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CIRCULAR
October 6, 2004

REQUEST FOR COMMENTS

SECURITIES CONCENTRATION CHARGE FOR POSITIONS IN BROAD BASED INDEX SECURITIES

AMENDMENTS TO THE GENERAL NOTES AND DEFINITIONS AND TO SCHEDULE 9 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 General Notes and Definitions and to Schedule 9 of the “Joint Regulatory Financial Questionnaire and Report” – Policy C-3 of the Bourse, which deal with the concentration charge of the largest ten issuer positions that are being relied upon for loan value. The objective of the proposed amendments is to define the term “broad based index”, and give the approved participants the option of treating positions in broad based index products in the same manner as the underlying basket of index securities for security concentration purposes.

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 broker-dealers 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.: 126-2004

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 General Notes and Definitions and to Schedule 9 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".



SECURITIES CONCENTRATION CHARGE FOR POSITIONS IN BROAD BASED INDEX SECURITIES

- AMENDMENTS TO GENERAL NOTES AND DEFINITIONS AND TO SCHEDULE 9 OF THE "JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT" – POLICY C-3 OF THE BOURSE

I OVERVIEW

Bourse de Montréal Inc. (the Bourse) wishes to amend General Notes and Definitions and Schedule 9 – Concentration of Securities – of the "Joint Regulatory Financial Questionnaire and Report" (JRFQR), Policy C-3 of the Bourse dealing with the concentration charge of the largest ten issuer positions that are being relied upon for loan value.

The proposed amendments aim to allow approved participants the option of treating positions in broad based index products in the same manner as the underlying basket of index securities for security concentration purposes.

II DETAILED ANALYSIS

A) Current Rules

Under the current rules of the Bourse, approved participants must disclose in Schedule 9 of Policy C-3 the largest ten issuer security positions that are being relied upon for loan value so that over exposure to an individual issuer and applicability of a concentration charge can be determined. In determining whether an

exposure to a particular issuer is a concern, the combined inventory and client account collateral "amount loaned" exposure is calculated and compared to the approved participant's risk adjusted capital.

Thus, Schedule 9 of Policy C-3 intends to identify significant issuer risk and capture issuer exposure. In order to focus on significant issuer risk the current Notes and Instructions to Schedule 9 of Policy C-3 exempt debt securities with a margin rate of 10% or less from consideration. Other securities, namely broad based index securities, warrant different treatment in determining whether positions held represent significant issuer risk. This is because the issuer risk associated with these products is lessened as they provide the performance on a diversified basket of securities.

B) Issues and Alternatives Considered

Broad based listed index products (i.e., index participation units) have become popular vehicles for both approved participants and their clients to invest in a broad range of companies without having to invest individually in the companies themselves. A broad based index product (as opposed to an index sector product) also has the advantage of reducing both the issuer and sector risk that may be associated with individual security holdings. As a result, it is believed that broad based index securities warrant different treatment in determining whether they represent significant issuer risk to the approved participant.

The proposed amendments seek to allow approved participants the option of treating positions in broad based index products in the same manner as the underlying basket of index securities for security concentration purposes. Therefore, approved participants will have the option of reporting the "amount loaned" exposure for each index constituent security position held in determining whether any concentration charge applies.

Moreover, it is proposed to add a definition for the term "broad based index" in the General

Notes and Definitions of Policy C-3. To qualify as a “broad based index” an index must, among other things, be comprised of twenty or more securities with an average market capitalization of at least \$50 million that represent a broad range of industry and market sectors. The requirement that a broad range of industry and market sectors must be represented ensures that sector index products are considered for securities concentration purposes in the same manner as they are today, as sector risk in many situations may be as high as individual issuer risk (i.e., gold sector).

For products that qualify as broad based index products, approved participants will be given the option of treating these positions in the same manner as the underlying basket of index securities for security concentration purposes. Therefore, the proposal does not suggest that there is no issuer risk associated with holding broad based index securities, but rather suggests that the risk is no different than if positions were held in the underlying basket of index securities. The specific optional calculation proposed would allow the broad based index product position to be reported as though individual positions in the underlying securities to the index were held. These “constituent” issuer securities positions held would be combined with other positions held for the same issuer to determine the overall amount loaned exposure to an individual issuer.

