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CIRCULAR
December 20, 2004

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

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) approved amendments to Rules Seven, Eleven and Fifteen and the addition of Rule Nine to the Rules and Policies of the Bourse, which deal with margin and capital requirements for options, futures contracts and other derivative instruments. These amendments will become effective on January 1, 2005.

The first objective of the amendments is to permit the use of SPAN^{®1} and TIMS^{™2} systems to calculate the capital requirement for positions in derivatives held by approved participants. The second objective of the amendments is to simplify the current rules relating to margin and capital requirements for equity and index-related derivatives, to broaden their application and to correct errors contained therein.

A. USE OF SPAN AND TIMS RISK-BASED MARGINING SYSTEMS

Approved participants have now the option to use either SPAN or TIMS to determine their capital requirements for their derivative positions. Approved participants who prefer to continue using the current strategy-based approach are allowed to do so. However, when a methodology is selected, approved participants must use it consistently and they won't be allowed to change the methodology without the prior consent of the Bourse.

Circular no.: 161-2004
Amendments no.: 011-2004

¹ SPAN[®] is a registered trademark of the Chicago Mercantile Exchange for the Standard Portfolio Analysis of Risk Performance Bond System.

² TIMS[™] is a registered trademark of the Options Clearing Corporation for the Theoretical Intermarket Margin System.

As mentioned in article 9002, the assumptions to use in the capital requirement calculation by SPAN and TIMS must be those used by the Canadian Derivatives Clearing Corporation. Also, the use of SPAN and TIMS is only for approved participant accounts constituted exclusively of positions in derivatives and consequently, it is prohibited for the time being to use these systems to determine margin requirements for client accounts.

B. AMENDMENTS TO CURRENT STRATEGY-BASED MARGIN AND CAPITAL RULES

A general review of Rule Eleven and Rule Fifteen of the Bourse permitted to identify improvements that could be made to margin and capital rules for positions in and offsets involving equity and index-related derivatives. The key amendments, grouped together under Rule Nine, are as follows³:

- 1) Until now, approved participants would use certain offset strategies for their inventory account, but could not use them for the client accounts. From now on, the following offset strategies will also be available for client account use:
 - long call options and long put options [*article 9105 c*];
 - long call options and short call options and long put options [*article 9105 d*];
 - short call options and long warrants [*article 9105 e*];
 - long index call options and short qualifying index baskets [*article 9109 c*];
 - long index put options and long qualifying index baskets [*article 9109 d*];
 - long tripo combination [*articles 9106 e), 9109 e) et 9124 e*];
 - short tripo combination [*articles 9106 f), 9109 f) et 9124 f*].
- 2) Excess conservatism was found in certain margin and capital requirement calculations. Amended margin and capital calculations are as follows:
 - **Floating margin rate and tracking error margin rate**
The 0.50 percent cushion is removed from the calculation methodology [*article 9001 k*];
 - **Minimum margin requirement for short index options or short index participation unit options**
The percentage is reduced from 5.00% to 2.00% [*article 9103 b*];
 - **Minimum margin requirement for a short put option position**
The minimum percentage amount is based on the aggregate exercise value of the option rather than the market value of the underlying security [*article 9103 b*];
 - **Short call option and short put option spread**
Margin and capital required are based on the difference between the exercise values of both options [*articles 9105 b), 9205 b), 9108 b) and 9208 b*];

³ For details regarding the justification for the amendments made, see circular no.: 022-2004, published February 17, 2004, entitled "Request for Comments – Margin and capital requirements for options, futures contracts and other derivative instruments".

▪ **Short call option and long underlying interest combination**

Margin and capital required for an offset involving a deep-in-the-money call option are limited to the maximum loss that would be experienced with a price drop equivalent to the margin rate percentage [*articles 9106 a), 9206 a), 9109 a) and 9209 a)*];

▪ **Short put option and short underlying interest combination**

Margin and capital required for an offset involving a deep-in-the-money put option are limited to the maximum loss that would be experienced with a price increase equivalent to the margin rate percentage [*articles 9106 b), 9206 b), 9109 b) and 9209 b)*];

▪ **Long put option and long underlying interest combination**

Margin and capital required are equivalent to the time value for an offset involving an in-the-money put option [*articles 9106 d), 9206 d), 9109 d) and 9209 d)*].

- 3) To avoid rule duplication and to facilitate the listing of new products, specific references to the S&P/TSX index and to sectorial stock indices were removed. However, it was necessary to add a definition for the terms “index” and “tracking error margin rate” [*article 9001 – see section C below for additional information*].
- 4) Some offset strategies were hard to find and their drafting was inconsistent. Margin and capital rules that were in Rules Eleven and Fifteen were not only transferred to the new Rule Nine but were also organized in a more logical fashion and with a consistent wording. Also, even though the additions and amendments presented in 1 and 2 above apply only to equity and index-related derivatives, margin and capital rules for interest rate related derivatives and for over-the-counter options are presented in Rule Nine using a similar wording [*article 9301 and the following articles*].

C. AMENDMENTS TO CURRENT MARGIN AND CAPITAL RULES FOR POSITIONS IN AND OFFSETS INVOLVING LONG OPTIONS

From now on, a loan value is given to any “in-the-money” portion of a long option market value when it is greater than the margin or capital required on the underlying interest. A loan value is also given to any “time value” [the excess, if any, of an option’s market value over its “in-the-money” value] portion of the long option market value when the period to expiry is equal to or greater than nine months. In addition, the amendments allow to standardize the margin treatment of approved participant account and client account positions in long options.

D. INDEX PRODUCTS FLOATING MARGIN RATES AND TRACKING ERROR MARGIN RATES

The elimination of specific references to the S&P/TSX index and to sectorial stock index resulted in the removal of fixed rates in the calculation of margin and capital requirements for index-related product offsets. To represent the true risk, a tracking error margin rate for each offset will be calculated by the Bourse and will be updated when justified by market conditions⁴. Also, the Bourse will provide the floating margin rates for all index-related products listed at the Bourse

⁴ In future, floating margin rates and tracking error margin rates will be included in the monthly circular on futures contract margin requirements.

instead of only the floating margin rates for S&P/TSX 60 Index products, as it was the case until now.

The following floating margin rates and tracking error margin rates have been determined and are effective for the close of business on January 1, 2005:

FLOATING MARGIN RATES	BASKET OF INDEX SECURITIES	INDEX PARTICIPATION UNITS
S&P/TSX 60 Index	3.50%	3.25%
S&P/TSX Capped Gold Index	8.00%	8.00%
S&P/TSX Capped Financials Index	2.75%	2.75%
S&P/TSX Capped Information Technology Index	8.75%	8.75%
S&P/TSX Capped Energy Index	5.25%	5.25%

TRACKING ERROR MARGIN RATES	INDEX and IPU	INDEX and FUTURES	IPU and FUTURES
S&P/TSX 60 Index	1.00%	1.25%	1.50%
S&P/TSX Capped Gold Index	1.25%	1.00%	1.50%
S&P/TSX Capped Financials Index	1.00%	1.25%	1.50%
S&P/TSX Capped Information Technology Index	1.75%	1.50%	2.25%
S&P/TSX Capped Energy Index	1.00%	0.75%	1.25%

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