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| <input checked="" type="checkbox"/> | Trading – Interest Rate Derivatives | <input checked="" type="checkbox"/> | Back-office - Options |
| <input checked="" type="checkbox"/> | Trading – Equity and Index Derivatives | <input checked="" type="checkbox"/> | Technology |
| <input checked="" type="checkbox"/> | Back-office – Futures | <input checked="" type="checkbox"/> | Regulation |

CIRCULAR
September 28, 2006

REQUEST FOR COMMENTS

EXCHANGE FOR RISK (EFR) TRANSACTIONS

PROPOSED NEW ARTICLE 6815A AND AMENDMENTS TO ARTICLE 6005

Summary

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) has approved new article 6815A and amendments to article 6005 of the Rules of the Bourse, which deal with Exchange for Risk (EFR) transactions. The objectives of these amendments are to offer market participants the added flexibility for adjusting or unwinding existing positions, and initiating new positions, in either Over-The-Counter (OTC) derivatives or the equivalent Bourse futures contracts and to respond to customer needs to conduct these trades in a secure and transparent marketplace.

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.: 162-2006

The Board of Directors of the Bourse has the power to approve the adoption or amendment of various Rules and Policies of the Bourse. 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. These changes are submitted to the Autorité for approval.

Comments on the proposed new article 6815A and amendments to article 6005 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
P.O. Box 61, 800 Victoria Square
Montréal, Quebec H4Z 1A9
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
P.O. Box 246, Tour de la Bourse
Montréal (Quebec) H4Z 1G3
E-mail: consultation-en-cours@lautorite.qc.ca*

Appendices

For your information, you will find in appendices an analysis document of the proposed rule amendments as well as the proposed regulatory text together with the specifications of the SXF contract. 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”.



PROPOSED NEW ARTICLE 6815A AND AMENDMENTS TO ARTICLE 6005

EXCHANGE FOR RISK (EFR) TRANSACTIONS

A -- Proposed Amendments to the Rules

Bourse de Montréal Inc. (the Bourse or MX) proposes to add new article 6815A in Rule Six of the Bourse relative to Exchange for Risk (EFR) transactions and to amend article 6005.

B -- Rationale

Under current article 6815 of the Rules of the Bourse relating to Exchanges for Physicals (EFP), market participants can exchange a futures contract position against a position in a related physical cash instrument, normally a bond for a bond futures contract or a basket of securities for an index futures contract. The current EFP rule is restrictive in nature given the multitude of over-the-counter (OTC) products that are considered close substitutes to the Bourse's products. The Bourse would like to extend the scope of its Rules to allow market participants to simultaneously exchange a futures contract position against an OTC derivative position such as a swap, forward rate agreement or other closely related financial instrument.

Essentially, the proposed regulatory amendment would allow holders of OTC derivatives and/or swap agreement positions to exchange them against an equivalent futures contract listed on the Bourse. For example, an OTC Forward Rate Agreement (FRA) with a 3-month term and a \$1 million notional value could be deemed acceptable for exchange with a BAX futures contract. Or, an OTC interest rate swap could be deemed acceptable for exchange with a strip or a bundle of BAX futures contracts of a similar term.

The proposed new article 6815A would:

- 1) provide market participants with greater flexibility for unwinding existing positions or initiating new positions, in either OTC derivatives or the equivalent Bourse futures contracts; and
- 2) attract untapped OTC business to the Bourse.

Proposed new article 6815A entitled Exchange for Risk (EFR) Transactions will apply to both interest rate and equity related Bourse futures contracts.

Since EFRs are off-exchange transactions, in addition to adding new article 6815A, it is necessary to amend article 6005 of the Rules of the Bourse. Article 6005 prohibits the execution of off-exchange transactions in securities or derivative instruments listed on the Bourse except in specific cases. For instance, paragraph m) of this article permits the execution of EFPs pursuant to article 6815.

