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CIRCULAR
January 25, 2010

ADDITION OF RISKLESS BASIS CROSS TRANSACTIONS ON S&P/TSX INDEX (SXF) AND SECTORIAL INDEX (SXA, SXB, SXH, AND SXY) FUTURES CONTRACTS

AMENDMENTS TO ARTICLES 6005 AND 6380 OF RULE SIX OF BOURSE DE MONTRÉAL INC.

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) and the Autorité des marchés financiers (the AMF) have approved amendments to articles 6005 and 6380 of the Rules of the Bourse, which deal with riskless basis cross transactions on Index (SXF) and Sectorial Index (SXA, SXB, SXH and SXY) futures contracts. The purpose of these amendments is to permit a new trading mechanism for the equity index futures contracts that allows the execution of riskless basis cross transactions.

The riskless basis cross transaction is a trade where an approved participant and a client engage in prenegotiation discussions to agree upon the terms of an index futures contracts transaction to take place outside the Bourse's electronic trading system. This trade must include the acquisition by the approved participant of a position in the cash market. The terms agreed upon by the approved participant and its client also include the amount of exposure to the index required and the basis spread between the average price of the cash exposure acquired by the approved participant and the index futures contracts that will be crossed to the client.

These amendments will become effective on **Friday January 29, 2010**. The amended articles and related procedure are attached herein and are available on the Web site of the Bourse.

Amendments to the Rules of the Bourse

A. Amendment to Article 6005

Article 6005 enumerates the off-exchange transactions that are permitted by the Bourse. This article has been amended by adding 6005 f) stipulating that the riskless basis cross transaction is a permitted off-exchange transaction.

Circular no.: 009-2010
Amendments: 001-2010

B. Amendments to Article 6380

Article 6380 applies to prenegotiation discussions, cross transactions, prearranged transactions and block trades.

a. Amendment to Paragraph 1) of Article 6380

This paragraph has been amended to add the riskless basis cross transaction to the list of transactions that may result from prenegotiation discussions.

The Bourse, for housekeeping purposes, has also amended this paragraph by making reference to Exchange for Risk (EFR) transactions for which amendments to article 6815 of the Rules were implemented on April 21, 2008.

b. Addition of a new Paragraph 5) to Article 6380

This paragraph was added to article 6380 to permit a riskless basis cross transaction and the conditions under which it may be executed.

Comments Received

The regulatory amendments that are discussed in this circular were subjected to a request for comments published by the Bourse on May 15, 2008 (Circular No. 075-08). http://www.m-x.ca/f_circulaires_en/075-08_en.pdf

Following the publication of the request for comments, the Bourse received a comment letter. As required by the AMF, the Bourse has published and attached herein the comments received, as well as the Bourse's response.

For further information, please contact Karen McMeekin, Head of Market Operations, Financial Markets, 514- 871-3548 or at kmcmeekin@m-x.ca.

François Gilbert (s)
Vice-President, Legal Affairs, Derivatives

Encl.

6005 Off-Exchange Transactions
(10.10.91, 19.11.93, 14.07.95, 22.11.99, 21.04.08, 30.05.08, 29.01.10)

The only transactions in any securities or derivative instruments listed on the Bourse which an approved participant may make off the Bourse are the following:

a) a transaction made to adjust an execution error on a client's order;

b) a transaction made as a result of the exercise of an option or of a delivery pursuant to a futures contract;

c) an Exchange for Physicals (EFP) transaction or an Exchange for Risk (EFR) transaction pursuant to article 6815 or a Substitution of over-the-counter derivative instruments for futures contracts pursuant to article 6815A;

d) an off-exchange transfer of securities or derivative instruments pursuant to article 6816;

e) a block trade in a security or derivative instrument designated by the Bourse and executed according to the provisions of article 6380;

f) a riskless basis cross transaction in a security or derivative instrument designated by the Bourse and executed according to provisions of article 6380.

