



CIRCULAR 079-19

May 22, 2019

REQUEST FOR COMMENTS

AMENDMENTS TO ARTICLE 6.208 OF THE RULES OF BOURSE DE MONTRÉAL INC.

The Rules and Policies Committee of Bourse de Montréal Inc. (the “**Bourse**”) and the Special Committee of the Regulatory Division of the Bourse approved amendments to article 6.208 of the Rules of the Bourse in order to clarify the requirements pertaining to the pricing of EFRP transactions.

Comments on the proposed amendments must be submitted at the latest on **June 21, 2019**. 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:

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Autorité des marchés financiers
800 Victoria Square, 22nd Floor
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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 ("**SRO**") 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).

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.

The Division is under the authority of a Special Committee (the "**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 of the Bourse governing approved participants. The Board of Directors has delegated to the Rules and Policies Committee of the Bourse its powers to approve or amend these Rules upon recommendation from the Special Committee.

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I. SUMMARY

Bourse de Montreal Inc. (the “Bourse”) had redrafted Article 6.208¹, relating to Exchange of Futures for Related Products (“EFRP”), in the course of the modernization of the Rules of the Bourse (the “Rules”). These changes came into effect in January 2018, incorporating the content of the *Procedures for the execution and reporting of exchange for physical (EFP), exchange for risk (EFR) and substitution of OTC derivative instruments for futures contracts transactions* within the article. The Regulatory Division of the Bourse (the “Division”) is hereby proposing changes to the paragraph governing the pricing, Article 6.208 (a) (viii), and to paragraph e) of the same article.

II. ANALYSIS

a. Background

Prior to January 2018, EFRP transactions were governed by Article 6815 of the Rules and the provisions of the *Procedures for the execution and reporting of exchange for physical (EFP), exchange for risk (EFR) and substitution of OTC derivative instruments for futures contracts transactions* (the “Procedures”). The Procedures provided additional details on the requirements relating to the execution of transactions involving the exchange of futures contracts, including the pricing.

The Rules and Procedures prescribed that an EFRP transaction can be concluded at a price that is mutually agreed by the parties to the transaction at the condition that the price at which the futures contract leg of the EFRP is arranged is ‘reasonable’. Following the redrafting of the article in 2018, the requirement around the pricing of an EFRP was modified such that the condition of reasonableness now applies to the price at which the EFRP transaction is arranged instead of the price of the futures contract leg.

The revised article also introduced a non-mandatory reference range, indicating that “*although there is no requirement for an EFRP to be executed within the daily high and low prices, execution outside of that price range may result in a request by the Regulatory Division for additional information about the transaction*”.

b. Description and Analysis of Market Impacts

In the course of their respective supervisory functions, the Market Operations Department of the Bourse and the Division have to look at EFRP transactions in light of the requirements specified in the Rules.

The Division has made certain observations in the application of the current Article 6.208 when considering the requirements related to pricing. As such an analysis was conducted, including a comparative analysis with other exchanges, to ensure that the article addresses the pricing requirement consistently with the expectations of the Bourse when dealing with the supervision

¹ Previously Article 6815

of EFRP transactions and be clear to market participants entering into the arrangement of EFRP transactions.

The following illustrates examples of observations made by the Division. On the same day 2 EFRP transactions are reported to the Bourse. The highest price traded for the underlying futures contract during that day was 133.29 which occurred at approximately 8:30 a.m. ET. The first EFRP transaction was executed at 11:24 a.m. ET and reported within the prescribed hour with the futures leg priced at 133.20. At the time the EFRP was executed, the market price of the underlying futures contract was 132.61 and the bid/ask price was 132.60/132.61. The second EFRP transaction was executed at 2:14 p.m. ET and reported within the prescribed hour with the futures leg priced at 133.20. At the time the first EFRP was executed, the market price of the underlying futures contract was 132.50 and the bid/ask price was 132.49/140.50. In reviewing these transactions, the Division's staff would consider the following questions: 1) Since the agreement price is closer to the highest price of the day at 8:30 a.m. ET instead of the market price of the underlying futures contract at the reported time, is the reported time the actual time at which the transaction has been agreed on? 2) What are the factors that motivated the price of the futures leg to be priced way off the posted price when the transaction was agreed to?

