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CIRCULAR
August 15, 2006

REQUEST FOR COMMENTS

MARGIN AND CAPITAL OFFSETS FOR OPTION STRATEGIES CLARIFYING AMENDMENTS TO ARTICLES 9105 AND 9205

AMENDMENTS TO ARTICLES 9107 AND 9207 TO MAKE CURRENT MARGIN OFFSETS APPLICABLE TO OPTIONS OTHER THAN INDEX AND INDEX PARTICIPATION OPTIONS AND TO RECOGNIZE THREE NEW COMPLEX OPTION STRATEGIES FOR CAPITAL AND MARGIN PURPOSES

Summary

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) has approved amendments to articles 9105, 9205, 9107 and 9207 of the Rules of the Bourse. The purpose of these amendments is to eliminate existing inefficiencies in the current rules and allow for minimum capital and margin requirements that better reflect the risks relating to options strategies. These amendments are also aimed at eliminating the existing restrictions that limit the application of margin and capital offsets to index products, providing approved participants and their clients with a much broader array of available offsets.

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 supervision responsibilities of 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.: 148-2006

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 articles 9105, 9205, 9107 and 9207 of the Rules 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
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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
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Montréal (Quebec) H4Z 1G3
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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".



MARGIN AND CAPITAL OFFSETS FOR OPTION STRATEGIES

CLARIFYING AMENDMENTS TO ARTICLES 9105 AND 9205

AMENDMENTS TO ARTICLES 9107 AND 9207 TO MAKE CURRENT MARGIN OFFSETS APPLICABLE TO OPTIONS OTHER THAN INDEX AND INDEX PARTICIPATION OPTIONS AND TO RECOGNIZE THREE NEW COMPLEX OPTION STRATEGIES FOR CAPITAL AND MARGIN PURPOSES

I SUMMARY

A) Current Rules

Current article 9105 of the Rules of Bourse de Montréal Inc. (the Bourse) sets the margin requirements applicable to client accounts when such accounts hold relatively simple option spread or combination positions. Article 9205 of the Rules does the same for similar positions held by approved participants.

Article 9107 of the Rules set the margin requirements applicable to more complex option spread positions held in client accounts. Article 9207 does the same for similar positions held by approved participants. The spread positions currently provided for in articles 9107 and 9207 of the Rules of the Bourse are the following ones: box spreads¹, long butterfly spreads² and short butterfly spreads³. Both articles also limit the application of these option strategies for capital and margin purposes to index options and to index participation unit options.

B) The Issue

In the case of articles 9105 and 9205 of the Rules of the Bourse, paragraph a) of each of these articles does not specify, contrarily to paragraphs b) to e) of these same articles, that the options constituting the spread positions referred to in this paragraph (long call/short call or long put/short put) must be on the same number of trading units and on the same underlying interest. The Bourse is of the opinion that the absence of a clear specification that the options that constitute the spread positions referred to in

¹ Paragraph a) of articles 9107 and 9207 defines a box spread as a position consisting of a long and short call option and a long and short put option with the same expiry month and where the long call option and short put option, and short call option and long put option have the same strike price.

² Paragraph b) of articles 9107 and 9207 defines a long butterfly spread as a position consisting of a short position in two call options (or put options) and the short call options (or short put options) are at a middle strike price and are flanked on either side by a long call option (or long put option) having respectively a lower and higher strike price.

³ Paragraph c) of articles 9107 and 9207 defines a short butterfly spread as a position consisting of a long position in two call options (or put options) and the long call options (or long put options) are at a middle strike price and are flanked on either side by a short call option (or short put option) having respectively a lower and higher strike price.

paragraph a) of articles 9105 and 9205 must be on the same number of trading units and on the same underlying interest creates a risk of misinterpretation. Effectively, paragraph a) of these articles could, due to a lack of precision, be interpreted as allowing that the option spreads referred to in this paragraph be made up of options representing a different number of trading units and/or having a different underlying interest while in fact the general principle governing option spreads and combinations is that such spreads and combinations must be, for capital and margin purposes, made up of options having the same number of trading units and the same underlying interest.

With regard to articles 9107 (applicable to client account positions) and 9207 (applicable to approved participant accounts), their current wording limits the application of the permitted capital and margin offsets to positions that involve only index options and options on index participation units (IPU options). This means that similar positions involving equity options or any other type of options that are not index options or IPU options are not eligible to the margin offsets permitted by articles 9107 and 9207, even though such positions permit to reduce the risks related to equity options or other types of options as efficiently as they do it for index options and IPU options. Furthermore, the number of option strategies allowed by these articles for capital and margin offset purposes is relatively limited and does not include more complex option strategies that are also very efficient to reduce risks and that are becoming more frequently used for this purpose. Thus, more complex option strategies such as long condor spreads, short iron butterfly spreads and short iron condor spreads (all these strategies are defined and explained in the detailed analysis that follows) are not provided for in articles 9107 and 9207 of the Rules of the Bourse and this although these strategies contribute to significantly reduce risks as further explained hereafter.

As a result of the limitations imposed by articles 9107 and 9207 of the Rules of the Bourse not only on the type of underlying interest but also on the number of capital and margin offset strategies that are acceptable for margin purposes, a client or an approved participant using these types of strategies will be subjected to inadequate margin or capital requirements and the actual risk reduction of their option positions will not be taken in consideration as it should be.