6380 Prenegotiation Discussions, Cross Transactions, Prearranged Transactions, Block Trades and Riskless Basis Cross Transactions
(25.09.00, 24.09.01, 29.10.01, 31.01.05, 10.11.08, 29.01.10)

For the purpose of this article, the terms hereunder are defined as follows:

1) Prenegotiation Discussions

Prenegotiation discussions are considered having occurred when approved participants engage in negotiations with each other or with other approved participants and/or clients prior to entering orders which may result in a cross transaction, a prearranged transaction, a block trade, an exchange-for-physical or exchange-for-risk transaction (according to the provisions of article 6815 of this Rule), a substitution transaction (according to the provisions of article 6815A of this Rule) or a riskless basis cross transaction. Clients must consent to allow approved participants to engage in prenegotiation discussions with other approved participants and/or clients with respect to an order.

2) Cross Transactions

A cross transaction is considered having occurred when two orders of opposite sides originating from the same approved participant are intentionally executed against each other in whole or in part as a result of prenegotiation discussions.

3) Prearranged Transactions

A prearranged transaction is considered having occurred when one or more approved participants engage in prenegotiation discussions in order to agree on the terms of a transaction before entering the orders in the electronic trading system of the Bourse.

Execution of cross transactions and prearranged transactions are permitted by the Bourse when:

i) they are on eligible securities or derivative instruments;

ii) the orders are for a quantity equal to or greater than the minimum quantity threshold established for that eligible security or derivative instrument;

iii) the prescribed time delay between the input of an order and its opposite side order is respected;

iv) the transactions are executed in accordance with the Procedures Applicable to the Execution of Cross Transactions and the Execution of Prearranged Transactions.

The eligible securities or derivative instruments, the prescribed time delays and the minimum quantity thresholds are determined by the Bourse and published in the Procedures Applicable to the Execution of Cross Transactions and the Execution of Prearranged Transactions.

It is forbidden to use the hidden quantity functionality of the electronic trading system of the Bourse to execute a cross transaction or a prearranged transaction.

4) Block Trades

A block trade is considered having occurred when one or more approved participants and/or clients engage in prenegotiation discussions to arrange large size transactions away from the electronic trading system of the Bourse (as permitted by article 6005 of this Rule) at prices mutually agreed upon, report to the Bourse the terms of their agreement and the Bourse agrees to them.

An approved participant of the Bourse may execute a block trade for a quantity equal to or greater than the applicable minimum volume threshold in a security or derivative instrument, other than an equity option or a share futures contract, designated by the Bourse pursuant to the following conditions:

i) A block trade may be arranged in a designated security or derivative instrument only during the trading hours and business days authorized by the Bourse. Once a block trade has been arranged, an approved participant must submit details of the block trade to the Bourse as soon as practicable and in any event within the period of time prescribed by the Bourse.

ii) A block trade may be arranged only in a security or derivative instrument that has been designated by the Bourse for that purpose. Such designations will be published by the Bourse, together with the minimum volume thresholds applying to those designated securities or derivative instruments. Approved participants are permitted to enter into block trades in any strategy recognized by the Bourse.

iii) Where a strategy involves the trading of two or more different securities or derivative instruments, the smaller of the minimum volume thresholds of the securities or derivative instruments comprised in the block trade will be applied to each of these securities or derivative instruments. Where the strategy involves the trading of two or more different contract months and/or strike prices of the same contract month, the minimum volume threshold will apply to each leg of the trade, except where specific provision has been made within the published minimum thresholds.

iv) Approved participants may not aggregate separate orders in order to meet the minimum volume thresholds.

v) The price at which a block trade is arranged must be “fair and reasonable” in light of (i) the size of such a block trade; (ii) currently traded prices and bid and ask prices in the same contract, at the relevant time; (iii) currently traded prices and bid and ask prices in other contract months for futures contracts or other option series for options contracts; (iv) currently traded prices and bid and ask prices in other relevant markets, including without limitation the underlying markets; (v) the volatility and liquidity of the relevant market; and (vi) general market conditions.

vi) Block trades shall not set off special term~~s~~ orders or otherwise affect orders in the regular market.

vii) It is strictly prohibited for an approved participant, for both the buyer and the seller, to enter into a block trade to circumvent the contract month roll in the corresponding security or derivative instrument.

The eligible securities or derivative instruments and the minimum quantity thresholds are determined by the Bourse and published in the Procedures for the Execution of Block Trades.

5) Riskless Basis Cross Transactions

A riskless basis cross transaction occurs when an approved participant and a client engage in pre negotiation discussions to conclude a riskless basis cross transaction outside of the posted order book (as permitted by article 6005 of this Rule) at a pre-determined price. The futures contract price is comprised of an average price resulting from a preliminary transaction in the cash market plus a prenegotiated basis spread mutually agreed upon between the approved participant and the client.