It is therefore proposed to amend paragraph m) of article 6005, which will become paragraph c), so that EFRs executed pursuant to proposed new article 6815A be added to the list of permitted off-exchange transactions.

In addition, it is proposed to delete most paragraphs of article 6005 because the provisions are only applicable in the context of a stock market.

It is proposed to amend paragraphs c), f) and n), which will become paragraphs a), b) and d), in order to clarify and harmonize the language used.

Also, it is proposed to add paragraph e) in order to include block trades executed according to article 6380 in the permitted off-exchange transactions.

The OTC Interest Rate Derivatives Market in Canada

The market for OTC interest rate products in Canada is very large as is demonstrated by data published by the Bank of Canada on a triennial basis regarding the average daily turnover and

notional amount outstanding of OTC interest rate derivatives in Canada cited below. It is to be noted that in 2004 there were more than US\$4 trillion in outstanding interest rate derivatives contracts in the OTC market in Canada with an average daily turnover of US\$12 billion. By comparison, the notional amount outstanding of all Bourse interest rate futures and options contracts was US\$623 billion as of July 31, 2006.

Over-the-counter (OTC) derivatives notional amount outstanding in Canada

Notional amount outstanding in billions of U.S. dollars

| Interest Rate Derivatives | | | | |
|---------------------------|------|---------------------|---------|-------|
| | FRAs | Interest Rate Swaps | Options | Total |
| 2001 | 278 | 1 928 | 345 | 2 551 |
| 2004 | 583 | 2 974 | 474 | 4 031 |

Source: Bank of Canada Triennial Survey of OTC Derivatives Markets

Over-the-counter (OTC) derivatives market turnover in Canada

Average daily turnover in billions of U.S. dollars

| Interest Rate Derivatives | | | | |
|---------------------------|------|---------------------|---------|-------|
| | FRAs | Interest Rate Swaps | Options | Total |
| 1995 | 3.0 | 1.0 | 0.3 | 4.3 |
| 1998 | 2.4 | 2.9 | 1.1 | 6.4 |
| 2001 | 2.9 | 6.1 | 0.9 | 9.9 |
| 2004 | 3.4 | 7.3 | 1.4 | 12.1 |

Source: Bank of Canada Triennial Survey of OTC Derivatives Markets

Bourse de Montréal Interest Rate Futures & Options Contracts

Average Daily Turnover and Notional Amount Outstanding in billions of U.S. dollars (Jan-July 2006)

| MX- Interest Rate Futures & Options Contracts | | |
|---|------------------------|-----------------------------|
| | Average Daily Turnover | Notional Amount Outstanding |
| BAX | 62 | 481 |
| CGB | 3 | 25 |
| OBX | 3 | 117 |

Source: Bourse de Montréal

C – Objectives

The objectives of the proposed new article 6815A of the Rules of the Bourse that relate to exchange for risk and of the proposed amendment to paragraph m) of article 6005 to include EFRs in the list of off-exchange transactions permitted by the Bourse are:

- 1) to offer market participants the added flexibility for adjusting or unwinding existing positions, and initiating new positions, in either OTC derivatives or the equivalent Bourse futures contracts; and
- 2) to respond to customer needs to conduct these trades in a secure and transparent marketplace.

For illustrative purposes, the following table highlights the different exchanges that allow market participants to exchange OTC derivatives for exchange traded futures contracts:

| Exchange | (Exchange for Swap / Exchange for FRA / Exchange for Risk) |
|-----------------------------|--|
| MX | |
| EUREX | √ |
| EURONEXT | √ |
| CBOT | √ |
| CME | √ |
| SFE | √ |
| NYMEX | √ |
| Winnipeg Commodity Exchange | √ |

D – Impact of the Proposed Rule

The proposed new article 6815A and the related proposed amendment to article 6005 will allow market participants to combine access to the Bourse's interest rate, stock index futures and single stock futures contracts with their closely related OTC derivatives products, increasing the flexibility of the Bourse's products as a risk management tool. The other amendments to article 6005 will clarify and harmonize the language used and ensure consistency with other sections of the Rules.