II DETAILED ANALYSIS

A) Current Rules and proposed amendments

1) Paragraph a) of articles 9105 and 9205 – Option Spreads and Combinations

In 2003 and 2004 the Bourse proceeded to a complete review of its Rules regarding capital and margin requirements applicable to derivative instruments. This review led to the implementation of new Rule Nine on January 1, 2005 which included, among other things, articles 9105 (applicable to client account positions) and 9205 (applicable to approved participant accounts). Each of these two articles contains five (5) paragraphs identified as follows:

- a) call spreads and put spreads;
- b) short call – short put spreads;
- c) long call – long put spreads;
- d) long call – short call – Long put; and
- e) short call – long warrant

Paragraphs b) to e) inclusively of both articles 9105 and 9205 do specify that the options that are part of the above-mentioned spreads or combinations must have the same number of trading units and the same underlying interest.

However, this precision was omitted in the case of paragraph a) of both articles 9105 and 9205 when Rule Nine was implemented. The absence of a clear specification that the options that constitute the spread position referred to in paragraph a) of articles 9105 and 9205 must be on the same number of trading units and on the same underlying interest could potentially create a risk of misinterpretation. Effectively, paragraph a) of these articles could, due to a lack of precision, be interpreted as allowing that the option spreads referred to in this paragraph be made up of options representing a different number of trading units and/or having a different underlying interest while in fact the general principle governing option spreads and combinations is that such spreads and combinations must be, for capital and margin purposes, made up of options having the same number of trading units and the same underlying interest.

In order to clarify the intent of paragraph a) of articles 9105 and 9205 of the Rules of the Bourse and to eliminate any risk of incorrect interpretation or application, it is therefore proposed to amend paragraph a) of these two articles by adding therein a specification identical to the one that is currently found in paragraphs b) to e) of articles 9105 and 9205 and which provides that the options that are part of the spreads or of the combinations must be on the same number of trading units and on the same underlying interest.

2) Articles 9107 and 9207 – Option Spreads Involving Index Products (Current Title of articles)

a) Limitation to index products

Articles 9107 (applicable to client accounts) and 9207 (applicable to approved participant accounts) allow margin and capital offsets for the following positions:

- i) box spread;
- ii) long butterfly spread; and
- iii) short butterfly spread.

As already mentioned and as indicated by their actual title, the current wording of articles 9107 and 9207 limits the application of the permitted capital and margin offsets to positions that involve only index options and options on index participation units (IPU options). This means that similar positions involving equity options or any other type of options that are not index options or IPU options are not eligible to the margin offsets permitted by these two articles even though holding such positions in equity options (or other types of options) permits to reduce the risks efficiently as they do for index options and IPU options.

As a result of these limitations, a client or an approved participant using these types of strategies for equity options or for options other than index options or IPU options will be subjected to margin or capital requirements that do not recognize the risk reducing effect of positions described in articles 9107 and 9207 and that will be overly conservative.

The Bourse therefore proposes that the three above-mentioned strategies capital and margin offsets that are currently restricted to index options and IPU options be made available for any type of options. This would be achieved by the inclusion, where needed, of the words “*on the same underlying interest*” wherever necessary in articles 9107 and 9207 and by the deletion of any specific reference to index options and IPU options.

In addition to the proposed amendments mentioned in the previous paragraph, the Bourse also proposes amendments to the margin and capital requirements applicable to short butterfly spreads so

that it be allowed that the proceeds from the sale of the short options be used to reduce the margin or capital required. It is to be noted that such an amendment would contribute to harmonize the Bourse’s margin and capital requirements applicable to this strategy with those that are currently applied by U.S. exchanges in this case. For example, the regulations of the Chicago Board Options Exchange (subparagraph (c)(5)(C)(7) of Rule 12.3 – Margin Requirements) and of the New York Stock Exchange (subparagraph (f)(2)(G)(v) of Rule 431 – Margin Requirements) provide for such a reduction.

b) Addition of three new complex strategies for margin and capital offset purposes

It is proposed to add to the margin and capital offsets that are currently available in articles 9107 and 9207 of the Rules of the Bourse three new complex option strategies that are considered to be “market neutral”.

The three additional strategies that the Bourse is proposing to add to the current margin and capital offsets available are:

- i) long condor spread;
- ii) short iron butterfly spread; and
- iii) short iron condor spread.

i) Long Condor Spread

A long condor spread is a position constituted by the combination, on the same underlying interest and with all options expiring on the same date, of four separate option series having ascending exercise prices and equal intervals between their strike prices. Two of the four options are either short calls flanked on either side by a long call (long call/short call/short call/long call) or short puts flanked on either side by a long put (long put/short put/short put/long put). The first long position in the sequence has a strike price lower than the subsequent positions of the sequence while the second long position (which is also the last position of the sequence) has a higher strike price than the preceding positions of the sequence. As already mentioned, the strike prices of the long condor spread sequence must be in an ascending order and the intervals between each of the strike prices must be equal. For example, a long condor spread using put options would look as follows:

Figure 1 - Long Condor Spread

Long Put	Short Put	Short Put	Long Put
Feb.45@0.5	Feb.50@1	Feb.55@2	Feb.60@16.5

As can be seen from Figure 1:

- 1) the strike prices are in ascending orders;
- 2) the expiry months are identical; and
- 3) the intervals between the strike prices are equal (\$5.00 interval).

