CIRCULAR 089-21
May 18, 2021

REQUEST FOR COMMENTS

AMENDMENTS TO THE RULES OF BOURSE DE MONTREAL INC. CONCERNING EQUITY INDEX & SHARE FUTURES EXCHANGE FOR RISK ("EFR") TRANSACTIONS

On May 11, 2021, the Rules and Policies Committee of Bourse de Montréal Inc. (the "**Bourse"**) approved amendments to Article 6.208 of the Rules of the Bourse concerning equity index and share futures Exchange for Risk ("EFRs") transactions in order to bring clarity to the types of equity index swaps that are permitted within EFR rules and provide more flexibility.

Comments on the proposed amendments must be submitted at the latest on **June 18, 2021**. Please submit your comments to:

Alexandre Normandeau
Legal Counsel
Bourse de Montréal Inc.
1800-1190 av des Canadiens-de-Montréal
P.O. Box 37
Montreal, Quebec H3B 0G7
E-mail: legal@tmx.com

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

Me Philippe Lebel
Corporate Secretary and
Executive Director, Legal Affairs
Autorité des marchés financiers
Place de la Cité, tour Cominar
2640 Laurier boulevard, suite 400
Québec (Québec) G1V 5C1
Fax : (514) 864-8381
E-mail: consultation-en-cours@lautorite.qc.ca

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).

THE FUTURE IS YOURS TO SEE.

AMENDMENTS TO THE RULES OF BOURSE DE MONTREAL INC. CONCERNING EQUITY INDEX & SHARE FUTURES EXCHANGE FOR RISK ("EFR") TRANSACTIONS

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I. DESCRIPTION

Bourse de Montreal (the "Bourse") is proposing to modify its rules concerning the characteristics of acceptable index swap instruments involved in equity index and share futures Exchange for Risk ("EFRs") transactions. The changes come as a result of feedback received from both approved participants and internal stakeholders within the Bourse who wish to bring clarity to the types of equity index swaps that are permitted within EFR rules and to provide more flexibility by reducing the correlation percentage of the swap instrument to the underlying index deemed as too stringent compared to other futures exchanges.

II. PROPOSED AMENDMENTS

The Table of types of futures contracts and acceptable OTC derivative instrument for EFRs within Paragraph c) of article 6.208 of the Rules of the Bourse is proposed to be amended as follows:

1. replace the term "Plain vanilla swap" by "Total Return swap" in the characteristic of acceptable index swaps for stock index futures and share futures;
2. lower the minimum correlation from 90% to 70% of acceptable index swaps for stock index futures.

III. ANALYSIS

a. Background

An Exchange of Futures for Related Products ("EFRP") transaction involves a privately negotiated off-exchange execution of an Exchange futures or options contract and, on the opposite side of the market, the simultaneous execution of an equivalent quantity of the cash product, by-product, related product, or OTC derivative instrument corresponding to the asset underlying the Exchange contract.

One party to the EFRP must be the buyer of the Exchange contract and the seller of the related position; the other party to the EFRP must be the seller of the Exchange contract and the buyer of the related position. The Exchange contract and the corresponding related position must be executed for accounts with the same beneficial ownership.

As stated above, an EFR consists of the simultaneous execution of a Futures Contract and a corresponding OTC swap or other OTC derivative transaction.

The Bourse currently recognizes plain vanilla swaps as an acceptable OTC derivative instrument for stock index future EFRs. The issue with this is that plain vanilla swaps are typically associated with interest rate products in which the cash flows are based on the interest payments made on a nominal sum known as the principal or notional. The interest payments can be made at different rates, can be fixed or floating and can be made at different frequencies. A vanilla (or plain) swap normally involves exchanging fixed and floating rate payments on the same currency.

A Total Return swap ("TRS"), on the other hand, is where two counterparties swap the total return of a single asset or basket of assets in exchange for periodic cash flows, typically a floating rate such as LIBOR +/- a spread and a guarantee against any capital losses. A TRS is similar to a plain vanilla swap except the deal is structured such that the total return (cash flows plus capital appreciation/depreciation) is exchanged, rather than just the cash flows.

