CIRCULAR 084-22
July 19, 2022

<u>REQUEST FOR COMMENTS</u>

AMENDMENTS TO THE RULES OF BOURSE DE MONTRÉAL INC. TO MODIFY THE DELIVERY PERIOD OF THE 30-YEAR GOVERNMENT OF CANADA BOND FUTURES (LGB)

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 the Rules of the Bourse in order to modify the delivery period of the 30-year government of Canada Bond Futures (LGB).

Comments on the proposed amendments must be submitted at the latest on **August 19, 2022**. 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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Corporate Secretary and
Executive Director, Legal Affairs
Autorité des marchés financiers
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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.

AMENDMENTS TO THE RULES OF BOURSE DE MONTRÉAL INC. TO MODIFY THE DELIVERY PERIOD OF THE 30-YEAR GOVERNMENT OF CANADA BOND FUTURES (LGB)

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I. DESCRIPTION

Bourse de Montréal Inc. (the "Bourse") hereby proposes to modify the Rules of the Bourse (the "**Rules**") pertaining to the delivery period on the 30-Year Government of Canada ("GoC") bond futures ("LGB") in order to alleviate concerns associated with the embedded wildcard option and improve market efficiency. Ultimately, the objective is to stimulate more activity in the contract and maintain its attractiveness. The Bourse considers that a well-functioning LGB market is desirable for the growth of its listed yield curve offering and strives to ensure that its contract design is in line with the needs of its market participants. Therefore, the Bourse proposes to change the delivery period so that it can happen on one single day. Specifically, the Bourse proposes to allow delivery only if a participant has a position at the end of the last Trading day of the Delivery month, thus reducing any delivery uncertainty and the one-sided appeal of the wildcard option. The Bourse believes that these proposed amendments will enhance market efficiency by addressing concerns from key-end users.

Unless otherwise defined herein, any defined term used in this analysis will have the meaning described in the Rules.

II. PROPOSED AMENDMENTS

The Bourse proposes to modify articles 12.412, 12.414, 12.416 and 6.309B of its Rules in order to reduce the delivery period and make the delivery process more transparent to both long/short parties. Currently, the delivery notice must be submitted between the second business day preceding the first business day of the delivery month, and the second business day preceding the last business day of the delivery month, inclusively (12.414). The Bourse is suggesting to modify the Rules to indicate that the delivery notice must be submitted on the last Trading day, that is on the seventh business day preceding the last business day of the contract month.

Currently, the Delivery of Thirty-year Government of Canada Bond Futures shall be done on the second business day following the submission of the Delivery notice by the Approved Participant holding a Short Position, or on any other day as determined by the Clearing Corporation. Delivery shall be completed no later than the last business day of the Delivery Month (12.416). While the delivery process is expected to remain the same, we suggest that the delivery be completed no later than two business days following the submission of the delivery notice, which, as mentioned above, happens on the last Trading day.

Table 1: Submission of delivery notice and delivery day requirements for the LGB contract

LGB specification	Current	Proposed
Submission of delivery notice requirement for LGB (12.414)	Between the second business day preceding the first business day of the Delivery Month, and the second business day preceding the last business day of the Delivery Month, inclusively.	On the last trading day, that is on the seventh business day preceding the last business day of the contract month.
Delivery day requirement for LGB (12.416)	No later than the last business day of the Delivery Month.	No later than two business days following the submission notice.

Additionally, the Bourse proposes to amend the wording of two delivery standards criteria, to harmonize with the fact that the delivery notices would only be sent on one day. Therefore, the delivery notice period would become the delivery notice day. To reflect that distinction and to minimize the impact on the delivery basket determination processes, the Bourse proposes to link two delivery standard criteria to the first day of the delivery month instead of to the first delivery notice day. This change is considered minor given that a new 30Y GoC bond is issued every three to four years and that the LGB delivery basket changes at about the same frequency.

