
- ix) The details of a block trade must be reported by Approved Participants for both the buyer and seller to the Market Operations Department by telephone at 1-888-696-6366 or at 514-871-7871 and on a Block Trade Reporting Form, available on the Bourse’s web site at http://www.m-x.ca/rob_formulaire_en.php, within 15 minutes of the Block Trade’s execution.
- x) Following validation of the trade details by the Bourse (which is not a confirmation by the Bourse that the block trade has been effected in accordance with this Article), the Bourse shall disseminate the trade and price information relating to the block trade.

- xi) Upon request, the Approved Participant shall provide evidence that the block trade transaction has been effected in accordance with these Rules.

[...]

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TRADING

A. GENERAL FRAMEWORK AND PROCEDURES

[...]

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Electronic Trading of Derivatives Instruments Traded on the Bourse

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6380 Transactions Required on Bourse Facilities

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All trading in Listed Products must occur on or through the electronic trading system or in accordance with the rules of the Bourse.

[...]

6380d. Block Trades

- 2) **In general.** Approved Participants of the Bourse may negotiate and execute a transaction off of the electronic trading system pursuant to the following conditions:
 - xii) A block trade transaction may be arranged and executed only during trading hours on the Bourse for the eligible derivative.
 - xiii) Block trades are only permitted in the derivative instruments and for a quantity which meets or exceeds the minimum volume thresholds as follows:

ELIGIBLE DERIVATIVES	MINIMUM VOLUME THRESHOLD
30-Day Overnight Repo Rate Futures Contracts (ONX)	1,000 contracts
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Ten-Year Government of Canada Bond Futures Contracts (CGB)	1,500 contracts
Two-Year Government of Canada Bond Futures Contracts (CGZ)	250 contracts
30-Year Government of Canada Bond Futures Contracts (LGB)	100 contracts
Five-Year Government of Canada Bond Futures Contracts (CGF)	500 contracts

ELIGIBLE DERIVATIVES	MINIMUM VOLUME THRESHOLD
Options on Three-Month Canadian Bankers Acceptance Futures Contracts	2,000 contracts
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Bankers' Acceptance Futures Contracts quarterlies five through eight (BAX Reds)	1,000 contracts
Three-Month Canadian Bankers' Acceptance Futures Contracts quarterlies nine through twelve (BAX Greens)	500 contracts

- xiv) Where a block strategy involves the trading of different derivative instruments, or different contract months or premiums of the same instrument, each of derivatives of the strategy need meet only the lowest applicable threshold.
- xv) Approved Participants may not aggregate separate orders in order to meet the minimum volume thresholds.
- xvi) Each party to a block trade must be an accredited counterparty as defined in section 3 of the Quebec Derivatives Act, CQLR c I-14.01.
- xvii) The price at which a block trade is arranged must be “fair and reasonable” in light of (a) the size of the block trade; (b) currently traded prices and bid and ask prices in the same derivative instrument; (c) the underlying markets; and (d) general market conditions, all at the relevant time. The fairness and reasonableness of the price of a block trade priced at a basis to an index as permitted under paragraph 2 of this article may also take into account the following additional considerations: (e) financing rates, (f) expected dividend income, and (g) time remaining until the index futures contract expiration, all at the relevant time. Although there is no requirement for a block trade to be executed within the daily high and low prices, execution outside of that price range may result in a request by the Regulatory Division for additional information about the transaction.
- xviii) Block trades shall not trigger special terms orders or otherwise affect orders on the electronic trading system.
- xix) A block trade on a contract roll strategy is not permitted, except for the FTSE Emerging Markets Index futures contract.
- xx) The details of a block trade must be reported by Approved Participants for both the buyer and seller to the Market Operations Department by telephone at 1-888-696-6366 or at 514-871-7871 and on a Block Trade Reporting Form, available on the Bourse’s web site at http://www.m-x.ca/rob_formulaire_en.php, within 15 minutes of the Block Trade’s execution.
- xxi) Following validation of the trade details by the Bourse (which is not a confirmation by the Bourse that the block trade has been effected in accordance with this Article), the Bourse shall disseminate the trade and price information relating to the block trade.

- xxii) Upon request, the Approved Participant shall provide evidence that the block trade transaction has been effected in accordance with these Rules.

[...]