CIRCULAR 137-20
August 12, 2020

REQUEST FOR COMMENTS

AMENDMENTS TO THE RULES OF BOURSE DE MONTREAL INC. TO MODIFY THE NOMINAL VALUE OF THE TWO-YEAR GOVERNMENT OF CANADA BOND FUTURES (CGZ)

On May 11, 2020, the Rules and Policies Committee of Bourse de Montréal Inc. (the "**Bourse**") approved amendments to the Rules of the Bourse in order to modify the nominal value of the Two-Year Government of Canada bond futures ("CGZ").

Comments on the proposed amendments must be submitted at the latest on **September 14, 2020**. Please submit your comments to:

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

M^{e} Philippe Lebel
Corporate Secretary and
Executive Director, Legal Affairs
Autorité des marchés financiers
Place de la Cité, tour Cominar
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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).

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TABLE OF CONTENTS

I. DESCRIPTION

Bourse de Montréal Inc. (the Bourse) hereby proposes to modify the nominal value of the Two-Year Government of Canada bond futures (“CGZ”) from C$200,000 to C$100,000 of Government of Canada (“GoC”) bonds with a 6% notional coupon, in order to better reflect market conditions and stimulate more activity on the contract. The Bourse considers that a well-functioning CGZ market is desirable for the growth of its products and wishes to ensure its contract design is in line with the needs of its market participants. Therefore, the Bourse proposes to implement the proposed amendment before revitalizing its CGZ contract, currently planned in the second half of 2020. The Bourse believes this proposed amendment will better serve the needs of market participants and will offer greater market efficiency.

Contract specifications of the CGZ contract were changed multiple times since the product’s introduction in 2004, in an attempt to stimulate product acceptance by market participants. Throughout the years, The Bourse has implemented changes to the contract nominal value, notional coupon and delivery standards. However, these modifications, alongside different incentive programs, have had limited success as the CGZ contract average daily volume per year oscillated between 0 and 900 contracts from 2004 to 2015. In fact, the product has not seen any activity since 2016. Nevertheless, the Bourse is encouraged by the success of its Five-Year Government of Canada bond futures relaunch in December 2018 and believes it can recreate a similar model for the CGZ contract. Furthermore, as a result of the changing market environment and of the successful Five-Year Government of Canada bond futures revitalization, multiple Canadian and foreign participants have requested that the Bourse puts efforts in developing the CGZ contract. This feedback was the result of trading opportunities in the two-year segment of the Canadian yield curve that have become evident to the aforementioned parties.

The reduction of the CGZ nominal value is proposed and supported by market participants as it would allow two important features:

- The ability by the Bourse to list curve spread strategies alongside the liquid Five-Year (“CGF”) and Ten-Year (“CGB”) Government of Canada bond futures.
- The reduction in the tick value of the contract, enabling more price precision

II. PROPOSED AMENDMENTS

The Bourse proposes to amend Article 12.100 of the Rules, reducing the nominal value of the CGZ contract. Specifically, the Bourse aims to change the nominal value of the CGZ underlying Government of Canada bond from C$200,000 to C$100,000.

Table 1: Proposed modifications to the CGZ specifications

Specification	Current	Proposed
Underlying Interest	The Underlying Interest is $200,000 nominal value of a Government of Canada Bond with a 6% notional coupon.	The Underlying Interest is $100,000 nominal value of a Government of Canada Bond with a 6% notional coupon.

In order to determine the appropriate nominal value for the CGZ contract, the Bourse surveyed market participants and benchmarked its product design with comparable products at major international derivatives exchanges. The Bourse also took into consideration technological enablers, notably the ability to list inter-group strategies ("IGS")[1] for products having the same underlying nominal value and tick value (minimum price fluctuation value).

III. ANALYSIS

a. Background

The CGZ contract was listed in May 2004 and at that time, the contract size was C$100,000 with a notional coupon of 6%. The CGZ had been introduced in an effort to provide a tradable transparent GoC listed yield curve offering, thereby providing approved participants and their clients with increased spread trading opportunities.

On November 17, 2004[2], the Bourse amended the delivery terms by:

- Including originally issued 10-year GoC bonds in the basket of deliverables due to the limited amount outstanding of 2-year GoC bond issues.
- Reducing the minimum price fluctuation from 0.01 (C$10) to 0.005 (C$5)

On July 24, 2006[3], the Bourse amended the contract size from C$100,000 to C$200,000 to harmonize the contract with the 2-year US treasury bond futures contract. The notional coupon was also reduced from 6% to 4% and the minimum amount outstanding for GoC bonds eligible for inclusion in the basket of deliverables was reduced from C$3.5 billion to C$2.4 billion.