E -- Public Interest

The proposal is in the public interest because it is designed to make it more efficient for participants to manage their risk exposures by combining OTC derivatives with futures contracts.

F -- Process

The staff of the Bourse recommends to the Rules and Policies Committee approval of proposed new

article 6815A and of proposed amendments to article 6005 of the Rules of the Bourse.

G – List and Characteristics of the OTC Instruments Acceptable for EFR Transaction Purposes

Following the approval of new article 6815A and the related proposed amendment to article 6005, the Bourse will publish in a circular the list of permissible OTC instruments and the acceptable characteristics of these instruments as described in Appendix I. This information will also be available and updated on the Bourse's website.

H – References:

- Rules of Bourse de Montréal Inc – Articles 6815 – Exchanges for Physicals (E.F.P.) and 6005 – Off-Exchange Transactions
- Winnipeg Commodity Exchange - Rule 8C.04: - Exchange for Risk
- CBOT - Rule 331.08 - Exchange of Futures for Related Transactions
- NYMEX - Rule 6.21A - Exchange of futures for, or in connection with swap transactions
- Euronext - Interest rate products (Basis trading facility)
- Bank of Canada – Triennial Surveys of OTC Derivatives Markets

Exchange for Risk: List of permissible OTC instruments

| | Bond Futures | Short-Term Interest Rate Futures | Stock Index Futures | Equity / Index Options |
|--|-----------------|--|------------------------|---------------------------|
| Vanilla Interest Rate Swaps | √ | √ | | |
| Equity Swaps | | | √ | √ |
| Forward Rate Agreements - FRAs | | √ | | |
| OTC Options (and Strategies) on any of the available OTC derivatives instruments above | √ | √ | √ | √ |

The following outlines the characteristics of OTC instruments that would be acceptable for EFR purposes.

Swaps:

Interest rate

- standard plain vanilla OTC swap;
- written under the terms of an ISDA[®] Master Agreement;
- comprised of regular fixed rate payments against regular floating rate payments;
- All swap payments must be denominated in the currency of a G7 member country;
- The OTC interest rate swaps must be highly correlated with an $R^2 = 0.90$ or greater so that the futures are a suitable instrument for hedging the OTC derivatives transaction.

Equity

- standard plain vanilla OTC swap;
- written under the terms of an ISDA[®] Master Agreement;
- comprised of regular fixed rate payments or regular floating rate payments against the positive or negative performance of a basket of securities or a stock index;
- All swap payments must be denominated in the currency of a G7 member country;
- The OTC equity swaps must be highly correlated with an $R^2 = 0.90$ or greater so that the futures are a suitable instrument for hedging the OTC derivatives transaction.

Forward Rate Agreements (FRAs):

- conventional FRA;

- written under the terms of an ISDA[®] Master Agreement;
- predetermined interest rate;
- agreed start/end date;
- have a defined interest (repo) rate.

OTC Options and OTC Option strategies:

- Any individual or combination of stock and equity index options underlying an OTC derivative can form the risk transaction component of an EFR transaction against any of the Bourse's stock index or single stock futures contracts.
- Any individual or combination of bond, interest rate swap or FRA options (e.g. caps, floors, collars) underlying an OTC derivative can form the risk component of an EFR transaction against any of the Bourse's interest rate futures contracts

Bonds Underlying an OTC derivative used in an EFR Transaction must have the following characteristics:

- fixed coupon rate;
- bullet maturity issue (a coupon paying bond with no repayment of principal until maturity);
- no embedded optionality or early redemption features;
- an ISIN code;
- fixed principal amount;
- denominated in the currency of a G7 member country.

