REQUEST FOR COMMENTS

AMENDMENTS TO ARTICLE 6.206 OF THE RULES OF BOURSE DE MONTRÉAL INC. TO MODIFY THE MINIMUM VOLUME THRESHOLDS FOR BLOCK TRANSACTIONS ON THE TWO-YEAR AND FIVE-YEAR GOVERNMENT OF CANADA BOND FUTURES CONTRACTS

On March 16, 2021, the Rules and Policies Committee of Bourse de Montréal Inc. (the "**Bourse"**) approved amendments to Article 6.206 of the Rules of the Bourse in order to update the minimum volume thresholds for block transactions on the Two-Year ("CGZ") and Five-Year ("CGF") Government of Canada bond futures.

Comments on the proposed amendments must be submitted at the latest on **April 23, 2021**. 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:

Me Philippe Lebel
Corporate Secretary and
Executive Director, Legal Affairs
Autorité des marchés financiers
Place de la Cité, tour Cominar
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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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I.   DESCRIPTION

Bourse de Montréal Inc. (the "Bourse") hereby proposes to amend its rules to update the minimum volume thresholds for block transactions on the Two-Year ("CGZ") and Five-Year ("CGF") Government of Canada ("GoC") bond futures in order to better reflect market conditions following the launch of market making programs in the CGF (December 2018) and in the CGZ (December 2020). The Bourse considers the minimum volume thresholds for block transactions to be important for the development of an efficient market in its GoC bond futures product suite, especially for products in growth phases. Therefore, the Bourse is revisiting the CGZ and CGF block thresholds with the objective of determining more optimal levels for market participants, in line with existing market dynamics. The Bourse believes that the proposed amendments will provide a healthy balance between providing market transparency and fairness, while protecting clients from excess volatility and price disruption.

II.   PROPOSED AMENDMENTS

The Bourse proposes to amend the minimum volume thresholds for block transactions on the CGZ and CGF contracts during the regular trading hours (6:00 am and 4:30 pm ET). Specifically, the Bourse proposes to increase the minimum volume thresholds from 250 contracts to 1,500 contracts for CGZ and from 500 contracts to 1,000 contracts for CGF during that time period. There is no change contemplated with regards to the block thresholds during the extended hours period (2:00 am and 6:00 am ET).

In order to determine the appropriate minimum volume threshold for the CGZ and CGF contracts, the Bourse analyzed internal market data, surveyed market participants and benchmarked block trade thresholds with comparable products at major international derivatives exchanges. The Bourse also took into consideration the minimum quantity thresholds in place for the Bourse's other block trade-eligible products. The Bourse believes that the proposed amendments remain consistent with its objective of providing market participants with an efficient price discovery mechanism and hedging utility.

III.   ANALYSIS

a.   Background

Block transactions offer a convenient way for market participants to execute large transactions on a specific contract at a single price. These transactions are privately negotiated between counterparties (usually institutional traders or large commercial firms) and executed apart from the central limit order book ("CLOB") of the Bourse. After their off-exchange agreement, block transactions must be submitted to the Bourse within a prescribed time delay for reporting purposes. Block transactions are required to be submitted to the Bourse directly on the Bourse's website[1].

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[1] Block trade reporting form available at https://www.m-x.ca/rob_formulaire_en.php

Clients involved in block markets are usually buy-side institutions needing to transact large sizes. When working with large positions, participants are often concerned that a large order size may have a negative and disruptive impact on the market by inducing excess volatility and price dislocations. When the order book cannot absorb sizable orders in an efficient manner, it creates unnecessary volatility which can disrupt orderly efficient markets and affect investor confidence. For these reasons, participants often prefer off-exchange transactions facilities to ensure that they can have all their contracts filled at a single price, with minimum market impacts.

Two-Year Government of Canada Bond Futures:

The last time the Bourse made modifications to the CGZ block threshold during the regular trading hours was in 2018, when the product was not being traded by participants and therefore saw no volume. At that time, the minimum volume threshold for block transactions was reduced from 500 contracts to 250 contracts, in an effort to encourage participation and build open interest in the product in the absence of sustained liquidity provided in the electronic market[2]. However, the threshold was not immediately reassessed when the Bourse implemented a reduction in the CGZ nominal value from C$200,000 to C$100,000 in November 2020[3]. To keep the threshold consistent, it should be increased to 500 contracts (for an equivalent underlying notional value of C$$50,000,000).