A long condor spread should normally result in a net debit being charged to the investor. This net debit also represents the maximum risk of the position. The long condor spread can be derived from the netting of two long butterfly spreads as demonstrated by the following example:

Long Butterfly Spread No. 1

- (a) Buy 1 \$50 Call @ \$12.00 - \$1,200.00 premium to pay
 - (b) Sell 1 \$55 Call @ \$8.00 - \$800.00 premium to receive
 - (c) Sell 1 \$55 Call @ \$8.00 - \$800.00 premium to receive
 - (d) Buy 1 \$60 Call @ \$6.00 - \$600.00 premium to pay
- Net debit to pay: \$200.00

Long Butterfly Spread No. 2

- (e) Buy 1 \$55 Call @ \$8.00 - \$800.00 premium to pay
 - (f) Sell 1 \$60 Call @ \$6.00 - \$600.00 premium to receive
 - (g) Sell 1 \$60 Call @ \$6.00 - \$600.00 premium to receive
 - (h) Buy 1 \$65 Call @ \$5.00 - \$500.00 premium to pay
- Net debit to pay: \$100.00

Cost of Trade in Long Butterfly Spreads No. 1 and No. 2: \$300.00

Netting of Long Butterfly Spreads No. 1 and No. 2 in order to create a Long Condor Spread

- (c) and (e) are netted together
- (d) and (g) are netted together

Once these nettings done, the remaining positions consist of (a), (b), (f) and (h) above thus constituting a long condor spread as follows:

- (a) Buy 1 \$50 Call @ \$12.00 - \$1,200.00 premium to pay
 - (b) Sell 1 \$55 Call @ \$8.00 - \$800.00 premium to receive
 - (f) Sell 1 \$60 Call @ \$6.00 - \$600.00 premium to receive
 - (h) Buy 1 \$65 Call @ \$5.00 - \$500.00 premium to pay
- Net debit to pay: \$300.00

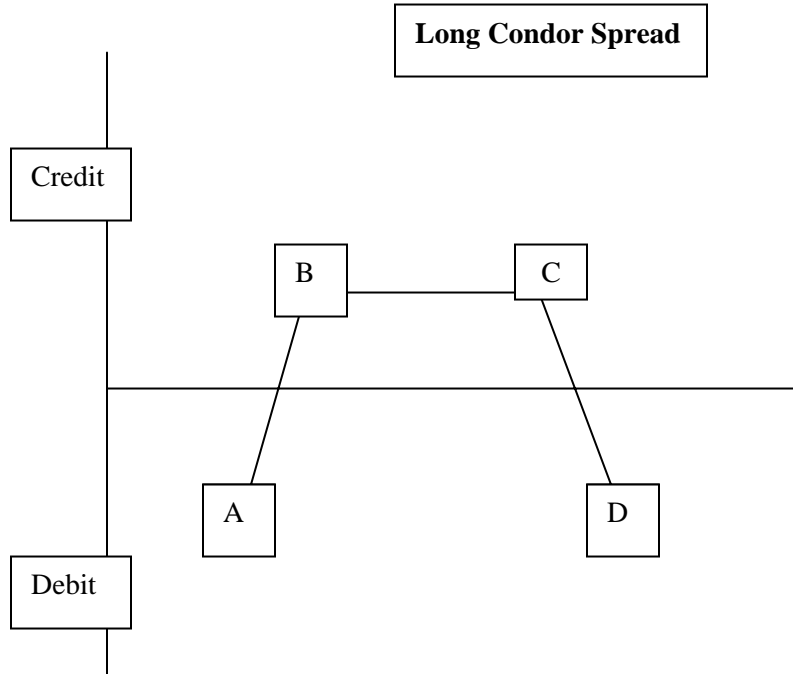
It is to be noted that the net debit of \$300.00 is identical to the total net debit for the two long butterfly spreads that were netted together.

The maximum profit for this long condor spread would be \$200. This would occur if the stock traded between \$55 and \$60 (the middle strike prices or the condor body).

The maximum loss: for this long condor spread would be \$300 (i.e. the net debit paid for the position). This would occur if the stock traded at/above \$65 or at/below \$50 (the outer strike prices or wings).

The existing margin and capital requirements of the Bourse for the two long butterfly spreads, which requires margin totalling the net market value of the short and long options, are appropriate for the long condor spread. This is in harmony with recent US regulatory amendments which require that "net debit" be paid in full. Therefore, the Bourse, for ease of reference, proposes to formally recognize the long condor spread strategy for margin and capital offset purposes. This would be

achieved by adding a new paragraph d) to each of articles 9107 and 9207 of the Rules of the Bourse describing the position and the margin or capital requirement applicable thereon.



The trade:

- 1) Buy put (or call) A:
- 2) Sell put (or call) B and sell put (or call) C, put (call) B having a strike price higher than put (call) A and put (call) C having a strike price higher than put (call) B; and
- 3) Buy put (or call) D with a strike price higher than put (call) C.

All options have identical expiries and intervals between strike prices are identical.

Market expectation: Direction neutral/volatility bearish. A long condor spread allows for a greater degree of volatility, hence a wider band of profit potential than a long butterfly spread.

Profit and loss characteristics:

Profit will be maximised when the underlying settles between the strike prices of puts (calls) B and C, but will decline as the market rise above these strike prices or decreases below these strike prices.

A loss will occur if the underlying rises towards strike price of put (call) D or falls towards put (call) A. In any event, the loss will be limited to the cost of establishing the position.

The lower break-even point will be reached when the underlying reaches the level of the lowest strike price (put (call) A) plus the cost of establishing the spread and the higher break-even will be reached when the underlying reaches the level of the highest strike price (put (call) D) minus the cost of establishing the spread.