Table 2: Excerpt of the Delivery Standards for the LGB contract

LGB specification	Current	Proposed
Delivery Standards (a) (iii) (12.412)	[...] a Bond not issued at a 30-year auction which would otherwise meet the standards of this rule, is also deemed to be deliverable, if during the last 12-month period preceding the **first Delivery notice day** of the Delivery Month, its re-openings total a minimum nominal amount of $3.5 billion	[...]a Bond not issued at a 30-year auction which would otherwise meet the standards of this rule, is also deemed to be deliverable, if during the last 12-month period preceding the **Delivery Month**, its re-openings total a minimum nominal amount of $3.5 billion
Delivery Standards (a) (iv) (12.412)	GoC Bonds which are issued and delivered on or before the 15th day preceding the **first Delivery notice day** corresponding to the Delivery Month of the contract	GoC Bonds which are issued and delivered on or before the 15th day preceding the **Delivery Month** of the contract;

As a result of these changes, the Bourse proposes an amendment to sub-paragraph (b)(ii) of Article 6.309B on Position Limits for Futures Contracts to maintain its applicability for each designated Government of Canada Bond Futures Contract while avoiding any confusion that these changes might entail. The calculations, methodologies and applicability period associated with the position limits remain unchanged for each of these contracts. The following table summarizes the proposed wording change:

Table 3: Excerpt of the Position limits for Futures contracts

Position Limits	Current	Proposed
Position Limits for Futures Contracts (b) (ii) (6.309B) - First Delivery Month	[...] the Futures Contract equivalent to 5% of the total outstanding amount of Government of Canada Bonds eligible for Delivery for the designated Government of Canada Bond Futures Contracts at the **start of trading** on the **first** business day prior to the first **Delivery notice** day of the first Delivery Month. Such position limits become effective at the market close on the first business day of the first Delivery Month.	[...] the Futures Contract equivalent to 5% of the total outstanding amount of Government of Canada Bonds eligible for Delivery for the designated Government of Canada Bond Futures Contracts at **market close** on the **fourth** business day prior to the first **business** day of the first Delivery Month. Such position limits become effective at the market close on the first business day of the first

The proposed modifications are based on consultations with dealers and end-user clients, and are meant to increase the contract's effectiveness as a trading and hedging instrument. The feedback the Bourse has received from the industry is that a shorter delivery period would respond to market participants' concerns around the wildcard option and help initiate growth in the futures contract.

III. ANALYSIS

a. Background

The Bourse relaunched the LGB contract via a new market making program in November 2021 with a few adjustments to the contract specifications earlier in the year. After a reasonable start in the first few months (average daily volume of 500 contracts, open interest reaching 3,500 contracts), the first roll period and delivery month brought some challenges to market participants, which led some key early supporters to exit the market. As a result, statistics for the LGB contract deteriorated since March 2022, with daily volume and open interest averaging 270 and 1,480 contracts respectively since then. Considering existing volumes, the Exchange has been gathering feedback from market participants and evaluating the potential for product adjustments with the aim of making the product a more successful one.

In a recent article,[1] the Bourse covered the specific characteristics of the LGB contract, including the embedded wildcard option. That option refers to a right held by the seller of the futures contract that permits the seller to wait until after-hours trading before delivering its bonds to the futures contract buyer. By standards, and after consultation with market participants, the potential wildcard premium under the LGB contract seems to greatly offset the one under comparable bond futures contracts, namely CGZ, CGF and CGB - in part due to the LGB's lower conversion factor. In the Bourse's view, reducing the delivery period would help restrain the

[1] LGB: A primer for CGB Users, available at https://m-x.ca/f_publications_en/lgb_primer_en.pdf

market impact of the wildcard option, disliked by many participants, and as such help stimulate the market.

Because bond prices can still move after 3pm and before 5:30pm, investors can profit from a wildcard exercise and, in a number of cases, the delivery experience is not optimal for the long position. While the estimated profits tend to be moderate and the time span for delivery makes it difficult to capitalize on the option, the experience may dissuade some participants from trading the LGB contract.