Finally, on September 1, 2010[4], the Bourse:

- Changed the notional coupon rate for the CGZ contract from 4% back to 6%.
- Excluded 5-year and 10-year GoC bonds from the basket of deliverable bonds.

All of the above changes were made to improve the attractiveness of the CGZ contract while fostering liquidity. However, these efforts proved to be relatively unsuccessful, as illustrated by figure 1 below. Note that the highest average daily volume on record, which was 1,306 contracts, coincided with the launch year of the CGZ. The contract continued to trade until 2007 following which, as of 2008 and until end of 2009, it saw no volume; light trading resumed in 2010 and continued through to 2015.

The successful contract launch in 2004 could have been facilitated by the fact that two large Canadian banks were designated as market makers. The increase in volume in 2011, following zero volume in 2008 and 2009, could be attributable to the Bourse's launch of the Yield Curve Project, which saw the contracting of five firms, for a period of 5 years, regarding the market making of: 1) the BAX's second and third year quarterly expiries, 2) the CGZ, and 3) the CGF. À

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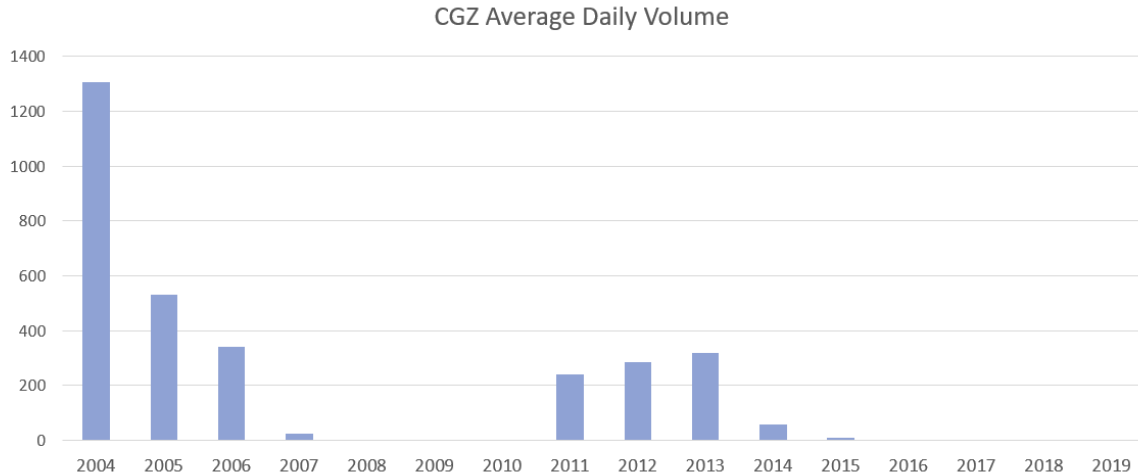
[1] Inter-group strategies combine instruments from different groups in the trading engine. They allow the component instruments (or legs) to trade simultaneously, and only simultaneously, in a single transaction.

[2] https://www.m-x.ca/f_circulaires_en/150-04_en.pdf

[3] https://www.m-x.ca/f_circulaires_en/136-06_en.pdf

[4] https://www.m-x.ca/f_circulaires_en/105-2010_en.pdf

Figure 1: CGZ contract historical average daily volume ("ADV")