A riskless basis cross transaction can be executed on the Bourse once the approved participant has acquired market exposure using cash instruments as prescribed in the procedures established by the Bourse.

In order to qualify as a riskless basis cross transaction, the following conditions_must be respected:

i) Riskless basis cross transactions must at all times be executed in accordance with such other procedures, terms and conditions that the Bourse may prescribe from time to time.

ii) The futures contracts that are eligible to riskless basis cross transactions, and the last day and time for executing such transactions shall be determined by the Bourse.

iii) The cash components acceptable for the purpose of a riskless basis cross transaction are those specified in the procedures set by the Bourse.

iv) Each party to a riskless basis cross transaction must satisfy the Bourse, upon request, that the transaction is a bona fide transaction. To this effect, parties to such a transaction must maintain and must provide to the Bourse upon request complete records and documentary evidence relating to such transaction including all records relating to the purchase or sale of securities and futures contracts and to any transfer of positions made in connection with such transaction.

v) It is prohibited for any party to a riskless basis cross transaction to effect a transaction which is contrary to the requirements and practices prescribed by the rules, policies and procedures of the Bourse or to effect such a transaction for the sole purpose of reporting, registering or recording a price that is not a bona fide price or of making a transaction which is a "wash trade", an accommodation trade or a fictitious sale.

vi) A riskless basis cross transaction may be made at such prices that are mutually agreed upon by the two parties to this transaction. However, the price at which the futures contract leg of the transaction is arranged must be fair and reasonable in light of factors such as, but not limited to, the size of the transaction, the currently traded prices and bid and ask prices in the same contract at the relevant time, the volatility and liquidity of the relevant market as well as the general market conditions.

vii) Each riskless basis cross transaction must be reported to the Bourse in accordance with the procedures set by the Bourse. Such report must be in the form prescribed by the Bourse and must contain all the information required on such prescribed form.

viii) Each riskless basis cross transaction must be immediately disseminated by the Bourse once it has validated it.

ix) It is strictly prohibited for any party, for both the buyer and the seller, to enter into a riskless basis cross trade to circumvent the contract month roll in the corresponding security or derivative instrument.

PROCEDURE APPLICABLE TO THE EXECUTION OF RISKLESS BASIS CROSS TRANSACTIONS ON S&P/TSX INDEX FUTURES CONTRACTS

Bourse de Montréal Inc. (the Bourse) authorizes riskless basis cross transactions on listed S&P/TSX Index futures contracts. The Bourse provides approved participants with a facility that permits the purchase/sale of index futures contracts against cash instruments for an average cash market price plus a pre-negotiated basis. A riskless basis cross has no impact on the existing cash market as the initiated operation results in a riskless transaction in the books of the approved participant.

Approved participants receiving requests from clients who cannot or do not want to hold cash securities in their accounts but who wish to acquire market exposure in the most efficient way possible (either on the cash or exchange-traded fund "ETF" markets) are authorized to do a riskless basis cross. The sole intent and purpose of the riskless basis cross is to allow market participants to use the attributes of the underlying cash market to take on the market position requested by the client and then to replicate it through the use of futures contracts thus leaving the approved participant with no resulting market position and the client with a final position in the futures contract.

Once the terms of the riskless basis cross have been agreed to with the client, the approved participant begins the transaction by taking a position in the cash instruments in its own account on behalf of the client. The approved participant then has to execute the riskless basis cross transaction (by contacting the Market Operations Department of the Bourse) and allocate the futures contract position, functionally equivalent to the cash market exposure, (as initially requested by the client) into the client's account.

Approved participants must apply the following procedures when executing riskless basis crosses:

- The approved participant accepts the order to execute a transaction on behalf of its client (who wishes to acquire index market exposure with a resulting futures position) for an average cash market price plus a pre-negotiated basis (spread).

- The terms of the transaction should either be a fixed pre-negotiated basis established prior to execution of the transaction or a guaranteed (by the approved participant to the client) closing or executed price of the cash component in which circumstance the basis will be adjusted accordingly.