Additionally, the early success of the Bourse's new market making program on the CGZ contract implemented in Decembre 2020[4] fast tracked the review of the block thresholds, as the product reached an average daily volume of 5,000 contracts and an open interest level of nearly 40,000 contracts only two months after launch. The Bourse observed 14 block transactions with an average size of 1,251 contracts during that time period[5], suggesting that the current threshold of 250 contracts is too low, and therefore proposing the new threshold of 1,500 contracts as a result. The average bid-ask size observed at the top of the book is often of a few hundred lots. Finally, the lower dollar value of a basis point of the CGZ contract compared to bond futures with longer tenors is another argument in favor of having a higher block threshold[6], since more contracts are required to obtain the same level of risk than with medium or long-term bond futures.

Five-Year Government of Canada Bond Futures:

The last time the Bourse made modifications to the CGF block threshold during regular trading hours was in 2009, when the product was re-listed. At that time, no minimum volume threshold was in place for the contract and the Bourse decided to implement a 500 contracts block threshold to support the re-listing efforts and no modifications have been made since. However, given the liquidity increase observed following the implementation of a new market making program in December 2018, the Bourse considers it is appropriate to update the minimum volume threshold. In 2020, the CGF product reached an average daily volume of 21,798 contracts and an open

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[2] https://www.m-x.ca/f_circulaires_en/133-18_en.pdf
[3] https://www.m-x.ca/f_circulaires_en/186-20_en.pdf
[4] https://www.m-x.ca/f_publications_en/cgz_launch_two_year_bond_futures_en.pdf
[5] Representing about 10% of the CGZ volume
[6] Argument also put forward in the comparative analysis section.

interest level of 70,114 contracts. In 2020, the Bourse observed 21 block transactions with an average size of 977 contracts. This represents less than 1% of the CGF volume but the average size being about twice the current block threshold suggests that the current block threshold of 500 contracts can be increased to 1,000 contracts.

b. Objectives

The objective is to strengthen the functioning of the Canadian derivatives market and better serve the interests of market participants. As a result, the Bourse would like to provide CGZ and CGF market participants with an efficient mechanism of price discovery and hedging utility. The Bourse proposes to update the CGZ and CGF minimum volume threshold for block transactions to take into account recent market developments following the implementation of market-making programs in these contracts. More specifically, the Bourse believes that the proposed block thresholds will:
- increase the utility and the effectiveness of its products for hedgers and speculators involved in the CGZ and CGF markets.
- continue to accomodate large order activity that would otherwise be negotiated away from the organized listed market.
- align the Bourse's practices with international best practices of major electronic derivatives exchanges.

Block transactions are intended to meet institutional demand for prompt and straightforward execution of large orders, as well as to mitigate the detrimental impact of large trades on the quality of the order book while still maximizing the likelihood that the CLOB remains the main way to conduct trading. The objective of implementing block thresholds that are more reflective of market conditions is to allow participants to execute large trades at a fair price with limited negative impact while ensuring these types of transactions don't represent an outsized part of the market, or even have them become common and primary practice.

c. Comparative Analysis

An overview of the minimum volume thresholds for block transactions at international derivatives exchanges for comparable contracts is provided in table 1 below.

Table 1: International benchmarking of government bond futures 2020 average daily volume ("ADV") and current minimum block thresholds

Government Bond Futures	MX (GoC Bond Futures)	CME* (US Bond Futures)	Eurex (German Bond Futures)	ICE (UK Bond Futures)
2Y ADV (Block threshold)	5k+ (250 regular, 100 extended)	387k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	337k (4,000)	83 (250 Standard publication, 1000 Delayed publication)
5Y ADV (Block threshold)	20k+ (500 regular, 100 extended)	902k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	530k (3,000)	70 (100 Standard publication, 1000 Delayed publication)
10Y ADV (Block threshold)	100k+ (1500 regular (3500 large size), 350 extended)	1.5M (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	767k (2,000)	203k (500 Standard publication, 1500 Delayed publication)
30Y ADV (Block threshold)	0 (100 regular*, 100 extended)	134k (5,000 (RTH), 2,500 (ETH), 1,250 (ATH))	56k (100)	30 (50 Standard publication , 250 Delayed publication)

*RTH = Regular Trading Hours, ETH = European Trading Hours, ATH = Asian Trading Hours
Sources: Contract specifications and exchange websites

From this table, we can see that lower block thresholds are usually in place for products in development stages (i.e. small ADV). This is mainly observed at ICE for their 2Y, 5Y and 30Y government bond futures products, as well as at Eurex for their 30Y bond futures.

Also observable at ICE and Eurex is an inverse relationship between a contract duration and its minimum volume thresholds. That is because products with higher duration also have a higher risk (dollar value of a basis point change), which usually translates into greater market quality (depth and order sizes) for shorter duration products, facilitating risk offsets for that portion of the yield curve. For example, it takes about six 2Y bond futures contracts to offset the risk of a corresponding 10Y bond futures product.