Stock Baskets Underlying an OTC derivative used in an EFR Transaction must have the following characteristics:

- be highly correlated to the underlying index with an $R^2 = 0.90$ or greater;
- represent at least 50% of the underlying index by weight; or, include at least 50% of the stocks of the underlying index;
- have a notional value fairly equal to the value of the futures contract component of the transaction;
- exchange traded funds (ETFs) are acceptable provided that they mirror stock index products traded on the Bourse.

6815A Exchange for Risk (EFR) Transactions

(00.00.06)

- a) An exchange of a futures contract for, or in connection with an over-the-counter (OTC) derivative instrument and/or swap agreement (an Exchange for Risk (EFR) transaction) consists of two discrete, but related simultaneous transactions: a risk transaction and a futures contract transaction. At the time such transaction is effected, the parties to the futures contract transaction must be the same parties to the risk transaction and the buyer and the seller of the futures contract must be, respectively, the seller and the buyer of the OTC derivative instrument and/or swap agreement. The risk component of the EFR transaction must involve an OTC derivative instrument and/or swap agreement that is related to and that has a reasonable price correlation with the underlying interest of the futures contract being exchanged. The quantity or value covered by the risk component of the EFR transaction must be approximately equivalent to the quantity or value covered by the futures contract.
- b) Each party to an EFR transaction must satisfy the Bourse, upon request, that the transaction is a bona fide EFR transaction. To this effect, parties to an EFR transaction must maintain all documentary evidence relating to such transaction and must provide such documentary evidence to the Bourse upon its request.
- c) An EFR transaction may be made at such prices as are mutually agreed upon by the parties to the transaction. However, the futures contract leg of an EFR transaction between two different approved participants must be priced within the high and low prices of the trading session during which the EFR transaction is deemed to have been reported to the Bourse.
- d) An EFR transaction executed during the trading hours of the related futures contract must be submitted to the Bourse on the same business day. An EFR transaction executed after the close of trading of the related futures contract must be submitted to the Bourse no later than 10:00 a.m. on the next business day.
- e) The futures contracts that are eligible to EFR transactions, and the last day and time for executing an EFR transaction shall be determined by the Bourse.
- f) OTC derivative instruments and/or swap agreements used in an EFR transaction shall be those approved by the Bourse as acceptable for the purpose of such EFR transaction.
- g) An EFR transaction with the same legal entity on both sides of the transaction will be permitted provided the following conditions are complied with:
 - i) each of the two sides of the transaction must be under separate control; and
 - ii) the parties must be able to demonstrate that the EFR transaction was a legitimate arms-length transaction.
- h) The approved participants involved in an EFR transaction must maintain a full and complete record of such transaction, the actual transfer of possession of the OTC derivative instruments and/or swap agreements and, as the case may be, the transfer of funds related thereto. Each approved participant involved in an EFR transaction shall provide to the Bourse, upon request, all records pertaining to such

EFR transaction, including those relating to the transfer of funds related thereto and any record maintained in connection therewith. It is the responsibility of the approved participant to ensure that all EFR transactions comply with this Rule. All approved participants shall submit a signed EFR transaction report in the form prescribed by the Bourse. Such report shall be submitted to the Bourse by 12:00 noon, Montréal time, no later than one (1) business day after the day of clearing the EFR transaction.

- i) It is prohibited for any approved participant and approved person to effect an EFR transaction which is contrary to the Rules of the Bourse and which results or could result in a reported, registered or recorded price that is not a bona fide price or which is a transaction of a fictitious nature.