Long Condor Spread - Example

Buy 1 \$50 call @ 12.00	(\$1,200)
Sell 1 \$55 call @ 8.00	\$800
Sell 1 \$60 call @ 6.00	\$600

Buy 1 \$65 call @ 5.00 (\$500)
 Net Debit = $(-\$1,200 + \$800 + \$600 - \$500) = \$300$
 Maximum Gain = $(\$50 - \$55) * 100 - \$300 = \200 (Occurs between 2nd & 3rd strike prices)
 Maximum Loss = \$300 (Net debit paid) (Occurs at outside of lowest and highest strike prices)

ii) Short Iron Butterfly Spread and Short Iron Condor Spread

The structure and the risk parameters for the short iron butterfly spread and the short iron condor spread are similar. Both consist of four option series (2 puts and 2 calls as exhibited in Figures 2 and 3 below on the “Net Position” line), with exercise prices in ascending order. The condor or butterfly “body” is made up of two short options (1 put and 1 call) and is flanked on either side by “wings” made up of two long options (1 put and 1 call). The main distinction between the two strategies is that with a short iron butterfly, the two short options have the same strike price, whereas with a short iron condor the two short options have different strike prices.

Figure 2

	Puts				Calls			
	Feb.45@0.5	Feb.50@1	Feb.55@2	Feb.45@16.5	Feb.50@12	Feb.55@8	Feb.60@6	Feb.65@5
Short Iron Butterfly								
Long Butterfly					1	-2	1	
Short Box		1	-1		-1	1		
Net Position		1	-1			-1	1	
Net Premium paid (received)		\$ 100	(\$ 200)			(\$ 800)	\$ 600	

Figure 3

	Puts				Calls			
	Feb.45@0.5	Feb.50@1	Feb.55@2	Feb.45@16.5	Feb.50@12	Feb.55@8	Feb.60@6	Feb.65@5
Short Iron Condor								
Long Butterfly					1	-2	1	
Long Butterfly						1	-2	1
Short Box		1	-1		-1	1		
Net Position		1	-1				-1	1
Net Premium paid (received)		\$ 100	(\$ 200)				(\$ 600)	\$ 500

In practice, and as shown by the net positions in Figures 2 and 3 above, both the short iron butterfly spread and the short iron condor spread can be viewed as the combination of a bull put spread⁴ and a bear

⁴ A “bull put spread” is a type of options strategy that is used when the investor expects a moderate rise in the price of the underlying asset. This strategy is constructed by purchasing one put option while simultaneously selling another put option with a higher strike price. The goal of this strategy is realized when the price of the underlying stays above the higher strike price, which causes the short option to expire worthless, resulting in the trader keeping the premium. This type of strategy is also known as a “credit spread” because the amount received by selling the put option with a higher strike is more than enough to cover the cost of purchasing the put with the lower strike. The maximum possible profit using this strategy is equal to the difference between the amount received from the short put and the amount used to pay for the long put. The maximum loss an investor can incur when using this strategy is equal to the difference between the strike prices and the net credit received. Bull put spreads can be created with in-the-money or out-of-the-money put options, all with the same expiration date.

APPENDIX A

call spread⁵. In pairing together the bull put spread and the bear call spread, the total risk is less than the sum of the risk of both spread positions if they were viewed as "stand-alone spreads". However, under the current rules of the Bourse, both of the underlying spreads are subject to separate margin and capital requirements. As a result, the Bourse margin requirements for client positions in a short iron condor position would be \$1,000⁶ less the net credit received (\$200 – see Figure 3 above) while the maximum loss would be \$300 (the strike price interval⁷). While the capital requirements for approved participant positions in "call spreads and put spreads" are slightly lower than the margin requirements for customer positions, they would still be at \$ 900⁸ less the net credit received (\$200) compared to a maximum possible loss of \$300.

In either case, the result is excess conservatism as the rules do not reflect that the maximum loss is restricted to the difference in strike prices on either underlying spread (bull put or bear call), less the net credit received when the position was initially created. Only one of the underlying spreads would be affected negatively by a sudden movement in the price of the underlying security. In contrast to the current margin and capital requirements of the Bourse, the US regulators' minimum margin and capital requirements for short iron butterfly and short iron condor spreads are equal to the strike price interval less the net credit received, which is the maximum loss.

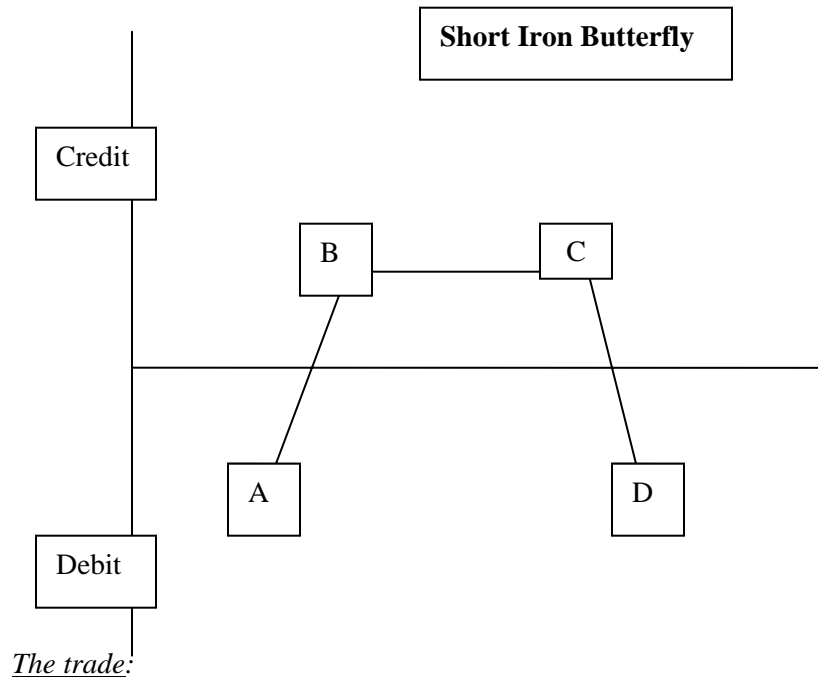
A short iron butterfly spread could also be created by combining a long butterfly spread and a short box spread as shown in Figure 3, but then, pursuant to the Bourse's current requirements, the margin and capital required would be \$700 (less the net credit received) for both clients and approved participants positions, still higher than the maximum possible loss. Finally, a short iron condor spread could also be created by combining two long butterfly spreads and a short box spread as shown in Figure 3, but the Bourse's margin and capital requirement would be \$800 (less the net credit received) for both clients and approved participant positions, once again higher than the maximum possible loss. Calculations are shown in the examples below:

5 A "bear call spread" is an option strategy used when a decline in the price of the underlying asset is expected. It is achieved by selling call options at a specific strike price while also buying the same number of calls, but at a higher strike price. The maximum profit to be gained using this strategy is equal to the difference between the price paid for the long option and the amount collected on the short option. For example, let's assume that a stock is trading at \$30. An option investor has purchased one call option with a strike price of \$35 for a premium of \$0.50 and sold one call option with a strike price of \$30 for a premium of \$2.50. If the price of the underlying asset closes below \$30, then the investor collects \$200 ($(\$2.50 - \$0.50) * 100$ shares/contract).

6 The margin requirement calculations for the short iron condor spreads are based upon a value of the underlying security at \$60.

7 By definition, the maximum loss is the difference in strike prices on either spread less the net credit [$(55-50 * 100) - (200)$ or $(65-60 * 100) - (200)$] in the case of the short iron condor.

8 The capital requirement calculations for the short iron condor spreads are based upon a value of the underlying security at \$60.



The trade:

- 1) Buy put A;
- 2) Sell put (B) and sell call (C), both having an identical strike price, such strike price being higher than put A; and
- 3) Buy call D having a strike price higher than put B and call C.

All options have the same expiries.

Market expectation:

Direction neutral/volatility bearish. The underlying is at, or near the strike price of put B (and call C) and is expected to remain at this level, or it is felt that volatility will fall.

Profit and Loss characteristics:

Profit is limited to the net credit received upon establishing the position. It will be at its maximum when the underlying value is equal to the strike price of put B (or call C).

A limited loss will occur if there is a directional move in the market. This loss will be at its maximum when the underlying value is equal to or lower than the strike price of put A or equal to or higher than the strike price of call D.

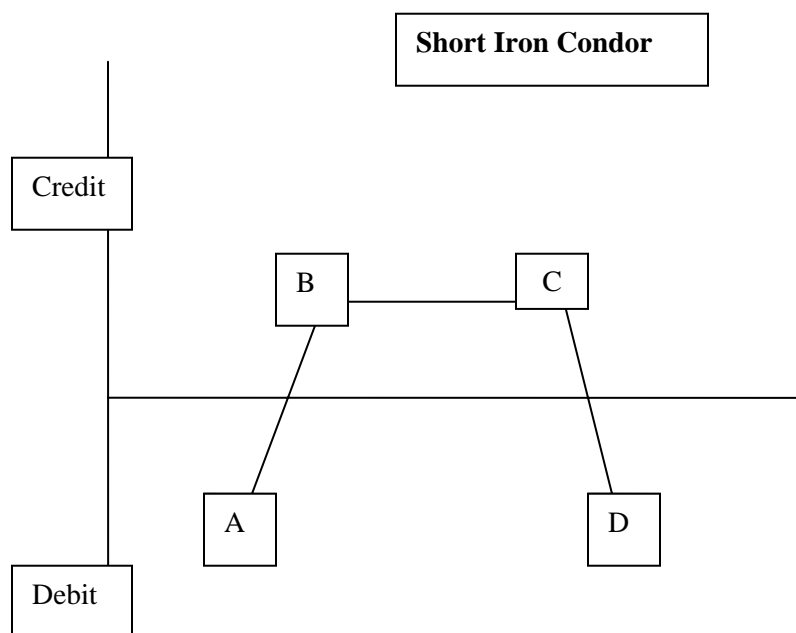
The break-even point will be reached when the underlying is above or below the strike price of put B and call C by the same amount as the net credit received upon establishing the position.

Buy 1 \$50 put @ 1.00	(\$100)
Sell 1 \$55 put @ 2.00	\$200
Sell 1 \$55 call @ 8.00	\$800
Buy 1 \$60 call @ 6.00	(\$600)

Net Credit = $(-\$100 + \$200 + \$800 - \$600) = \$300$

Maximum Gain = \$300 = Net credit received (occurs when the underlying value is equal to the strike price of sold put and call)

Maximum Loss = \$200 (occurs when the underlying value is equal to or lower than the strike price of long put or equal to or higher than the strike price of long call)



The trade:

- 1) Buy put A;
- 2) Sell put B with a strike price higher than put A;
- 3) Sell call C with a strike price higher than put B; and
- 4) Buy call D with a strike price higher than call C.