Such a change has not been brought to other products before and will be applied exclusively to the LGB contract until further notice. In 2020, the Bourse implemented a different modification to the LGB contract by altering the time to maturity criteria of the delivery standards. While the nature of the objective is different, the ultimate goal is aligned and aims at simplifying the products' delivery standards.

b. Objectives

The objective of the proposed amendment is to make the contract more attractive to key users, in order to help the product grow and build enough critical initial liquidity. By changing the delivery period and linking it to the last Trading day, the Bourse believes the delivery process associated with the LGB contract will be more transparent and more convenient for users trading it. The Exchange aims to provide the market with an attractive 30-year contract that meets the needs of its initial supporters, in an effort to grow volume and open interest. Following a product specification exercise, the consideration of various options and in consultation with market participants, the Bourse deemed it important to propose a modification in the delivery notice for the LGB contract.

More specifically, the Bourse believes that the proposed modifications will:

- increase the effectiveness of the LGB contract for market participants involved in the Canadian bond futures market.
- help build initial liquidity in the LGB contract by reducing uncertainty related to embedded options and delivery period (e.g: wildcard option).
- facilitate the management of the Canadian 30-year sector exposure.

The Bourse believes that these amendments remain consistent with its objective to: 1) provide market participants with an efficient price discovery mechanism as well as hedging tool 2) strengthen the functioning of the Canadian derivatives market and 3) better serve the interests of market participants.

c. Comparative Analysis

The Bourse believes that the proposed modifications on the LGB contract do not deviate from international product specifications, although most exchanges tend to have interval periods for the delivery process. Eurex-Buxl bond futures notice day occur on the last Trading day and the delivery day is restricted to one day making the contract comparable to our new proposal:

Table 4: Delivery requirements for international 30-year bond futures

Exchange	MX - proposal	MX - current	ICE	Eurex	CME
Futures contract	LGB	LGB	Ultra Long Gilt	Euro-Buxl	Ultra 30Y US T-Note
Delivery notice	On last trading day	b/w 2nd business day preceding the first business day of the delivery month and the 2nd business day preceding the last business day of the delivery month inclusively	b/w 2nd business days preceding the first business day of the delivery month and the 1st business day after the last trading	on the last trading day of the maturing futures (by the end of the post-trading full period)	b/w 2nd business day prior to the delivery month to the 2nd business day of the last business day of the delivery month inclusively.
Delivery day	t+2 notice day	t+2 notice day no later than the last business day of the delivery month	any business day in delivery month (seller's choice)	10th calendar day of the respective quarterly month	any business day in delivery month up to the last business day

Source: Contract specification on exchanges websites (TMX, ICE, Eurex, CME)

Based on this international benchmarking, the Bourse considers that the proposed modifications would make the delivery process similar to that of the Eurex for its bond futures product suite.

We also note that the delivery period for US treasury bond futures is not the same for all contracts. In particular, the delivery period for short and medium term US treasury bond futures (2-year to 5-year) is about one week longer than that of longer term (10-year and 30-year).[2] This example is another evidence that delivery periods are not necessarily standardized for a given set of bond futures products, as can be observed in the well-developed US bond futures market.

d. Analysis of Impacts

i. Impacts on Market

Impacts on existing contracts

In order to make the transition as smooth as possible, the Bourse suggests applying the delivery change only to contracts with no existing open interest. To ensure participants are well informed

[2] https://www.cmegroup.com/trading/interest-rates/files/us-treasury-futures-delivery-process.pdf

of these changes, the Bourse expects to communicate these adjustments accordingly (e.g: notice and discussions with key users).

Market perception and cross-market activity

Consultations with key participants reveal that such a change could significantly help develop the LGB product. Market stakeholders support the idea of having only one day where you can get assigned for delivery since that removes the implicit uncertainty. Considering the limited volume and open interest associated with the LGB contract, the Bourse believes the impact on market participants should be minimal. Rather, the proposed delivery adjustment aims to reduce the impact of embedded options, currently detrimental to a well-functioning LGB market.

The expected downside, however, is that altering the delivery to the last Trading day would reduce the potential for recovery in the event of an error for key participants. Even so, this situation already exists as of the last notice day, as participants having positions at the end of that day would automatically go into the delivery process. The Bourse expects the reduced uncertainty and improved market perception to outweigh the potential challenges of reduced operational leeway during the delivery process.