As previously indicated, the condition of 'reasonableness' now applies to the price at which the EFRP transaction is arranged instead of the price of the futures contract leg only. Based on comparative analysis with other exchanges such as the CME, ICE Futures US, ICE Futures Europe and ASX, the price of an EFRP transaction is negotiated between parties entering the transaction. In providing a framework for the negotiation of the price, the former 3 exchanges have an approach similar to the Bourse's whereby they prescribe that the price agreed by the parties to the EFRP transaction should be 'reasonable'. In considering the 'reasonable' test, the article refers to certain factors which should be taken into account, such as the size of the transaction, currently traded price and bid and ask prices in the same futures contract, the underlying market and general market conditions (volatility and liquidity). Therefore, since the 'reasonable' test in Article 6.208 is linked to the price of the EFRP transaction, it is in line with other exchanges and adequately conveys how the Bourse expects EFRP transactions to be arranged.

On the other hand, the reference to prices executed within the daily high and low prices, added to the revised article, only appears in the guidance notes issued by ICE Futures Europe² on factors to be considered when arranging an EFRP. Benchmarking with other exchanges, such as CME, ICE Futures US and ASX shows no similarity for this specific factor in either their rules or guidance on EFRP transactions.

In assessing the daily high and low prices as a factor to be considered when arranging an EFRP transaction, the Division observed that the article may not be clear to market participants on whether they should refrain from being outside this range and if they are expected to, what are the consequences if parties were to agree on a price outside the range. Moreover, the article refers to the '*...EFRP to be executed within the daily high and low prices...*', when it should have referred to the price of the futures contract leg.

² ICE Futures Europe Guidance on the Exchange for Physical ("EFP"), Exchange for Swap ("EFS"), Soft Commodity Exchange for Related Positions ("EFRP") and Basis Trading facilities

In negotiating the price of the EFRP transaction, limiting the price of the futures contract leg to the daily high and low prices can potentially conflict with the *'reasonable'* test already in place. It is therefore submitted that the factors prescribed under the article in relation to establishing a reasonable EFRP price, for instance the size of the transaction, bid and ask prices and market conditions, among others that may be applicable, provide sufficient guidance to market participants on considerations they should have when agreeing on a price.

For example, there are several situations where the Division may consider that it is reasonable for the EFRP agreement price to be outside of the high and low of the day. Three examples include: 1) A large transaction that concluded near the high or low of the trading day. Depending on the liquidity for the instrument the futures leg may be priced outside of the posted bid/ask. Although the price may never meet that high or low this transaction may not raise concerns provided a reasonable price was used and participants are able to demonstrate the same if requested. 2) Situations where the underlying futures contracts displays low liquidity. Given the lack of transactions many transactions might be concluded outside the high or low of the trading day. This would again not necessarily raise any flags as long as the size of the transaction, bid and ask prices and market conditions could explain the selected price. 3) EFRP transactions with a cash leg not part of the deliverable basket. Generally these transactions involve cash legs which have lower correlation to the underlying future which may therefore allow additional flexibility on the price to provide for market context.

In light of the above, the Division is proposing to amend Article 6.208 related to the requirements on the pricing of an EFRP transaction to remove the reference to the high and low range and reinforce the *'reasonable'* factor. These amendments will provide clarity to market participants on the scope within which an EFRP transaction can be negotiated and reviewed by the Division.

c. Benchmarking

The Division has conducted a comparative analysis with other exchanges (CME, ICE Futures US, ICE Futures Europe and the ASX) on their rules and guidance documents pertaining to the treatment of the pricing element of an EFRP transaction. As noted in the previous sections, the comparative analysis confirms that the approach chosen by the Bourse as part of the modernization of its Rules, to apply the reasonable test on the EFRP transaction rather than the price of the futures contract leg, is in line with its peers. Except for ICE Futures Europe which adds a threshold for the price to fall within the daily high and low prices, other exchanges do not restrict the negotiation of the price of either the futures leg or the EFRP transaction to the daily high and low range. The expectation of those exchanges is for parties to the EFRP transaction to negotiate a reasonable price, where they take into account factors such as the prevailing market prices and they conform to the specifications of the futures leg contract. Therefore if the price is away from prevailing market prices, parties to the EFRP transaction should be able to demonstrate why it was so.

d. Proposed Amendments

Please refer to the attached amendments to Article 6.208 of the Rules.