All options have identical expiries and intervals between strike prices are identical.

Market Expectation: Direction neutral/volatility bearish A Short Iron Condor allows for a greater degree of volatility and hence a wider band of profit potential than a Short Iron Butterfly.

Profit and Loss characteristics:

Profit will be maximised where the underlying remains at or within the strike prices of put B and call C, but will decline as the market rises or falls beyond these strike prices. Profit will be limited to net premium received for the trade.

Losses are limited and will occur if the underlying rises to or above the strike price of call D or falls to or below the strike price of put A.

Lower break-even point will be reached when the underlying falls below the strike price of put B by the amount of the premium received. Upper break-even point will be reached when the underlying rises above the strike price of call C by the amount of the premium received.

Buy 1 \$50 Put @\$ 1.00 (\$100)

Sell 1 \$55 put @2.00 \$200

Sell 1 \$60 calls @6.00 \$600

Buy 1 \$65 calls@ 5.00 (\$500)

Net Credit = (-\$100 + \$200 + \$600 – \$500) = \$200

Maximum Gain = \$200 = Net credit received (occurs when the underlying remains at or within the strike prices of put B and call C)

Maximum Loss = \$300 (will occur if the underlying rises to or above the strike price of call D or falls to or below the strike price of put A)

B) OBJECTIVE

The Bourse's objective in proposing to amend paragraph a) of articles 9105 and 9205 of the Rules of the Bourse by adding a mention that the option spreads to which this paragraph a) refers must be on the same underlying interest is to clarify the interpretation and application of this paragraph and make its wording uniform with the wording of paragraphs b) to e) of these articles.

Complex option strategies such as the long condor spread; the short iron butterfly spread and the short iron condor spread reflect an increasing trend by investors to consider options as a risk management tool and to use more sophisticated option strategies. Recognizing these three strategies for capital and margin purposes will permit to reduce significantly the excessive conservatism of the current rules when calculating capital and margin requirements applicable to these types of positions. Such excess conservatism is inefficient in the sense that it penalizes holders of these types of positions by requiring excessive capital and margin in comparison with the real risk of these positions. It is not acceptable that users of options be discouraged from taking risk protecting positions by being required to put up more capital and margin than necessary.

As indicated in Appendix A, the complex offset strategies can be derived by combining and netting basic spreads, such as the butterfly spread and the box spread, which are already defined in articles 9107 and 9207 of the Rules of the Bourse. However, the application of the current rules to the proposed complex option strategies obliges the user of these strategies to calculate the capital and margin requirements on separate parts of the strategy and then to sum up the capital and margin requirements obtained on each of these parts. This results in an overall margin or capital requirement which can be significantly greater than the maximum risk presented by the overall position. This is particularly true with regard to the short iron butterfly spread and the short iron condor spread.

Concerning the long condor spread, although not specifically defined in the Rules of the Bourse, it is properly margined when the margin requirements for each part of the strategy are combined. However, in order to clarify the Rules and facilitate application, it is proposed to formally recognize the long condor spread strategy for margin and capital offset purposes.

The formal recognition of the complex offset strategies discussed above for capital and margin offset purposes should contribute in reducing existing inefficiencies in the current rules and allow for minimum capital and margin requirements that better reflect the risks relating to these strategies by not requiring capital or margin that is higher than the maximum loss that could be incurred in a worst case scenario.

Also, in line with the Bourse's proposal to eliminate the current restrictions of articles 9107 and 9207 of the Rules that limit the application of capital and margin offsets for box spreads, long butterfly spreads and short butterfly spreads to index options and index participation unit (IPU) options, the new capital and margin offsets that would be added for complex option strategies (long condor spreads, short iron butterfly spreads and short iron condor spreads) would be applicable to all types of options and not only to index options and IPU options.

C) PUBLIC INTEREST

The objective of the proposed amendments to Rule Nine of the Bourse is to expand the number of available capital and margin offsets by eliminating the restrictions on the currently available offsets that limit the application of these offsets to index products and by adding new offsets on more complex strategies.

Consequently, the proposed amendments are considered to be of public interest.

III COMMENTS

A) Efficiency

The main effect of the proposed amendments will be to eliminate existing inefficiencies in the current rules and allow for minimum capital and margin requirements that better reflect the risks relating to options strategies. Furthermore, the elimination of the existing restrictions that limit the application of margin and capital offsets to index products will provide approved participants and their clients with a much broader array of available offsets.

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 has been obtained, the proposed amendments, if they relate to capital and margin matters, are subsequently submitted to the Rules and Policies Committee of the Bourse for further approval. Once the approval process is completed, the proposed amendments, including this document, are 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 Sources

- Rule Nine of Bourse de Montréal Inc.
- Regulations 100.9 and 100.10 of the Investment Dealers Association of Canada
- Chicago Board of Trade (CBOE) – Rule 12.3 – Margin Requirements
- CBOE-Margin Manual
- New York Stock Exchange (NYSE) - Rule 431 – Margin Requirements
- <http://www.investopedia.com> for definitions of “bull put spread” and “bear call spread”