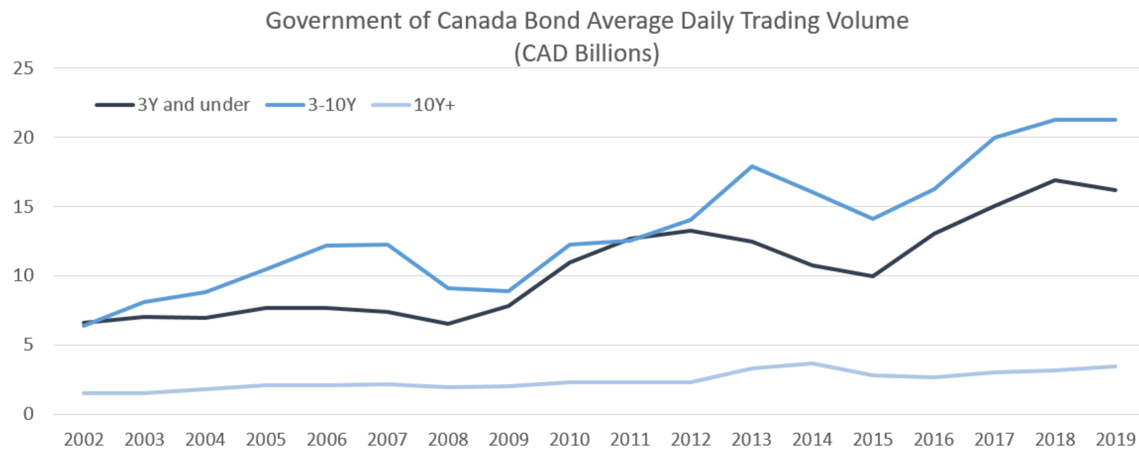
Source: Montreal Exchange

Following the successful revitalization of the CGF contract in December 2018, the Bourse believes that the conditions are right to undertake another attempt at developing the CGZ contract given that:

- Fixed income participants have no way of accessing the two-year segment of the Canadian yield curve, nor hedge exposure or leverage a market view, via an efficient futures market.
- The two-year segment of the Canadian curve is heavily traded in the cash market. GoC secondary market bond trading of maturities less than three years represent approximately 40% of the total GoC bond market.
- Providing a liquid two-year bond futures will further foster the development of the CGF and CGB futures contracts, as well as the BAX futures contract and eventually CORRA futures. A liquid two-year GoC bond futures will bridge the gaps between short-term products and the pivotal five year point of the curve (CGF), thereby enabling multiple trading strategies amongst fixed income futures products.
- The two-year US Treasury futures are the fastest growing Treasury futures contracts in volume and open interest in the last five years.

Based on IIROC statistics, over C$16B of GoC bonds with maturities less than three years are traded on a daily basis. That figure has doubled in the last 10 years.

Figure 2: Government of Canada bonds average daily trading volume



Source: IIROC statistics

Table 2: 2019 Government of Canada bonds average daily trading volume (and %)

3 years and under	3-10 years	Over 10 years
16.24B (40%)	21.28B (52%)	3.48B (8%)

Source: IIROC statistics

Furthermore, as part of recent business development activities, the Bourse has received very positive feedback from market participants concerning a possible revitalization of the CGZ contract. The early interest for both trading the product and potential partnerships is encouraging. Target clients (buy-side, bank desks, proprietary traders, etc) are for the most part already trading the CGF and CGB contracts; we do not see any major impediment for them to also integrate the CGZ contract into their portfolio management practices.

b. Objectives

The Bourse proposes to change the nominal value of the contract back to C$100,000 of GoC bonds in order to fulfill the following objectives:

- Enable inter-group strategies (IGS) with CGF and CGB contracts.
- Reduce the tick value to C$5 (0.005 = C$5), thereby enabling more trading granularity
- Make the product more suitable for smaller market participants, thereby increasing trading/hedging precision.
- Align with the underlying notional value of EUR (Euro-Schatz) and UK (Short Gilts) two-year Government bond futures and with AUD three-year Commonwealth Government Treasury bonds futures.

The global objective is to strengthen the functioning of the Canadian derivatives market and better serve the interests of market participants. Specifically, the relaunch of the CGZ contract aims to:

- Facilitate greater market efficiency through the offering of an additional point on the Canadian listed yield curve, allowing clients to trade multiple strategies (speculators and hedgers).
- Develop a listed and transparent alternative to the over the counter two-year Canadian interest rate market.
- Grow and strengthen the Bourse's fixed income product line.
- Promote transparent, exchange-traded products with regulatory oversight and backing.
- Offer greater diversity and attract additional trading from a broader set of users to the benefit of the entire market.

c. Comparative Analysis

Table 6 demonstrates that many other major international short-term Government bond futures contracts have a nominal value equivalent to $100,000 in their own currency, which is aligned with the modification proposed by the Bourse. The CGZ tick value would become equivalent to five Canadian dollars, similar, not considering the currency type, to that of the well functioning Euro-Schatz contract[5].