For example, two parties may enter into a one-year total return swap where Party A receives LIBOR + fixed margin (2%) and Party B receives the total return of the S&P TSX 60 on a principal amount of $1 million. If LIBOR is 0.5% and the S&P TSX 60 appreciates by 5%, Party A will pay Party B 5% and will receive 2.5%. The payment will be netted at the end of the swap with Party B receiving a payment of $25,000 ($1 million x 5% - 2.5%).

Total return swaps allow the party receiving the total return to gain exposure and benefit from a reference asset without actually having to own it. These swaps are popular with hedge funds because they get the benefit of a large exposure with a minimal cash outlay.

Due to the difficulty of evaluating OTC Derivative instruments[1,2] as potential result of illiquidity and possible wide swings in valuation caused by changes in the value of the underlying reference instrument, it can be an unreasonable constraint to market participants to achieve quasi-perfect correlation (represented by current 90% requirements) between the OTC product and the exchange-traded index futures contract. As a result, many exchanges have moved away from requiring a specific correlation minimum and replaced their rules with language that states that an EFR's OTC derivative instrument has a "reasonable" degree of price correlation to the commodity underlying the Exchange contract.

b. Objectives

In order to supplement and strengthen our EFRP rules, it is of utmost importance to deliver uniform and consistent procedures throughout our rules concerning exchange for related products. In addition, the need for clarity in Bourse procedures is essential to our market participants to pursue business objectives without uncertainty and ambiguity and allows The Bourse's Market Operations Department to provide continuous exceptional service without hesitation and undue limitations.

Here are the objectives:

1) Include the term "Total Return swap" as an acceptable OTC derivative instrument for stock index EFRs. Although its definition is included in EFR Bourse rules (*Regular fixed against floating rate payments against the positive or negative performance of a stock, exchange-traded fund (ETF), basket of Securities or a stock Index),* the omission of its term led to confusion amongst participants over its acceptance.

   In addition, it is proposed to remove the term "plain vanilla swap" as an acceptable OTC instrument for stock index EFRs as it is more analogous to interest rate or currency derivatives.

[1] https://www.math.nyu.edu/faculty/avellane/EquitiesTransparency-Study.pdf

[2] https://www.ivsc.org/files/file/download/id/192

2) Decrease the required correlation for stock index EFR from 90% to 70%. This change will align the stock index EFR rules with the ones for Interest rate swap correlation policies as cited in Bourse Rule 6 on Trading, Chapter C, article 6.208 (b)(c)[3].

The Bourse's current correlation requirement of 90% is typically associated with Equity Index Exchange for Physical ("EFP") transactions. In an EFP, the asset exposure represented by the cash leg must be identical to that which underlies the futures leg. This is not the case for an Exchange for Risk ("EFR") transaction, which consists of the simultaneous execution of an Exchange futures contract and a corresponding OTC swap or other OTC derivative transaction.

c. Comparative Analysis

Our review of global exchanges EFRP policies has revealed that:

- CME and ICE have almost identical procedures for EFRPs. Both exchanges do not set specific correlation % for equity index futures EFRs. Instead Rule 538C[4] of the CME states: *"The related position component of an EFRP must be the cash commodity underlying the Exchange contract or a by-product, a related product or an OTC derivative instrument of such commodity that has a reasonable degree of price correlation to the commodity underlying the Exchange contract.".* For further information regarding CME swap definitions, the Bourse refers participants to the August 13, 2012 Federal Register release (77 FR 48207) that defines swaps and the scope of the forward contract exclusion[5]. Instruments acceptable as the related position component of a stock index EFRP include stock baskets provided the basket is highly correlated to the index and, further, that the basket represents at least 50% of the underlying index by weight or includes at least 50% of the stocks in the underlying index. The notional value of the basket must be approximately equal to the value of the corresponding exchange contract.

