THE FUTURE IS YOURS TO SEE.®

FAQ

Regulatory Division of Bourse de Montréal Inc.

Subject: Trading in OTC Options

Rule Article: 6.12

Last Update: September 13, 2021

Questions regarding these frequently asked questions (the "FAQ") may be directed to the Regulatory Division (the "Division") of Bourse de Montréal Inc. (the "Bourse") at info.mxr@tmx.com, 514-787-6530, or toll-free at 1-800-361-5353 extension 46530.

Q1: What are over-the-counter options?

A1: Over-the-counter ("OTC") options are options contracts traded by mutual agreement between two parties without the use of an organized market. The terms of OTC options are not standardized and therefore parties have the flexibility to define their own terms. OTC options may be centrally cleared ("cleared OTC options") or not ("bilateral OTC options").

Cleared OTC options allow parties to submit their customized transactions for clearing at a central counterparty clearing house which becomes the counterparty for both the original trade parties. The venue providing clearing for OTC options determines which contract terms may be customized and how. In Canada, the Canadian Derivatives Clearing Corporation ("CDCC") provides central counterparty clearing services for OTC transactions on equity and ETF options.

Q2: Which terms of an OTC option can be customized?

A2: The following constitutes a non-exhaustive list of terms of OTC options that may be customized[1]:

[1] For bilateral OTC options, any term can be customized. For cleared OTC options, each venue offering cleared OTC options determines the terms that can be customized and the level of customization available on each of these terms.

- Strike price
  - For index options: index level, percentage of index level or other methods
  - For single-name equity or ETF options: price per share, percentage of stock or ETF unit price, or other methods
- Expiration date
- Exercise style (American, European or other styles)
- Settlement type (physical or cash settlement)
- Exercise settlement value method for cash-settled options (AM or PM settled, or other methods)
- Settlement date
- Option entitlement (i.e., number of shares per option)
- Other features (e.g., barriers)

Q3: Under which circumstances may Approved Participants and Foreign Approved Participants trade OTC options?

A3: Approved Participants and Foreign Approved Participants (collectively, "Participants") may trade OTC options when the conditions and criteria prescribed in the Rules are met, ensuring that no OTC market develops in options listed for trading on the Bourse ("Listed options").

As a general rule, Article 6.2 of the Rules, provides that:

> *"Subject to the exceptions set out in Article 6.12, (...), all Transactions in Listed Products made by Approved Participants, an affiliated corporation or a Person must take place on the Bourse during a trading session thereof."*

The exceptions set out in Article 6.12 describe when trading OTC options are permitted :

> *"(a) Notwithstanding Article 6.2, an Approved Participant or an Approved Person may make or participate in an Over-the-counter Trade in any Put or Call Option, provided that such Option:*
>
> *(i) does not relate to underlying Securities which are the object of Options issued by the Canadian Derivatives Clearing Corporation; or*
>
> *(ii) does relate to underlying Securities which are the object of Options issued by the Canadian Derivatives Clearing Corporation, but whose terms are materially different from those of any series of options issued by the Canadian Derivatives Clearing Corporation."*

Therefore, there is no restriction to trade any OTC option provided that such option does not relate to the underlying security[2] of a Listed option.

[2] An entity whose shares are listed on different venues in different currencies are considered different underlying securities. E.g. Blackberry shares listed on the Toronto Stock Exchange and Blackberry shares listed on a US marketplace are different securities.

Alternatively, when the underlying interest of the OTC option relates to an underlying security of a Listed option, the Bourse permits the trade as long as at least one term or aspect of the OTC option is materially different from that of any similar Listed option, as described in A4 and A5.

Q4: Which terms of an option contract could the Bourse consider to be "materially different"?

A4: The following are terms of an option contract that can usually be customized on venues[3] that offer clearing services of OTC options transactions[4]:

- Exercise price
- Expiration date
- Exercise style
- Settlement type

These terms are recognized in the industry as key contract terms in the context of cleared OTC options. CDCC[5] and some other foreign venues[6], offer customization on some or all of these terms.

Therefore, for purposes of subparagraph 6.12(a)(ii), it would be permitted to execute cleared or bilateral OTC options transactions that relate to the same underlying security as Listed options as long as at least one of these four terms of the OTC option is different from the same term of any similar Listed option. The Bourse may however consider additional factors when assessing whether the terms of an OTC option are materially different (see A5).

Q5: What additional factors does the Bourse consider when assessing whether the terms of an OTC option, taken individually or in combination, are materially different from those of a Listed option?

A5: The Bourse believes that the difference in one or some of the terms of an OTC option compared to those of a similar Listed option must result in a substantial difference in financial value or market risk between the OTC option and Listed option. Such a difference excludes the impact of any of the characteristics specific to an OTC instrument such as counterparty risk if not cleared, regulatory risk, absence of price discovery, absence of price improvement, absence of secondary market liquidity, etc.

It is the responsibility of the Participant to document and be able to demonstrate that the terms of an OTC option, taken individually or in combination, constitute a material difference from those of a Listed option. As such, Participants must keep an audit trail and adequate records in order to be able to demonstrate compliance with Article 6.2 and Article 6.12 should the Division make the request.

[3] It is to be noted that each venue offering cleared OTC options defines the level of customization available on each of these terms.

[4] In Circular 008-14, the Bourse identified the exercise price, expiration date and exercise style as terms that could be considered "materially different" when comparing the terms of an OTC option to those of a Listed option, without distinguishing cleared and bilateral OTC options.

[5] https://www.cdcc.ca/f_en/converge_page_en.pdf

[6] Foreign markets like Cboe and Eurex offer, in addition to their listed option contracts, cleared, customizable options contracts. On Cboe, customization is available on strike price, expiration date, and exercise style. On Eurex, customization is available on strike price, expiration date, exercise style, and settlement type.

In all circumstances, a Participant should not execute an OTC options transaction where terms have been negotiated solely for the purpose of avoiding a transaction on the Bourse. A Participant should not execute an OTC options transaction to avoid taking a bona fide market position exposed to market or execution risks.

Q6: Which considerations are irrelevant to the Bourse when determining whether the terms of an OTC option, taken individually or in combination, are materially different from those of a Listed option?

A6: Any considerations outside the financial value or market risk of the option contract itself (e.g., operational preferences, cash and collateral management, credit available for margining purposes, etc.) are not considered relevant for the purpose of determining whether the terms of an OTC option are materially different from those of a Listed option.

For example, the sole change in a term of a Listed option such as the settlement date or the option entitlement would not be considered in and of itself sufficient to consider the resulting OTC option as having terms materially different from those of a Listed option.

Q7: Could a Participant seek approval from the Division to trade an OTC option where terms are not considered to be materially different?

A7: No. To trade OTC options where the underlying securities relate to Listed options, at least one term or aspect of the OTC option must constitute a material difference as described in A4 and A5. The Participant should, at a minimum, be able to demonstrate the factors considered in concluding that the change to at least one term is materially different and that the OTC options transaction did not occur to avoid taking a bona fide market position exposed to market or execution risks.

Q8: Are Participants who trade OTC options required to transmit reports to the Bourse?

A8: Yes. As per Article 6.501, Participants must, pursuant to Article 6.12, report in the form prescribed by the Bourse, the total number of OTC puts and calls written, issued or guaranteed during each period ending at the close of business on the fifteenth and last days of each month or, if not a business day, the preceding business day. Reports must be transmitted to the Bourse within two (2) business days of the end of the period. Fees resulting from the late filing of these reports may be imposed. These fees can be found in the List of Fees on the Division's website.