CME has the same block thresholds for all government bond futures contracts. That is, among other things, because their full listed yield curve is well developed and liquidity is well established. Their regular hours threshold is therefore relatively high at 5k contracts. The Bourse is of the opinion that its bond futures product suite is not mature enough to contemplate a similar structure.

Based on this international benchmarking, the Bourse considers that the proposed modifications to increase the block thresholds will better align CGZ and CGF with international practices for comparable products, given their development stages.

d. Analysis of Impacts

i. Impacts on Market

As stated earlier, the intention of the Bourse is to strengthen the functioning of the Canadian derivatives market. The proposed modifications will be more reflective of liquidity conditions in the CGZ and CGF markets, which should provide more price transparency for participants. The Bourses believe the impact on market participants will be minimal as block transactions don't account for a large proportion of the volume in both contracts, and because some block transactions are already executed above the proposed thresholds.

The Bourse will still require that the price of the block trade be fair and reasonable in accordance with the prevailing Rules. As such, in determining the price, consideration must be given to factors including the trade size, the trade prices observable in the market, as well as bid and ask prices on the same contract at the relevant time period, the volatility and liquidity of the relevant market, and general market conditions. Upon request, the approved participant who arranges a block trade must provide satisfactory evidence that the block trade has been arranged in accordance with the Rules of the Bourse. The control parameters (prescribed time delay and minimum quantity thresholds) of block transactions are determined in order not to adversely impact:
- liquidity;
- price;
- transparency;
- the Bourse's participants and their clients who are active on its market.

ii. Impacts on Technology

The proposed rule amendments have no impact on the technological systems of the Bourse, its 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 amendments.

iii. Impacts on regulatory functions

The proposal has no impact on the compliance, supervision and reporting rules on the Bourse. Participants engaged in block transactions (regardless of the size of the trade and the reporting time delay applicable) should comply with the Rules of the Bourse and are subject to the oversight of the Regulatory Division of the Bourse. As a reminder, participants must at all times adhere to the principles of good business practice in the conduct of their affairs. Specifically for block transactions, the Bourse would like to remind participants that practices such as front running (article 7.6) are prohibited.

iv. Impacts on clearing functions

The proposed changes should have no impact on the clearing functions of CDCC, on CDCC's Rules and Operations Manual, nor on CDCC's Clearing Members, or other Industry participants dealing with CDCC.

v. Public Interest

The Bourse considers these amendments to be in the interest of the public as they will allow for better trading and hedging practices for market participants, while keeping as much activity as possible "on-screen". The proposed block thresholds will help increase market transparency and fairness. While block transactions provide a useful means for participants to analyze and value a security (compared to having those large transactions executed in the opaque OTC market), the Bourse believes the new thresholds will encourage more transactions on the electronic market and provide a healthier balance for market dynamics observed in these products.

IV.   PROCESS

The drafting process was initiated by the desire of the Bourse to review the relevance of GoC bond futures minimum block thresholds for products in liquidity development phases. Given the Bourse's current and upcoming initiatives regarding the revitalization of the yield curve, the Bourse believes that more appropriate block thresholds should be set to help generate interest in using the CGZ and CGF products and foster activity in these contracts.

The proposed amendments, 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 self-certification process, and to the Ontario Securities Commission for information purposes.

V.   ATTACHED DOCUMENTS

Proposed amendments to the Rules of the Bourse.

Article 6.206 Block Trades

    (a)   <u>In general</u>. Approved Participants may negotiate and execute a Transaction off of the Electronic Trading System pursuant to the following conditions:

        (i)   A block trade Transaction may be arranged and executed only during trading hours on the Bourse for the eligible derivative.

        (ii)   Block trades are only permitted in the Derivative Instruments and for a quantity which meets or exceeds the minimum volume thresholds as follows (only to the extent the eligible security or derivative instrument is available for trading):

Eligible derivatives instruments	Prescribed time delay (from 6AM until the end of the Trading Day)	Block - Minimum volume threshold (from 6AM until the end of the Trading Day)	Prescribed time delay (from 2AM until 5h59m59s)	Block - Minimum volume threshold (from 2AM until 5h59m59s)
	(As soon as practicable and in any event within the following time delay)		(As soon as practicable and in any event within the following time delay)	
[…]				
Two-Year Government of Canada Bond Futures Contracts (CGZ)	15 minutes	~~250~~ 1,500 contracts	1 hour	100 contracts
[…]				
Five-Year Government of Canada Bond Futures Contracts (CGF)	15 minutes	~~500~~ 1,000 contracts	1 hour	100 contracts
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[…]