- The approved participant begins the transaction by acquiring exposure (long or short) in the cash market on its client's behalf, using securities, baskets of securities, index participation units, or exchange-traded funds comprised of the underlying securities of the related index futures contracts that constitute the riskless basis cross. For the purpose of this type of operation, these instruments are accumulated in the approved participant's account.

- The cash portion of the riskless basis cross must be comprised of at least 80 percent of the components constituting the underlying index (ex: for the S&P/TSX60 index, at least 48 constituents must be part of the transaction)

- It is generally expected that, for the purpose of the riskless basis cross, approved participants will use all of the index components when taking position in the cash market. However, there are circumstances which may prevent an approved participant from acquiring certain index components, and the approved participant may therefore exclude these index components from the cash position. Examples of such circumstances include: an index component is on the approved participant's or client's internal restricted list (due to a corporate activity involving the issuer of the given component), a specific index component is halted from trading during the day of the operation, market conditions of a specific index component are inadequate (ex: if liquidity is insufficient to execute the transaction) or any other justifiable situation of a similar nature.

- The cash portion of the riskless basis cross must be reasonably correlated to the underlying index with a correlation coefficient (R2) of 90% or more.

- At the time agreed with its client the approved participant executes a riskless basis cross transaction for a predetermined quantity of index futures contracts. One side of this riskless basis cross transaction offsets the approved participant's position in the underlying cash market and the other side of the trade represents the total market exposure requested by the client. The resulting "unhedged" index futures contracts position is then allocated into the client's account.

- A riskless basis cross transaction may only be executed during the regular trading hours of the underlying instrument until the end of the extended session at the Toronto Stock Exchange (TSX). The transaction has to be executed the same day as and after the completion of the cash portion of the operation. In the event that the riskless basis cross operation has to be executed over a several day period, the futures portion of the operation has to be proportionate to the underlying portion at any given execution day.

- To execute the riskless basis cross transaction, the approved participant must provide the details of the concluded transaction to the Market Operations Department of the Bourse by filling out and submitting through the Bourse's Web page http://www.m-x.ca/efp_formulaire_en.php the prescribed "Contingent Trade Reporting Form". Once submitted, the riskless basis cross transaction will be registered by the Market Operations Department in the trading system. The transaction will then be specially marked and displayed in the systems (trading platform and data vendors) at the post trade recap level.

- Once concluded and registered, the riskless basis cross transaction will appear in the "Transaction Report" maintained on the Bourse's Web page http://www.m-x.ca/dailycrosses_en.php.

- There is no minimum time required to display (by the approved participant) the riskless basis cross transaction prior to execution. As soon as it is reported to the Market Operations Department at the Bourse, the transaction will be registered and displayed without delay.

- There is no minimum size restriction for a riskless basis cross transaction.

- There is no requirement for a riskless basis cross transaction to be executed within either the bid and ask or the daily high and low prices.

- The riskless basis cross transaction is excluded from the daily settlement price procedures, but is included in the daily volume figures.

- Approved participants involved in a basis cross transaction may be required to demonstrate to the Bourse:

    - that the transaction is comprised of at least 80% of the components constituting the underlying index; and
    - that the futures portion of the transaction replicates the underlying index and that components of the underlying index that are not included in the riskless basis cross were justifiably excluded (as described above) from the transaction; and
    - that the cash portion of the riskless basis cross has a minimum correlation of 90% to the underlying index; and
    - whether the transaction's pre-negotiated basis was fixed and established prior to the execution of the transaction or resulted from a guaranteed closing or executed price of the cash component; and
    - that the cash position and the futures contracts position (resulting from the riskless basis cross transaction) are properly recorded in both the approved participant's and client's accounts.

- While the approved participant must acquire the cash market position before executing the futures contract leg, the Bourse does not impose any time limit for the retention or liquidation by the approved participant of the cash market position. Once the riskless basis cross has been completed, the approved participant may manage the positions on its books as it sees fit.

