



## Cash markets

In the Canadian financial markets, bankers' acceptances are the barometer of short-term commercial interest rates. Introduced in Canada in 1962, bankers' acceptances are commercial drafts or short-term debt obligations that have been "accepted" by one of Canada's major banks. As used here, the wording "accepted" means that the payment of principal and interest is guaranteed by the issuing bank. Bankers' acceptances are issued on behalf of the bank's customer for repayment after a predetermined period of usually 30, 60, 90 days, 6 months or 1 year and in minimum denominations of C\$100,000. They are quoted at a discount on the basis of yield. In the secondary market, an investor purchasing bankers' acceptances buys them at the discounted price and receives the face value at maturity.

## Futures market

BAX futures were the first interest rate contracts to be listed on the Montréal Exchange. They are recognized as the benchmark for Canadian short-term interest rates.

BAX are quoted on an index basis: 100 minus the annualized yield of three-month Canadian bankers' acceptances. The trading unit for BAX represents a bankers' acceptance having a nominal value of C\$1,000,000 with a three-month maturity. In the futures market, the purchaser of a BAX contract buys it at its trading value. An actual payment is not required; rather, the purchaser deposits security (an initial margin) as a sign of good faith that the contract will be honored.

The buyer of a BAX contract has a long position in view of falling rates and the seller, a short position in view of increasing rates. A long position can be closed by either selling the contract at a later date or by waiting until it expires. If the position is closed by the sale of a contract, the difference between the purchase and sale price is the position's profit or loss. If the purchaser waits until the contract expires, the difference between the purchase and final settlement

price represents the position's profit or loss. It is important to note that users of derivative products (exchange-traded or over-the-counter) must consider all fees related to the trade.

BAX are cash settled as opposed to some futures where a physical instrument is delivered on expiry. As margin accounts are marked to market daily by the clearinghouse, the daily settlement price is used to determine each position's daily value. In other words, every day, money is either debited from or credited to an open position account showing the fair value of the position daily.

## Trading hours and operations

BAX trades from:

- Early session: 6:00 a.m. to 7:45 a.m.
- Regular session: 8:00 a.m. to 3:00 p.m.
- Curb session: from daily settlement to 4:00 p.m.

All times are local.

The early session expands access to the BAX market for the international clientele during non-Canadian business hours.

Orders are executed at the best market price on a "first-in, first-out" (FIFO) basis. As a result, order entry timing is important to ensure priority in the order book.

During the early session, there is a price movement limit based on a risk percentage established by the clearinghouse and on the margin requirements, which are subject to periodic changes. Conversely, throughout the regular trading session, there is no price movement limit.

The regular trading session starts with a pre-opening phase from 7:30 a.m. to 7:58 a.m. During this phase, users can enter, modify or cancel their orders while waiting for the market opening.

From 7:58 a.m. to 8:00 a.m., there is a non-cancellation period during which no cancellation or change is allowed; only entry of new orders is permitted. At 8:00 a.m., the market opens and orders received during the pre-opening are matched, establishing the theoretical opening price, which becomes the opening price of the futures. The trading session continues without any interruption, under normal circumstances, until 3:00 p.m. During the regular trading session, the net price change is established in relation to the previous day's settlement price rather than the early session's settlement price.

## Contracts traded

### Quarterly

Three years of quarterly BAX contracts are listed at all times. The standard quarterly cycle consists of March, June, September and December. The first year of contracts is commonly referred to as the *front four* and the contracts do not necessarily have to expire in the same calendar year. The second year of contracts is referred to as the *reds* and the third year, as the *greens*. These three years of quarterly maturities provide portfolio managers with an extended and more precise hedge across the yield curve. The large number of maturities available also offers more opportunities for calendar spreads, allows users to hedge longer-dated interest rate swaps and to combine cash and futures to create longer-term synthetic instruments.

### Serials

In addition, two near-term contracts are listed at all times so there are always three consecutive front months listed. These contracts expire in months other than the standard quarterly contracts. Referred to as *serial* futures, they are identical to the standard BAX contracts in all respects except for the expiry months. For example, on September 17, 2007, the October and November serial BAX futures are listed in addition to the BAX December quarterly contract. With the expiry of the October contract, the January serial BAX contract is immediately listed; with the expiry of the November contract, the February serial is added, and so forth.