III. AMENDMENT PROCESS

This amendment process is undertaken to amend the Article 6.208 (a) (viii) following observations made by the Division in the course of its activities and internal discussions with the Market Operations Department and other business lines of the Bourse. These discussions led the Bourse to analyze this specific part of the article to ensure it reflects the framework expected for the pricing an EFRP transaction.

IV. IMPACTS ON TECHNOLOGICAL SYSTEMS

The proposed amendments will have no impact on the Bourse's technological systems, those of its approved participants or independent software vendors.

V. OBJECTIVES OF THE PROPOSED AMENDMENTS TO THE RULES

The objectives of the proposed amendment is to clarify the requirements pertaining to the pricing of an EFRP transaction.

VI. PUBLIC INTEREST

The Bourse is of the view that the proposed amendments are not contrary to the public interest.

VII. EFFICIENCY

The proposed amendments will not have an impact on how an EFRP transaction is currently arranged. It will provide clarity on the expectations of the Bourse where concluding the price at which the EFRP will be arranged and as such enable the Division to have a better scope in supervising such transactions.

VIII. PROCESS

The proposed amendments are subject to the Special Committee and the Rules and Policies Committee of the Bourse for approval purposes. They will also be submitted to the Autorité des marchés financiers in accordance with the self-certification procedure and to the Ontario Securities Commission for information.

IX. APPENDIX

Appendix 1: Amendments to Article 6.208 of the Rules of the Bourse.

Chapter C—Prearranged Transactions and Trade Cancellation

[...]

Article 6.208 Exchange of Futures for Related Products

(a) EFRP Transactions in general. Exchanges for Related Product (“EFRP”) Transactions involving Futures Contracts listed and traded on the Bourse are permitted if such Transactions are executed in accordance with the requirements of this Article. An EFRP Transaction is composed of the privately negotiated execution of a Bourse Futures Contract and the opposite, simultaneous execution of an approximately equivalent quantity or value of cash product, by-product, related product, or Over-The-Counter (“OTC”) Derivative Instrument underlying the Futures Contract.

(i) An EFRP Transaction is permitted to be executed off of the Trading System pursuant to Article 6.204 if such Transaction is conducted in accordance with each of the requirements and conditions of this Article.

[...]

(viii) The price at which an EFRP Transaction is arranged and mutually agreed upon by parties to the Transaction must be “~~fair and~~ reasonable” in light of, notably: (w) the size of the Transaction; (x) currently traded prices and bid and ask prices in the same contract (y) the underlying markets; and (z) general market conditions, all at the time of the Transaction. ~~Although there is no requirement for an EFRP to be executed within the daily high and low prices, execution outside of that price range may result in a request by the Regulatory Division for additional information about the Transaction.~~

[...]

(e) Books and records of EFRP Transactions. Each party to an EFRP Transaction must maintain full and complete records and documentary evidence relating to the EFRP, including but not limited to all records relating to the purchase or sale of the cash market or OTC derivative component of the Transaction and to any transfer of funds or ownership made in connection with such Transaction. Such records include, but are not limited to, documentation customarily generated in accordance with market practice, such as cash account statements, Trade confirmation statements, ISDA® Master Agreements or other documents of title; third party documentation supporting proof of payment or transfer of

title, such as canceled checks, bank statements; cash account statements and cash instruments Clearing Corporation documents. In addition, Futures Contracts order tickets (which must clearly indicate the time of execution of the EFRP Transaction) must be maintained. If the price at which the EFRP Transaction is arranged is not within the prevailing market prices at the time of the Transaction, such records must demonstrate that the price is reasonable. Records related to the Transaction must be provided to the Bourse upon request and it is the responsibility of the Approved Participant to obtain and provide on a timely basis records of their clients as requested by the Bourse.

[...]

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