COMMENTS RELATED TO PROPOSED AMENDMENTS TO ARTICLES 6005 AND 6380 OF THE RULES OF The Bourse de Montréal inc.
RISKLESS BASIS CROSS TRANSACTIONS ON INDEX AND SECTORIAL INSTRUMENTS

Author of Comments	Comments	Response to Comments
RBC Capital Markets (“RBC CM”)	“In general, RBC CM supports the introduction of the new trading mechanism but looks to clarify certain aspects”	
	“With the proposed riskless basis cross transaction, the cash component is done according to some agreed upon parameters determined between the parties and then the resulting position is converted to futures at the executed level for delivery at a pre-determined basis. It is unclear with the introduction of the riskless basis cross as to when this level is agreed upon, although it appears to be prior to execution which would not allow for a change of basis should the market levels move substantially”.	**Response:** The terms agreed upon by the approved participant and the client must include: the moment for the operation to be executed, the acquisition by the approved participant of a position in the cash market, the required amount of index exposure, and the basis spread between the average price of the cash exposure acquired by the approved participant and the index futures that will be crossed to the client. These terms are agreed prior to execution. A substantial move in market levels during the course of execution will be reflected in the average price of the securities acquired.
	“….we seek clarification of the procedures set out in Appendix A. Section III C. “*Detailed Description of the Riskless Basis Cross*”, items #4 through #7”.	
	“Item #4 states “*At the moment agreed between the Approved Participant and its client, the approved participant will execute a riskless basis cross…..*”. Could you please clarify this statement in conjunction with item #2 whereby the Participant and the client have agreed upon the transaction. Would it not be solely the Participant’s responsibility to execute the trade whenever the execution leg in the cash market has been completed? We are unsure if there is a requirement to agree upon “*the moment*” of the execution of the riskless futures cross or, if another agreement is required on the basis spread after the exposure is obtained in the cash market due to a changing basis should the market move during the time of the risk execution”.	**Response:** The reference to “the moment agreed between the approved participant and its client” refers to the fact that the parties may agree that cash market exposure will be acquired on the day(s) and/or at the moment(s) as determined by the client. When the cash market execution has been completed it becomes the approved participants’ responsibility to proportionately execute the riskless basis cross on that same day. No other agreement is required on the basis spread after the exposure is obtained in the cash market.
	“Item #5 -While we understand the theoretical rationale for harmonization with TSX policy 4-107, we are not sure that it is relevant for riskless basis	**Response:** The 80% component share weighting requirement is intended to harmonize the requirements of the

	trades. In our opinion, the client would be holding the futures therefore, the need for the relaxation of the cash component to only 80% of the underlying index appears to be unnecessary. Since the dealer would presumably not be restricted in their cash holdings and the client wishes to hold futures (which by definition, are 100% weighting of the underlying index post the basis cross), this 80% allowance seems unnecessary and potentially introduces a difficult audit trail issue. In addition, this 80% weighting seems to contradict the comparison to the money market instrument in the example given in Appendix III, which would only be true with a 100% hedged weighting and the assumption of no movement in any of the other underlying variables".	Montréal Exchange with those of TSX Policy 4-107 by mirroring the requirements of the TSX policy. Given the similarity of the procedures and the identity of the instruments being used it is our view that it is preferable to harmonize requirements where possible and avoid a multiplicity of divergent rules and requirements. In addition, some approved participants may have trading restrictions (such as: securities as part of the firm's restricted "gray list") from owning certain securities, thus the 80% weighting. For example, RBC may be working a riskless basis cross for a client and may be restricted from owning RBC stock The example of the money market instrument was for illustrative purposes only, in order to demonstrate that the approved participant's final position would be riskless. The procedure is not intended to allow approved participants to acquire additional market exposure on their books, but to equip them with the required tools to provide futures market exposure to their clients by using and accessing the liquidity of the cash market.
	"Items #6 and #7 – We ask that these items be clarified as we are uncertain as to the reporting requirements and timing relative to (i) the Participant reporting the trade and,(ii) market operations displaying the trade".	**Response:** The approved participant must execute the trade on the day(s) as determined by the client and the same day during which the proportionate contingent cash portion has been executed. In order for the operation to be considered executed, the Contingent Trade Reporting Form (as provided on the Bourse's website) must be completed and submitted to the Market Operations Department. Upon reception of the transaction details, the trade is registered in the system and disseminated (without delay) by Market Operations.
	"We would also like to confirm that it is entirely appropriate to utilize the MOC facility for execution of the cash leg and then have the riskless basis cross transaction of the futures submitted and reported subsequent to the establishment of the final index level and that this does not cause any timing issues at the end of the day for execution and recording of the futures crosses".	**Response:** This is a valid point. It is appropriate to utilize the Market-On-Close (MOC) facility offered on the Toronto Stock Exchange (TSX) for the execution of the cash leg. We will amend the procedures in order to accept the riskless basis cross during regular trading hours and no later than 15 minutes after the closing of the underlying MOC facility.
	"The other concern that should be noted is the potential interaction of the riskless basis cross with the existing and currently actively quoted EFP market. It is important that a fair and	**Response:** It is not our intention to circumvent or diminish the active EFP requirement. The differences between an EFP and a riskless basis cross are significant,