The use of serial futures alleviates maturity mismatches and provides market participants with the opportunity to more precisely manage their short-term interest rate exposure. For example, on October 4, 2007, a treasurer knows that he will have a three-month rate fixing on October 15, 2007. Hedging this risk with a December BAX contract exposes the treasurer to date risk between the three-month rate fixing in 11 days and the three-month rate fixing in 74 days based on the expiry of the December BAX contract. By using the October serial BAX contract, the treasurer is able to match the rate fixing date of the hedge to the risk exposure, thereby greatly reducing the date risk.

### Strips

A *strip* is a simultaneous purchase or sale of an equally weighted series of standard quarterly contracts. There are many benefits in the use of standardized strips, such as executing multiple contract months in a single transaction, rapid trade execution in an active market, eliminating partial fills and more efficient trading in the back months.

The one-, two- and three-year strips consist of, respectively, the first four, eight and twelve standard quarterly contracts. The *front strip* consists of the first year of four consecutive standard quarterly contracts. The *red strip* consists of the second year of four consecutive standard quarterly contracts, and the *green strip* the third year. In the over-the-counter markets, the *red strip* is commonly referred to as the one-year/one-year forward and the *green strip* as the one year/two-year forward.

Strips are quoted on an average net change basis from the previous day's settlement price. For example, a *red strip* bought at +2 indicates the addition of two ticks to the close of the previous day's settlement price for each of the strip's contracts.

## Pricing BAX futures

The BAX price tends to reflect implied forward rates as calculated from the available rates on three-month Canadian bankers' acceptances in the cash market. The price also relies on the Eurodollar futures prices with the same maturities and the price of exchange contracts on the Canadian dollar against the U.S. dollar.

## Final settlement procedures

BAX trading ceases at 10:00 a.m. (Montréal time) on the second London (Great Britain) banking day prior to the third Wednesday of the contract month.

The settlement is based on the average of the three-month Canadian Bankers' Acceptance bid rates as quoted on the CDOR page of Reuters Monitor Service on the last trading day, at 10:15 a.m. (Montréal time), excluding the highest and the lowest values.

## Required margins

An initial margin is required from all approved participants and their clients. This good faith deposit ensures the financial position of both counterparts to a trade. Deposits are held at the central clearinghouse, the Canadian Derivatives Clearing Corporation (CDCC), and are marked to market on a daily basis. Various types of collateral can be deposited to meet the initial margin requirements including cash, government securities or similar highly liquid instruments. A client's minimum margin deposit is established through the use of a risk-based system and varies for speculators and hedgers. As margin requirements are subject to periodic changes, information on current requirements may be obtained from the Exchange.

In recognition of the more limited-risk characteristics of combined strategies (spreads or butterflies), the CDCC offers reduced-margin requirements for spread positions. For intermonth spreads, the margin applied varies depending on the contract months involved, while for intercommodity spreads (e.g. BAX versus CGB), a fixed ratio is used. Full details on current spread margins can be obtained from the Exchange.

## Position limits

The Exchange has a position reporting facility, which requires approved participants to supply details on positions over 300 futures contracts.

## Strategies using BAX

- Managing money market portfolios
- Hedging over-the-counter derivatives: interest rate swaps (floating rate), basis swaps, FRAs, and interest rate options
- Hedging Canadian/U.S. dollar forwards
- Hedging borrowings/investments
- Creating synthetic instruments
- Cross-market trading (BED spread)
- Spread or butterfly trading
- Arbitrage

## Advantages

- **Regulated market:** As a self-regulatory organization recognized by the Quebec Securities Act, the Exchange is required to ensure that approved participants comply with all regulations to safeguard an orderly and efficient market.
- **Electronic trading:** Through SAM (Montréal Automated System), the Exchange offers continuous immediate disclosure of competitive price quotes in real time, allowing the market to be more transparent. Trading is carried out at the best market price on a “first-in, first-out” (FIFO) basis.
- **Market transparency:** All market participants have access to quotes as well as market depth (via certain vendors).
- **Liquidity:** Competitive bid and ask spreads resulting from a strong involvement of domestic and global users stimulate volumes. With increasing volumes and greater market depth, trades can be done in a more effective manner.