C) Objective

The objective of the proposed amendments to General Notes and Definitions and to Schedule 9 of Policy C-3 of the Bourse is to allow approved participants the option of treating positions in broad based index products in the same manner as the underlying basket of index securities for security concentration purposes. The addition of a definition for the term “broad based index” in the General Notes and Definitions of Policy C-3 is proposed and the proposed amendments in the Notes and Instructions to Schedule 9 of Policy C-3 will give to the approved participants the option of reporting the “amount loaned” exposure for each index constituent security

position held in determining whether any concentration charge applies.

D) Effect of Proposed Rules

The proposed amendments seek to ensure that the concentration calculation continues to focus on significant issuer risk exposures. Approved participants will generally only take advantage of the optional “amount loaned” calculation for broad based index securities when it is likely that a securities concentration charge will otherwise result. Consequently, the proposed amendments will have no impacts on the capital market structure, the competition generally and the costs of compliance.

E) Public Interest Objective

This proposal was designed to facilitate an efficient capital-raising process and fair and open competition in securities transactions by imposing capital and margin requirements in relation to the inherent risks associated with the broad based index position. The proposal does not permit unfair discrimination among customers, issuers, brokers, dealers, approved participants or others. It does not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes. Consequently, the proposed amendments are considered to be in the public interest.

III COMMENTARIES

A) Effectiveness

The proposed amendments are believed to be effective in ensuring that the concentration calculation continues to focus on significant issuer risk exposures. It is believed that these proposed amendments are effective in achieving this objective with respect to the treatment of broad based index products.

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. Once the approval of the Special 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.

IV REFERENCES

- Policy C-3 of Bourse de Montréal Inc.

JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT
GENERAL NOTES AND DEFINITIONS

(...)

DEFINITIONS:

(f) “broad based index” means an equity index whose underlying basket of securities is comprised of:

1. twenty or more securities;
2. the single largest security position by weighting comprises no more than 35% of the overall market value of the basket of equity securities;
3. the average market capitalization for each security position in the basket of equity securities underlying the index is at least \$50 million;
4. the securities shall be from a broad range of industries and market sectors as determined by the Joint Regulatory Bodies to represent index diversification; and
5. in the case of foreign equity indices, the index is both listed and traded on an exchange that meets the criteria for being considered a recognized exchange, as set out in the definition of “regulated entities” in the General Notes and Definitions.

(...)

DATE: _____

SCHEDULE 9

PART II
JOINT REGULATORY FINANCIAL QUESTIONNAIRE AND REPORT

(Firm Name)

CONCENTRATION OF SECURITIES

[excluding securities required to be in segregation or safekeeping & debt securities with a margin rate of 10% or less (see note 45)]

<u>Description of Security</u> <i>[note 56]</i>	<u>Client position</u> <u>long/(short)</u> <i>[note 67]</i>	<u>Firm's own</u> <u>long/(short)</u> <i>[note 78]</i>	<u>Unit Price</u>	<u>Market value</u>	<u>Effective Margin rate</u>	<u>Loan value of securities</u> <i>[note 2]</i>	<u>Adjustments in arriving at amount loaned</u>	<u>"Amount loaned"</u> <i>[note 89]</i>	<u>Amount cleared within five business days</u>	<u>Adjusted amount loaned</u>	<u>Concentration charge</u> <i>[note 910]</i>
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SCHEDULE 9
NOTES AND INSTRUCTIONS

General

(...)

4. For the purpose of this schedule, an amount loaned exposure to “broad based index” (as defined in the General Notes and Definitions) positions may be treated as an amount loaned exposure to each of the individual securities comprising the index basket. These amount loaned exposures may be reported by breaking down the broad based index position into its constituent security positions and adding these constituent security positions to other amount loaned exposures for the same issuer to arrive at the combined amount loaned exposure.

To calculate the combined amount loaned exposure for each index constituent security position held, sum

(a) the individual security positions held, and

(b) the constituent security position held.

[For example, if ABC security has a 7.3% weighting in a broad based index, the number of securities that represents 7.3% of the value of the broad based index position shall be reported as the constituent security position.]

(...)