- On Eurex, EFRs are known as Exchange for Swaps ("EFS"). Cash transactions in EFS Trades for equity indexes are equity index swaps with the following characteristics[6]:
    - The share basket reflected via the swap shall be composed of at least ten different index components or a number of shares which represent at least half of the equity index underlying the futures contract
    - The market value of the part of the share basket reflected via the swap whose values are part of the equity index underlying the futures contract shall be at minimum 20 percent of the market value of the entire cash transaction

d. Analysis of Impacts

i. Impacts on Market

Below are the foreseeable impacts on the market:

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3 https://rules.m-x.ca/w/mx/en#!b/a6_208

4 https://www.cmegroup.com/content/dam/cmegroup/rulebook/CME/I/5/5.pdf

5 https://www.govinfo.gov/content/pkg/FR-2012-08-13/pdf/2012-18003.pdf

6 https://www.eurex.com/ex-en/trade/eurex-t7-entry-services/exchange-for-swaps

1) Maintain consistency throughout North American derivatives exchanges in applying similar EFR procedures for its equity index futures instruments.

2) Responding to client feedback quickly and attentively to avoid any disruptions and inconsistencies in procedural interpretation. Market participants have been leading catalysts in getting the Bourse to adopt clear rule modifications in a quick and decisive manner.

3) Strive to achieve uniformity across our EFRP rules for the Bourse's derivative products.

ii. Impacts on Technology

The proposed changes should have no impact on the technological activities of the Bourse.

iii. Impacts on regulatory functions

The proposed changes should have no material impact on the activities of the Regulatory Division of the Bourse. The Division reviews and monitors EFRP's transactions.

iv. Impacts on clearing functions

These rule amendments will have no impact on the clearing functions of CDCC.

v. Public Interest

The Bourse is of the view that the proposed amendments are not contrary to the public interest. Market participants will have a clearer picture of equity index futures EFR procedures which will alleviate potential confusion and enhance opportunities to increase EFR activity at the Bourse[7] for the aforementioned product.

IV. 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.

V. ATTACHED DOCUMENTS

Proposed amendments to the rules.

[7] No EFR stock index activity has been recorded on the Bourse in 2021 as of April 8, 2021

Article 6.208 Exchange of Futures for Related Products

(a) EFRP Transactions in general. Exchanges of Futures for Related Products ("EFRP") Transactions involving Futures Contracts listed and traded on the Bourse are permitted if such Transactions are executed in accordance with the requirements of this Article. An EFRP Transaction is composed of the privately negotiated execution of a Bourse Futures Contract and the opposite, simultaneous execution of an approximately equivalent quantity or value of cash product, by-product, related product, or Over-The-Counter ("OTC") Derivative Instrument underlying the Futures Contract.

(i) An EFRP Transaction is permitted to be executed off of the Trading System pursuant to Article 6.204 if such Transaction is conducted in accordance with each of the requirements and conditions of this Article.

[...]

(c) EFRs. EFR Transactions on the following Futures Contracts and the related OTC Derivative Instrument are recognized by the Bourse:

Types of Futures Contracts	Acceptable Over-the-Counter Derivative Instrument
[...]	
Stock Index	i) Index Swaps with the following characteristics: • ~~Plain vanilla~~ Total return swap, • Written under the terms of an ISDA® Master Agreement, • Regular fixed against floating rate payments against the positive or negative performance of a stock, exchange-traded fund (ETF), basket of Securities or a stock Index, • Denominated in currency of G7 country, and • Correlation R= 0.~~9~~70 or greater, using a generally accepted methodology; or ii) Any individual or combination of OTC equity or stock Index option positions; or iii) Index Forwards: Standard equity forward contract between two counterparties to buy a specific quantity of a stock, exchange-traded fund (ETF), basket of Securities or stock Index at a predetermined price for settlement at a future date.

Shares	i) Equity Swaps with the following characteristics: • ~~Plain vanilla~~ Total return swap, • Written under the terms of an ISDA® Master Agreement, • Regular fixed against floating rate payments against the positive or negative performance of a stock, exchange-traded fund (ETF), trust unit, basket of Securities or a stock Index, • Denominated in currency of G7 country; or ii) Any individual or combination of OTC equity Option positions; or iii) Equity Forwards: Standard equity forward contract between two counterparties to buy a specific quantity of a stock, exchange-traded fund (ETF), trust unit, basket of Securities or stock Index at a predetermined price for settlement at a future date.
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