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CIRCULAR
March 20, 2008

REQUEST FOR COMMENTS

SWAP AGREEMENTS WITH REGULATED ENTITIES

AMENDMENTS TO ARTICLE 7226

Summary

The Rules and Policies Committee of Bourse de Montréal Inc. (the Bourse) has approved amendments to article 7226 of the Rules of the Bourse, which deal with swap agreements with regulated entities. The purpose of these amendments is to clearly specify the margin requirements that are applicable to swap agreements for which the counterparty is a regulated entity.

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.: 047-2008

The Division is under the authority of a Special Committee appointed by the Board of Directors of the Bourse. The Special Committee is empowered to recommend to the Board of Directors the approval or amendment of some aspects of the Rules and Policies of the Bourse governing approved participants, among which, the Rules and Policies relating to margin and capital requirements. 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 with recommendation from the Special Committee. These changes are submitted to the Autorité for approval.

Comments on the proposed amendments to article 7226 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. 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".



SWAP AGREEMENTS WITH REGULATED ENTITIES

– AMENDMENTS TO ARTICLE 7226

I SUMMARY

A) Introduction

In their current version, paragraphs A) and B) of article 7226 of the Rules of Bourse de Montréal Inc. (the Bourse) do not explicitly specify the margin required for swap agreements in which the counterparty is a regulated entity. To determine what the required margin is, it is necessary to refer to Schedules 1 and 7 of the “Joint Regulatory Financial Questionnaire and Report” (JRFQR) of Policy C-3 of the Bourse where it is specified that the margin required on positions for which the counterparty is a regulated entity is the market value deficiency.

B) The Issue

It results from what is mentioned above that when an approved participant enters into a swap agreement with a counterparty that is a regulated entity, there is a risk of confusion and differing interpretations regarding the calculation of the required margin.

C) Objective

The objective of the proposed amendments is to clearly specify the margin requirements that are applicable to swap agreements for which the counterparty is a regulated entity.

D) Consequence of Proposed Amendments

The proposed amendments to article 7226 of Rule Seven will permit to eliminate any confusion and any interpretation problem regarding the calculation of the required margin for interest rate swap agreements or total performance swap agreements for which the counterparty is a regulated entity.

II DETAILED ANALYSIS

A) Current Rules

Article 7226 of Rule Seven of the Bourse specifies the margin requirements that are applicable to interest rate swap agreements and to total performance swap agreements.

Interest rate swap agreements relate to the exchange of a fixed interest rate payment against a floating interest payment or vice-versa. Total performance swaps involve the exchange of a payment based on the return of an asset (e.g. : capital gains/losses, interest or dividends) against a floating interest rate payment.

For the purpose of margin and capital calculations, the counterparty to the swap agreement is considered to be a client of the approved participant. Pursuant to the current provisions of article 7226, if this counterparty qualifies as an “acceptable institution”, as this term is defined in the JRFQR of Policy C-3 of the Bourse, no margin is required. If this counterparty qualifies as an “acceptable counterparty”, also defined in the JRFQR, then the required margin must correspond to the market value deficiency calculated for the swap agreement. Finally, if the client neither qualifies as an acceptable institution nor as an acceptable counterparty, the margin required must correspond to the loan value deficiency calculated for the swap agreement.

B) Comparison with Similar Provisions

When looking at the margin and capital rules of the Bourse as a whole, including the various provisions contained in the JRFQR form of

Policy C-3 of the Bourse, it can be noticed that the regulations as a whole provide for specific provisions applicable to another category of counterparty, the “regulated entities”, a term that is also defined in the JRFQR form of Policy C-3 of the Bourse.

Generally, regulated entities are subjected to margin requirements that are similar to the requirements that are applicable to acceptable counterparties, i. e. the required margin for this counterparty category must correspond to the market value deficiency.

But it appears that article 7726 of Rule Seven of the Bourse, although specifying what the margin requirements applicable to acceptable institutions and to acceptable counterparties are, is totally silent for what regards the requirements applicable to regulated entities.

This means, if the Rule is applied in its most stringent meaning, that for the purpose of article 7726 of Rule Seven of the Bourse, regulated entities should, for margin calculation purposes, be treated in the same manner as any client who does not qualify as an acceptable institution or as an acceptable counterparty.

On the other hand, if swap agreements are assimilated to the transactions that are subjected to the requirements of Schedules 1 and 7 of the JRFQR form (cash and securities loans, repos and reverse repos agreement), regulated entities should be treated in the same manner as acceptable counterparties and, as a consequence, be subjected to margin requirements that are significantly lower than if they were treated as ordinary clients.

C) Proposed Regulatory Amendments

There exists no justification for not treating regulated entities in the same manner as acceptable counterparties for what regards margin and capital requirement calculation that are applicable to swap agreements.