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<td>competitive EFP market is not diminished or circumvented by the use of the riskless basis cross facility. It may be useful to make the distinction and provide that the riskless basis cross should only be used when there is a desire for true independent execution of the cash leg with real liability execution in the market. And further, that it should not simply be a way to circumvent the existing EFP market where two parties are simply exchanging physical vs contractual holdings of the same underlying interest. We believe that it would be beneficial to clarify that in the text of the rules and policy”

“We would also seek clarification on the expected audit trail requirements, particularly where the Participant may be executing a number of strategies in the same Index on any particular day or, may be executing more than one riskless basis cross during a day. Is it necessary to isolate each trade to a different account? What are the reporting and timing requirements for the cash side of the transaction similar to what is required by the TSX for the Basis trade?”</td>
<td>the principal distinction being the requirement in the EFP procedures for a simultaneous exchange of physical securities and futures contracts. The cash market instrument leg of the EFP transaction must provide for a transfer of ownership of the cash market instrument to the buyer of this instrument. The riskless basis cross procedures require that the approved participant acquire the cash market instruments in its account before initiating the cross of futures for the client’s account.

Response:
Each party to a riskless basis cross transaction must satisfy the Bourse’s requirements that the transaction is a bona fide transaction. To that end, parties to such a transaction must maintain and must provide to the Bourse upon request complete records and documentary evidence relating to such transaction including all records relating to the purchase or sale of securities and futures contracts and to any transfer of positions made in connection with such transaction. The necessity to isolate or not each trade to a different account will depend upon the sophistication of the audit trail system and records of approved participants. As a general principle, if the trade recording system and procedures allow clearly tagging each trade and establishing its relationship with the ultimate beneficial owner of that trade, then the use of multiple accumulation accounts may not be necessary.

With respect to the reporting and timing requirements, the Bourse intends, for the sake of uniformity, to apply requirements that are similar to those of the TSX. Revisions will be made to the originally proposed procedure to specify that transaction reporting must be made as soon as practicable, on the same day as the execution of the proportionate cash leg and in any event, no later than 15 minutes after the closing of underlying Market-On-Close (MOC) facility offered on the Toronto Stock Exchange (TSX).

The required reporting form (as identified in the procedures) will also provide information as to what details of the cash side transaction shall be reported to the Bourse</td>
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	"Our final comment relates to Section II B, which states that the Bourse's current rules and procedures do not accommodate riskless basis transactions. We ask how the Bourse foresees Participants conducting compliance testing on these transactions and request that guidance be provided".	**Response:** Please note that Section IIB refers to the rationale section of the analysis. The rule change and new procedures are being introduced because this type of transaction is being requested by market participants and is not permitted under current rules and procedures. The proposed rule amendments will permit and therefore accommodate these transactions. With respect to compliance testing of the cash leg, approved participants will be expected to ensure that this leg of the transaction is executed in full compliance with the TSX and/or IIROC requirements that are applicable to basis trades (e.g.: proper flagging of trades, sufficient weighting of the shares basket, no special settlement terms, etc.). Compliance testing for the futures contracts leg of the transaction shall be designed to ensure that a verification is made to ensure that all the requirements set forth in the rules and the procedures have been complied with (e.g. futures contracts traded for the purpose of the transaction are approved by the Bourse, the cash component satisfies the requirements of the Bourse, the price is fair and reasonable, verification that the reporting of the transaction to the Bourse was done in an accurate, complete and timely manner, etc.) Compliance testing should also ensure that there is an appropriate audit trail for all aspects of the transaction. Also, if riskless basis cross trades involve a significant number of futures contracts and thus represent large notional amounts, the Bourse will expect from its approved participants that they establish a materiality threshold to ensure that all transactions that exceed such threshold are subjected to a detailed review.