6005 ~~Transaction~~Opération hors bourse
(10.10.91, 19.11.93, 14.07.95, 22.11.99, 00.00.06)

Les seules ~~transaction~~opérations de valeurs ~~inscrites mobilières et instruments dérivés inscrits à la Bourse~~ qu'un ~~membre participant agréé~~ peut effectuer hors bourse sont les suivantes :

- ~~a) une transaction de contrepartie effectuée hors bourse dans le but de procéder à un placement étendu;~~
- ~~b) une transaction faite pour compte lorsque la Bourse est d'avis que les opérations, ou certains éléments particuliers tels que le prix ou l'acquisition pour fins de contrôle, le justifient ;~~
- ~~ea) une transactionopération effectuée dans le but de corriger une erreur d'exécution de l'ordre d'un client ;~~
- ~~d) une transaction effectuée à une autre bourse, à la condition que la valeur mobilière soit inscrite à cette autre bourse;~~

~~Les membres peuvent exécuter sur un marché hors bourse étranger des ordres "exécuter ou annuler" négociables sur le champ pour un compte canadien si le total des frais imputés au client, y compris des frais raisonnables de change, d'exécution et de courtage (le "prix net") est plus avantageux que le prix net établi selon le cours affiché à la Bourse au moment de l'exécution.~~

~~Pour les fins du paragraphe précédent~~

- ~~• un ordre "négociable sur le champ" est un ordre au mieux, d'acheter à un cours limité égal ou supérieur au cours de vente le plus bas au même moment, ou un ordre de vendre à un cours limité égal ou inférieur au cours d'achat le plus élevé au même moment; et~~
- ~~• Seuls The London Stock Exchange et The NASDAQ National Market System sont des marchés hors bourse étrangers où sont permises des transactions en vertu de la présente exception.~~

~~Les ordres à cours limité non négociables sur le champ ne sont pas admissibles à la présente exception.~~

~~De plus, la présente exception ne s'applique qu'aux transactions pour compte d'un seul côté du marché. Il est interdit aux membres :~~

- ~~• d'effectuer une application mettant en cause un ou plusieurs comptes canadiens; et~~
- ~~• de "rencontrer" un autre membre afin d'exécuter une transaction pour compte pour des ordres de clients canadiens, ou d'effectuer une transaction de contrepartiste avec un autre membre~~
 - ~~— sur un marché hors bourse étranger.~~
- ~~e) une transaction d'une valeur mobilière appelée pour rachat ;~~
- ~~fb) une transactionopération résultant de la levée d'une option ~~d'achat ou de vente~~, ou de la livraison relative à un contrat à terme ;~~

- ~~g) les transactions de droits de souscription (rights) et d'actions émises ou devant être émises suite à la levée de ces droits ;~~
- ~~h) les transactions de droits d'achat (warrants) et d'actions émises ou devant être émises suite à la levée de ces droits pendant une période de 30 jours ouvrables précédant la date d'expiration ;~~
- ~~i) une transaction faisant partie d'une opération de placement étendu ;~~
- ~~j) une transaction d'une valeur mobilière inscrite dont la négociation est suspendue, à moins d'interdiction de la Bourse, mais non une transaction sur une valeur inscrite dont la négociation a été différée ou interrompue ;~~
- ~~k) une transaction d'une débenture inscrite où ;
 - ~~i) la transaction provient d'un ordre dont la valeur nominale est supérieure à 10 000 \$; ou~~
 - ~~ii) la transaction peut être complétée à un meilleur prix hors bourse ;~~~~
- ~~l) une transaction effectuée à l'extérieur du Canada selon les dispositions de l'article 6006 ;~~
- ~~mc) un échange physique pour de contrats (EFP) à terme pour l'équivalent en obligations selon les dispositions de l'article 6815 ou un échange d'instruments dérivés hors bourse pour contrats selon les dispositions de l'article 6815 A ;~~
- ~~nd) un transfert hors bourse de valeurs mobilières ou d'instruments dérivés de contrats à terme selon les dispositions de l'article 6816;~~
- ~~o) une transaction qui nécessite la livraison d'un prospectus (autre qu'un prospectus pour un placement 'par l'intermédiaire de la Bourse) à l'acheteur.~~
- e) une opération en bloc de valeurs mobilières ou d'instruments dérivés tel que désignée par la Bourse et exécutée selon les dispositions de l'article 6380.