Table 3: 2019 - Benchmarking of short-term Government bond futures

Exchange (Futures contract)	Nominal value of the contract	Tick size and tick value of the contract
MX (CGZ)	Current: C$200,000 nominal value of a Government of Canada bond Proposed: C$100,000 nominal value of a Government of Canada bond.	Current: 0.005 = C$10 Proposition: 0.005 = C$5
CME (2Y US Treasury futures)	U.S. Treasury notes having a face value at maturity of two hundred thousand dollars ($200,000)	(⅛) of (1/32) of one point= $7.8125
EUREX (Euro-Schatz)	EUR 100,000 Notional short-term debt instruments issued by the Federal Republic of Germany, the Republic of Italy, the Republic of France, the Kingdom of Spain or the Swiss Confederation	0.005 = EUR 5
ICE (Short-Gilt)	GBP 100,000 nominal value notional of short-term Gilt bonds	0.01 = GBP 10
ASX (3Y AUD bond futures	Commonwealth Government Treasury Bonds with a face value of A$100,000.	0.005 = approximately AUD 15 per contract (varying with the level of interest rates)

Source: Exchanges websites

[5] Average daily volume and open interest in 2019 were 355,639 and 1,342,874 contracts respectively.

d. Analysis of Impacts

i. Impacts on Market

Since the product has not seen any activity in recent years, impacts on the market are considered minimal. The proposed modification to the nominal value of the CGZ contract should enhance the attractiveness of CGZ mainly because as stated previously, it will enable inter-group strategies with other liquid Government of Canada bond futures, namely the CGF and the CGB contracts. This is a desirable feature for the product revitalization as it should help initial liquidity. IGS across the Bourse's GoC bond futures product suite is also requested by market participants as it enables multiple benefits:

- Ability to trade multi-legged strategies from different instrument groups.
- Elimination of execution risk when trading multi-legged strategies: No one leg of the strategy will be executed unless all legs are executed at the prices and ratios specified.
- Interaction of the strategy book with the regular outright order book through the implied pricing functionality, improving the fill rate and overall liquidity for both outright trades and strategies.

The proposed modification will also reduce the tick value from 0.005 = C$10 to 0.005 = C$5. This is desirable to be competitive with the two-year segment of the cash bond market and other similar OTC products. A lower tick value would make the contract more efficient from a hedging cost point of view. A smaller tick value reduces slippage (the difference between the expected price of a trade and the executed price of the trade), providing greater price precision for all market participants. The Bourse operates in a highly competitive environment (vs OTC markets) and the tick value of futures contracts is a key determinant to its success. There is little incentive to use the CGZ contract if the tick value is too high and competing products have much tighter bid-ask spreads. Therefore, a smaller tick value would provide better execution and cost efficiency to market participants.

The position limits for the Bourse's GoC bond futures are based on the amount outstanding of the deliverable baskets. In calculating the applicable position limits for the CGZ, the proposed modification to the nominal value of the CGZ will result in an increase to position limits published. Note that position limits (all expiries combined) are published at the beginning of each month and that first contract month position limits are published just prior to the beginning of each delivery month (March, June, September and December).

Market participants surveyed are aware of these impacts and this should not represent an impediment for them to trade the contract and hold the position desired for their different strategies.

ii. Impacts on Technology

The proposed changes should have no impact on the technological systems of the Bourse, CDCC, approved participants, independent software vendors, or any other market participants. The Bourse has not identified any impediments, whether technical, operational or other, to the implementation of the proposed amendment. Eventually, as the CGZ gains traction, new yield curve strategies could be listed by the Bourse, which may require technological development and push more technology vendors to write to new trading functionalities.

iii. Impacts on regulatory functions

Other than the changes in the published position limits for the CGZ, the proposed changes should have no impact on the regulatory functions of the Bourse.

iv. Impacts on clearing functions

The proposed changes will require a similar amendment to CDCC's Rules in order to take into account the modified nominal value of the CGZ.

v. Public Interest

The Bourse is of the view that the proposed amendment is not contrary to the public interest. In fact, the public and market participants are generally requesting clear rules that are consistent with the best practices of other international derivatives exchanges.

The Bourse's proposal should attract additional trading volume by offering market participants an improved contract design. A contract that is better tailored to participants' requirements will be more liquid and will attract more activity to the transparent and centrally-cleared futures market. The Bourse considers this amendment to be in the interest of the public as it will increase the efficiency of the CGZ contract, providing better trading and hedging practices for market participants.

IV. PROCESS

The proposed amendment, 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 regulatory self-certification process, and to the Ontario Securities Commission for information purposes. Subject to public comments, the proposed amendment will take effect immediately thereafter.

V. ATTACHED DOCUMENTS

Proposed rule changes.

Blackline version

Chapter B - Two Year Government of Canada Bond Futures

Article 12.100 Underlying Interest

The Underlying Interest is $~~200~~100,000 nominal value of a Government of Canada Bond with a 6% notional coupon.

Clean version

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Article 12.100 Underlying Interest

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