The Bourse therefore proposes to amend paragraphs A) and B) of article 7226 of Rule

Seven in order to add therein a reference to regulated entities.

The addition of this reference will allow clarifying the fact that the margin calculation based on the market value deficiency applies not only to acceptable counterparties, but also to regulated entities.

D) Public Interest

This proposal to amend article 7226 of Rule Seven of the Bourse intends to clarify margin requirements applicable to regulated entities for what regards swap agreements.

Since the proposed amendments will result in article 7226 clearly specifying that regulated entities must not be treated as ordinary clients for margin calculation purposes and, as a consequence, are eligible to lower margin requirements, the Bourse considers that the proposed amendments are of public interest.

E) Impact of Proposed Amendments on Systems

The proposed amendments will have no impact on the financial market structure, on competition and on compliance costs. Furthermore, they will allow harmonization of the provisions of article 7226 with those of other rules of the Bourse involving the calculation of margin and capital requirements based on the type of counterparty.

F) Financial Markets Interests

The Bourse considers that the proposed amendments will not affect the interests of financial markets and that they will not impose upon competition an unnecessary or inappropriate burden.

III COMMENTS

A) Efficiency

As previously mentioned, the objective of the proposed amendments to article 7226 of Rule Seven of the Bourse is to clarify the application of margin and capital requirements to regulated entities in connection with swap agreements.

The approval of these amendments will result in clearer regulations and will eliminate any confusion on its interpretation and application.

B) Process

The first step of the approval process for the regulatory amendments proposed in the present document consists in having the proposed amendments approved by the Special Committee – Regulatory Division of the Bourse. Once the approval of the Special Committee has been obtained, the proposed amendments, if they relate to capital and margin matters, are subsequently submitted to the Rules and Policies Committee of the Bourse for further approval. Once the approval process is completed, the proposed amendments, including this document, are simultaneously published by the Bourse for a 30-day comment period and submitted to the Autorité des marchés financiers for approval and to the Ontario Securities Commission for information.

IV SOURCES

- Article 7226 of Rule Seven of Bourse de Montréal Inc.
http://www.m-x.ca/f_regles_en/07_en.pdf
- Schedules 1 and 7 of the “Joint Regulatory Financial Questionnaire and Report” form - Policy C-3 of Bourse de Montréal Inc.
http://www.m-x.ca/f_regles_en/C-3_en.pdf

7226 Margin on Swaps

(01.05.92, 01.04.93, 01.01.04, 13.09.05)

A) Interest Rate Swaps

For the purposes of the present article, a “fixed interest rate” is an interest rate which is not reset at least every 90 days and a “floating interest rate” is an interest rate which is not a fixed interest rate. On interest rate swap agreements where payments are calculated with reference to a notional amount, the obligation to pay and the entitlement to receive must each be margined as separate components as follows:

- i) where a component is a payment calculated according to a fixed interest rate, the margin required must be the margin rate specified in article 7204 - Group I for a security with the same term to maturity as the outstanding term of the swap, multiplied by 125% and in turn multiplied by the notional amount of the swap;
- ii) where a component is a payment calculated according to a floating interest rate, the margin required must be the margin rate specified in article 7204 - Group I for a security with the same term to maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

The counterparty to the interest rate swap agreement must be considered to be the approved participant's client. No margin is required in respect of an interest rate swap entered into with a client which is an acceptable institution. The margin requirement for clients which are acceptable counterparties or regulated entities must be any market value deficiency calculated relating to the interest rate swap agreement. The margin requirement for clients which are other counterparties shall be any loan value deficiency calculated relating to the interest rate swap agreement, determined by using the same margin requirements for each swap component as calculated in clauses (i) and (ii) above.

B) Total Performance Swaps

On total performance swap agreements, the obligation to pay and the entitlement to receive must each be margined as separate components as follows:

- i) where a component is a payment calculated based on the performance of a stipulated underlying security or basket of securities, with reference to a notional amount, the margin requirement must be the normal margin required for the underlying security or basket of securities relating to this component, based on the market value of the underlying security or basket of securities;
- ii) where a component is a payment calculated according to a floating interest rate, the margin required must be the margin rate specified in article 7204 -Group I for a security with the same term to maturity as the remaining term to the swap reset date, multiplied by the notional amount of the swap.

The counterparty to the total performance swap agreement must be considered the approved participant's client. No margin is required in respect of a total performance swap entered into with a client which is an acceptable institution. The margin requirement for clients which are acceptable counterparties or regulated entities must be any market value deficiency calculated relating to the total performance swap agreement. The margin requirement for clients which are other counterparties must be any loan value deficiency calculated relating to the total performance swap agreement, determined by using the same margin requirements for each swap component as calculated in clauses i) and ii) above.