In addition, the new specifications might lead to new dynamics in the cash market (1pm+ on the last trading day) following the settlement of the LGB contract. If a significant amount of contract goes into delivery, both buyers and sellers could get active in the 30Y cash market to sell/buy the delivery tail. This might also improve the roll price based on discussions with fixed income players, which is an expected benefit.

Impacts of the proposed modifications on position limits

The position limits for the Bourse's GoC bond futures are based on the amount outstanding of the deliverable baskets. Reducing the delivery period should not have any direct impact on the determination process and on the contract limits.

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 supervision, surveillance nor the reporting requirements of the Bourse.

iv. Impacts on clearing functions

The Canadian Derivatives Clearing Corporation's Rules and Operational Manual need to be aligned with the changes proposed by the Bourse with respect to the delivery standards of the LGB. The proposed changes should have a minor impact on the technological systems of CDCC. Clearing Members or other market participants are not impacted on their technological systems.

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 offering better ease of trading. A contract that is better tailored to participants needs will be more liquid and will attract more activity to the transparent and centrally-cleared futures market. The Bourse believes the new delivery standards are in line with market expectations, will encourage more transactions on the electronic market and will provide a healthier balance of interests for participants.

IV. PROCESS

The drafting process was initiated by the desire of the Bourse to review the relevance of LGB product specifications following product relaunch. The Bourse believes that a more appropriate delivery procedure should be set to help generate interest in using the LGB and foster activity in this contract during its liquidity development phase.

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:

BLACKLINE VERSION

Article 12.412 Delivery Standards

(a) For Thirty-year Government of Canada Bond Futures, shall be deliverable only those Government of Canada Bond issues which:

[...]

(iii) are originally issued at 30-year auctions (a Bond not issued at a 30-year auction which would otherwise meet the standards of this rule, is also deemed to be deliverable, if during the last 12-month period preceding ~~the first Delivery notice day of~~ the Delivery Month, its re-openings total a minimum nominal amount of $3.5 billion);

(iv) are issued and delivered on or before the 15th day preceding ~~the first Delivery notice day corresponding to~~ the Delivery Month of the contract;

Article 12.414 Submission of Delivery Notice

To initiate the Delivery process, an Approved Participant holding a Short Position must submit a Delivery notice to the Clearing Corporation before the time limit set by the Clearing Corporation on the last Trading Day ~~any business day, between the second business day preceding the first business day of the Delivery Month, and the second business day preceding the last business day~~ of the Delivery Month.~~, inclusively.~~

Article 12.416 Delivery Day

Delivery of Thirty-year Government of Canada Bond Futures shall be done on the second business day following the submission of the Delivery notice by the Approved Participant holding a Short Position, or on any other day as determined by the Clearing Corporation. Delivery shall be completed no later than two business days following the last Trading Day ~~the last business day~~ of the Delivery Month.

Article 6.309B Position Limits for Futures Contracts

(b) (ii) For the first Delivery Month for each designated Government of Canada Bond Futures Contract, the maximum net Long Position or net Short Position which a Person may own or control is the Futures Contract equivalent of 5% of the total outstanding amount of Government of Canada Bonds eligible for Delivery for the designated Government of Canada Bond Futures Contracts at market close ~~the start of trading~~ on the fourth ~~first~~ business day prior to the first

~~Delivery notice~~ business day of the first Delivery Month. Such position limits become effective at the market close on the first business day of the first Delivery Month.

CLEAN VERSION

Article 12.412 Delivery Standards

(a) For Thirty-year Government of Canada Bond Futures, shall be deliverable only those Government of Canada Bond issues which:

[...]

(iii) are originally issued at 30-year auctions (a Bond not issued at a 30-year auction which would otherwise meet the standards of this rule, is also deemed to be deliverable, if during the last 12-month period preceding the Delivery Month, its re-openings total a minimum nominal amount of $3.5 billion);

(iv) are issued and delivered on or before the 15th day preceding the Delivery Month of the contract;

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