SUMMARY OF COMPLEX OPTIONS STRATEGIES

Proposed Complex Option Strategy	Basic Option Spread Components	Current IDA Margin Requirement-Rule Reference	CBOE Complex Option Strategy Margin Requirement-Rule Reference	Current Bourse Margin Requirement-Rule Reference
Long Condor Spread: 1 long put/2 short puts/1 long put or 1 long call/2 short calls/1 long call	2 long butterfly spreads	Customer positions: "Long Butterfly Spread" - 100.9 (h)(i)(B) Member positions: "Long Butterfly Spread" - 100.10 (h)(i)(B)	"Long Butterfly Spread or Long Condor Spread"- subparagraph (c)(5)(C)(6) of Rule 12.3 (Margin Requirements)	Client positions: "Long Butterfly Spread" Article 9107(d) Approved Participant positions: "Long Butterfly Spread" Article 9207(d)
Short Iron Butterfly Spread: 1 long put/1 short put/1 short call/1 long call	1 long Butterfly Spread and 1 short Box spread	Customer positions: Scenario 1:"Long Butterfly Spread" -100.9 (h)(i)(B) and "Box Spread"- 100.9(h)(i)(A) Scenario 2: "Call Spreads and Put Spreads" -100.9 (f)(i) Member positions: Scenario 1:"Long Butterfly Spread" -100.9 (h)(i)(B) and "Box Spread"- 100.9(h)(i)(A) Scenario 2: "Call Spreads and Put Spreads" -100.9 (f)(i)	"Short Butterfly Spread, Short Iron Butterfly Spread or Short Iron Condor Spread" - subparagraph (c)(5)(C)(7) of Rule 12.3 (Margin Requirements)	Client positions: Scenario 1:"Long Butterfly Spread" Article 9107(b) and "Box Spread"- Article 9107(a) Scenario 2: "Call Spreads and Put Spreads" Article 9105(a) Approved Participant positions: Scenario 1:"Long Butterfly Spread" Article 9107(b) and "Box Spread"- Article 9107(a) Scenario 2: "Call Spreads and Put Spreads" Article 9205(a)
Short Iron Condor Spread: long put/short put/short call/long call	2 long Butterfly Spreads and 1 short Box Spread	Customer positions: Scenario 1:"Long Butterfly Spread" -100.9 (h)(i)(B) and "Box Spread"- 100.9(h)(i)(A) Scenario 2: "Call Spreads and Put Spreads" -100.9 (f)(i) Member positions: Scenario 1:"Long Butterfly Spread" -100.9 (h)(i)(B) and "Box Spread"- 100.9(h)(i)(A) Scenario 2: "Call Spreads and Put Spreads" -100.9 (f)(i)	"Short Butterfly Spread, Short Iron Butterfly Spread or Short Iron Condor Spread" - subparagraph (c)(5)(C)(7) of Rule 12.3 (Margin Requirements)	Client positions: Scenario 1:"Long Butterfly Spread" -Article 9107 (b) and "Box Spread"- Article 9107(a) Scenario 2: "Call Spreads and Put Spreads" Article 9105 (a) Approved Participant positions: Scenario 1:"Long Butterfly Spread" -Article 9207 (b) and "Box Spread"- Article 9207(a) Scenario 2: "Call Spreads and Put Spreads" - Article 9205 (a)

9105 Options Spreads and Combinations

(01.01.05, 00.00.06)

a) Call spreads and put spreads

Where a client account contains one of the following spread pairings for an equivalent number of trading units on the same underlying interest:

- long call option and short call option; or
- long put option and short put option;

and the short option expires on or before the date of expiration of the long option, the minimum margin required for the spread pairing must be the lesser of:

- i) the margin required on the short option; or
- ii) the spread loss amount, if any, that would result if both options were exercised.

9107 Option Spreads Involving ~~Index Products~~ Complex Strategies

(01.01.05, 00.00.06)

In addition to the option spreads permitted in article 9105, the following additional option spread strategies are available for positions in ~~index options and index participation unit options~~:

a) Box spread

Where a client account contains ~~one of the following~~ a box spread combinations: on the same underlying interest with all options expiring at the same time

- ~~box spread involving index options; or~~
- ~~box spread involving index participation unit options;~~

~~such that a-the~~ a-the client holds a long and short call option and a long and short put option ~~with the same expiry month~~ and where the long call option and short put option, and short call option and long put option have the same strike price, the minimum margin required must be the lesser of:

- i) the greater of the margin requirements calculated for the component call and put spreads (paragraph a) of article 9105); and
- ii) the greater of the out-of-money amounts calculated for the component call and put spreads.

b) Long butterfly spread

Where a client account contains ~~one of the following~~ a long butterfly spread combination on the same underlying interest with all options expiring at the same time

- ~~• long butterfly spread involving index options; or~~
- ~~• long butterfly spread involving index participation unit options;~~

—such that ~~the~~ the client holds a short position in two call options (or put options) and the short call options (or short put options) are at a middle strike price and are flanked on either side by a long call option (or long put option) having respectively a lower and higher strike price, the minimum margin required must be the net market value of the short and long call options (or put options).

c) Short butterfly spread

Where a client account contains ~~one of the following~~ a short butterfly spread combination on the same underlying interest with ~~all~~ all options expiring at the same time

- ~~• short butterfly spread involving index options; or~~
- ~~• short butterfly spread involving index participation unit options;~~

—such that ~~the~~ the client holds a long position in two call options (or put options) and the long call options (or long put options) are at a middle strike price and are flanked on either side by a short call option (or short put option) having respectively a lower and higher strike price, the minimum margin required must be the amount, if any, by which the exercise value of the long call options (or long put options) exceeds the exercise value of the short call options (or short put options). The market value of any premium credit carried on the short options may be used to reduce the margin required.