- **Margins:** Contrary to the over-the-counter marketplace, any market participant meeting established margin requirements is allowed to take part in the futures market. Furthermore, any interest earned on the deposited collateral is paid to the owner of the account held at the CDCC.
- **Central clearinghouse:** The Canadian Derivatives Clearing Corporation (CDCC) ensures market integrity and stability by matching and clearing all trades and by monitoring all open positions on a daily basis.
- **Standardized contracts:** Contrary to the over-the-counter financial products, the futures contracts, through their standardization, provide uniformity allowing operational flexibility and rapid execution of positions, in a context of proactive interest rate risk management.

## Canadian Derivatives Clearing Corporation (CDCC)

The Canadian Derivatives Clearing Corporation is the issuer, clearinghouse and guarantor of interest rate, equity, currency and index derivative contracts traded on the Montréal Exchange. It also offers clearing services to other exchanges and partners. Established in 1975, the CDCC is a for-profit company owned by Bourse de Montréal Inc. The CDCC requires each member to maintain margin deposits with the clearinghouse in order to cover the market risk associated with each member's positions. The assessment of this risk is based on a set of well-defined criteria established by the clearinghouse. Margins are collected daily or more frequently during periods of market volatility.

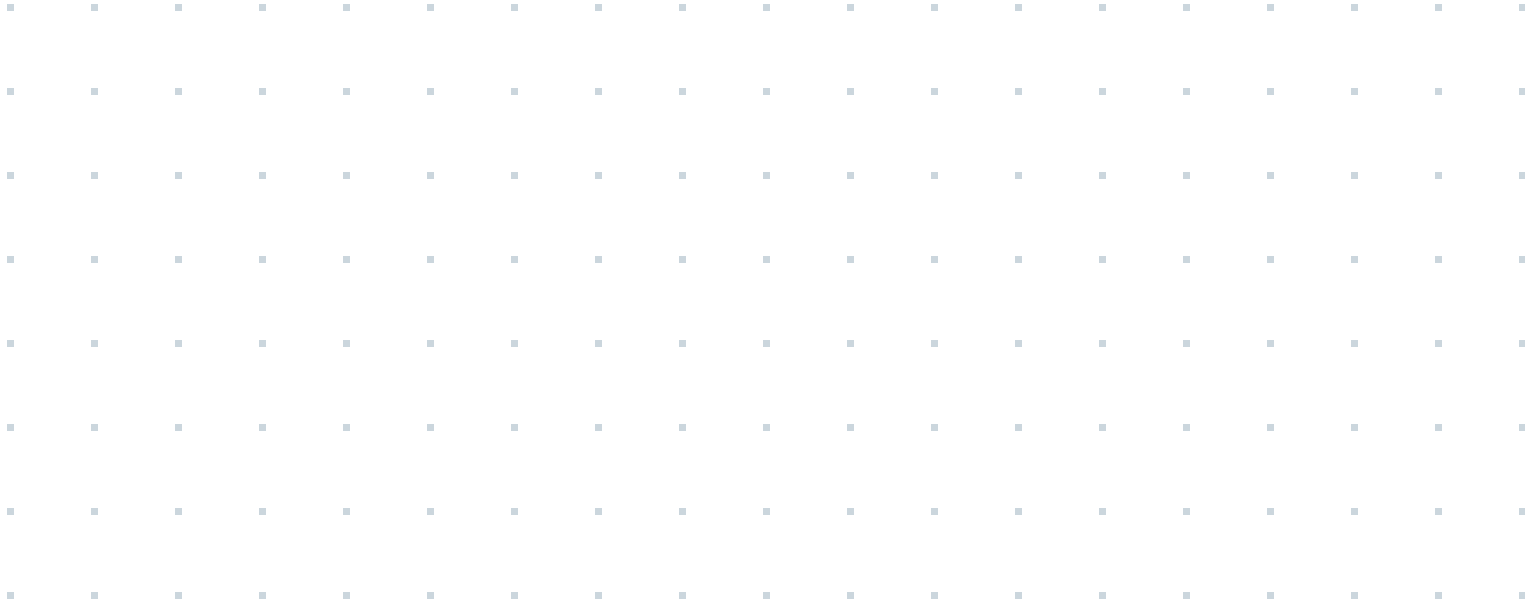


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