d) Long Condor Spread

Where a client account contains a long condor spread combination on the same underlying interest with all options expiring at the same time, such that ~~the~~ the client holds four separate option series wherein the exercise prices of the options are in ascending order and the interval between the strike prices is equal, comprising a short position in two call options (or put options) and the short call options (or short put options) are flanked on either side by a long call option (or long put option) having ~~respectively~~ respectively a lower and higher strike price, the minimum margin required must be the net market value of the short and long call options (or put options).

e) Short Iron Butterfly Spread

Where a client account contains a short iron butterfly spread combination on the same underlying interest with all options expiring at the same time, such that the client holds four separate option series wherein the exercise prices of the options are in ascending order, and the interval between the strike prices is equal, comprising short positions in a call option and a put option with the same strike price and the short options are flanked on either side by a long put option and a long call option having respectively a lower and higher strike price, the minimum margin required must be equal to the strike price interval multiplied by the unit of trading. The market value of any premium credit carried on the short options may be used to reduce the minimum margin required.

f) Short Iron Condor Spread

Where a client account contains a short iron condor spread combination on the same underlying interest with all options expiring at the same time, such that the client holds four separate option series wherein the exercise prices of the options are in ascending order, and the interval between the strike prices is equal, comprising short positions in a call option and a put option and the short options are flanked on either side by a long put option and a long call option having respectively a lower and higher strike price, the minimum margin required must equal the strike price interval multiplied by the unit of trading. The market value of any premium credit carried on the short options may be used to reduce the minimum margin required.

9205 Option Spreads and Combinations
(01.01.05, 00.00.06)

a) Call spreads and put spreads

Where an approved participant account contains one of the following spread pairings for an equivalent number of trading units on the same underlying interest:

- long call option and short call option; or
- long put option and short put option;

the minimum capital required must be the lesser of:

- i) the capital required on the short option; or
- ii) the spread loss amount, if any, that would result if both options were exercised.

9207 Option Spreads Involving ~~Index Products~~ Complex Strategies
 (01.01.05, ~~00.00.06~~)

In addition to the option spreads permitted in article 9205, the following additional option spread strategies are available for positions in ~~index options and index participation unit options~~:

a) Box spread

Where an approved participant account contains ~~one of the following~~ a box spread combinations: on the same underlying interest with all options expiring at the same time

- ~~• box spread involving index options; or~~
- ~~• box spread involving index participation unit options;~~

~~—~~ such that ~~the~~ approved participant holds a long and short call option and a long and short put option ~~with the same expiry month~~ and where the long call option and short put option, and short call option and long put option have the same strike price, the minimum capital required must be the lesser of:

- i) the difference, plus or minus, between the aggregate exercise value of the long call options and the aggregate exercise value of the long put options; and
- ii) the net market value of the options.

b) Long butterfly spread

Where an approved participant account contains ~~one of the following~~ a long butterfly spread combinations: on the same underlying interest with all options expiring at the same time

- ~~• long butterfly spread involving index options; or~~
- ~~• long butterfly spread involving index participation unit options;~~

~~—~~ such that ~~the~~ approved participant holds a short position in two call options (or put options) and the short call options (or short put options) are at a middle strike price and are flanked on either side by a long call option (or long put option) having respectively a lower and higher strike price, the minimum capital required must be the net market value of the short and long call options (or put options).

c) Short butterfly spread

Where an approved participant account contains ~~one of the following~~ a short butterfly spread combinations: on the same underlying interest with all options expiring at the same time

- ~~• short butterfly spread involving index options; or~~

- ~~short butterfly spread involving index participation unit options;~~

—such that ~~the~~ approved participant holds a long position in two call options (or put options) and the long call options (or long put options) are at a middle strike price and are flanked on either side by a short call option (or short put option) having respectively a lower and higher strike price, the minimum capital required must be the amount, if any, by which the exercise value of the long call options (or long put options) exceeds the exercise value of the short call options (or short put options). The market value of any premium credit carried on the short options may be used to reduce the capital required.

d) Long Condor Spread

Where an approved participant account contains a long condor spread combination on the same underlying interest with all options expiring at the same time, such that ~~the~~ approved participant holds four separate option series wherein the exercise prices of the options are in ascending order and the interval between the strike prices is equal, comprising a short position in two call options (or put options) and the short call options (or short put options) are flanked on either side by a long call option (or long put option) having a lower and higher strike price respectively, the minimum capital required ~~must be equal to~~ the net market value of the short and long call options (or put options).

e) Short Iron Butterfly Spread

Where an approved participant account contains a short iron condor butterfly spread combination on the same underlying interest with all options expiring at the same time, such that ~~the~~ approved participant holds four separate option series wherein the exercise prices of the options are in ascending order, and the interval between the strike prices is equal, comprising short positions in a call option and a put option with the same strike price and the short options are flanked on either side by a long put option and a long call option having ~~respectively~~ a lower and higher strike price, the minimum capital required ~~must be equal to~~ the strike price interval multiplied by the unit of trading. The market value of any premium credit carried on the short options may be used to reduce the minimum capital required.

f) Short Iron Condor Spread

Where an approved participant account contains a short iron condor spread combination on the same underlying interest with all options expiring at the same time, such that ~~the~~ approved participant holds four separate option series wherein the exercise prices of the options are in ascending order, and the interval between the strike prices is equal, comprising short positions in a call option and a put option and the short options are flanked on either side by a long put option and a long call option having ~~respectively~~ a lower and higher strike price, the minimum capital required must equal the strike price interval multiplied by the unit of trading. The market value of any premium credit carried on the short options may be used to reduce the minimum capital required.