NOTICE TO MEMBERS

No. 2020 - 106

August 12, 2020

REQUEST FOR COMMENTS

AMENDMENTS TO THE RULES OF THE CANADIAN DERIVATIVES CLEARING CORPORATION TO MODIFY THE NOMINAL VALUE OF THE TWO-YEAR GOVERNMENT OF CANADA BOND FUTURES (CGZ)

On July 31, 2020, the Board of Directors of Canadian Derivatives Clearing Corporation ("CDCC") approved certain amendments to Rule C-16 of CDCC in order to modify the nominal value of the Two-Year Government of Canada bond futures ("CGZ") from C$200,000 to C$100,000 of Government of Canada bonds with a 6% notional coupon.

Please find enclosed an analysis document as well as the proposed amendments.

Process for Changes to the Rules

CDCC is recognized as a clearing house under section 12 of the *Derivatives Act* (Québec) by the Autorité des marchés financiers ("AMF") and as a recognized clearing agency under section 21.2 of the *Securities Act* (Ontario) by the Ontario Securities Commission ("OSC").

The Board of Directors of CDCC has the power to approve the adoption or amendment of the Rules of CDCC. Amendments are submitted to the AMF in accordance with the self-certification process and to the OSC in accordance with the process provided in the Recognition Order.

Comments on the proposed amendments must be submitted before **September 14, 2020**. Please submit your comments to:

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Canadian Derivatives Clearing Corporation
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A copy of these comments shall also be forwarded to the AMF and to the OSC to:

M[e] Philippe Lebel
Corporate Secretary and
Executive Director, Legal Affairs
Autorité des marchés financiers
Place de la Cité, tour Cominar
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Market Regulation Branch
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Toronto, Ontario, M5H 3S8
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Email: marketregulation@osc.gov.on.ca

For any question or clarification, Clearing Members may contact Alexandre Normandeau at 514-787-6623 or at alexandre.normandeau@tmx.com.

Jay Rajarathinam
President and Chief Clearing Officer
CDCC

AMENDMENTS TO THE RULES OF THE CANADIAN DERIVATIVES CLEARING CORPORATION TO MODIFY THE NOMINAL VALUE OF THE TWO-YEAR GOVERNMENT OF CANADA BOND FUTURES (CGZ)

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I. DESCRIPTION

Bourse de Montréal Inc. (the Bourse) is proposing to modify the nominal value of the Two-Year Government of Canada bond futures (“CGZ”) from C$200,000 to C$100,000 of Government of Canada (“GoC”) bonds with a 6% notional coupon, in order to better reflect market conditions and stimulate more activity on the contract. Therefore, the rules of the Canadian Derivatives Clearing Corporation (“CDCC”), which also contain the nominal value of the CGZ within the delivery standards of the contract, need to be modified in order to reflect these proposed changes.

II. PROPOSED AMENDMENTS

The proposed amendments to Rule C-16 of CDCC’s Rules are attached herewith. Specifically, in alignment with the proposed changes of the Bourse’s rules, CDCC proposes to change the nominal value of the CGZ underlying Government of Canada bond contained in the delivery standards of the contract (section 1602), from C$200,000 to C$100,000.

III. ANALYSIS

a. Background

The Bourse proposes to update its rules pertaining to CGZ as it considers that a well-functioning CGZ market is desirable for the growth of its products and wants to ensure that its contract design is in line with the needs of its market participants. CDCC refers to the attached extracts of the Bourse’s detailed analysis regarding this modification to the CGZ nominal value for additional background and benchmarking information on the proposed amendments.

b. Objectives

CDCC’s Rules need to be aligned with the changes proposed by the Bourse. The Bourse proposes to change the nominal value of the contract back to C$100,000 of GoC bonds in order to fulfill the following objectives:

- Enable inter-group strategies (IGS) with CGF and CGB contracts;
- Reduce the tick value to C$5 (0.005 = C$5), thereby enabling more trading granularity;
- Make the product more suitable for smaller market participants, thereby increasing trading/hedging precision;
- Align with the underlying notional value of EUR (Euro-Schatz) and UK (Short Gilts) two year Government bond futures and with AUD three year Commonwealth Government Treasury bonds futures.

The global objective is to strengthen the functioning of the Canadian derivatives market and better serve the interests of market participants. Specifically, the relaunch of the CGZ contract aims to:

- Facilitate greater market efficiency through the offering of an additional point on the Canadian listed yield curve, allowing clients to trade multiple strategies (speculators and hedgers);
- Develop a listed and transparent alternative to the over the counter two year Canadian interest rate market;
- Grow and strengthen the Bourse’s fixed income products;

- Promote transparent, exchange-traded products with regulatory oversight and backing;
- Offer greater diversity and attract additional trading from a broader set of users to the benefit of the entire market.

c. Comparative Analysis

Given the nature of the proposed amendments, CDCC is of the view that a comparative analysis is not required.

d. Analysis of Impacts

i. Impacts on Market

Since the product has not seen any activity in recent years, impacts on the market are considered minimal. The proposed modifications are meant to increase CGZ's effectiveness as a trading and hedging instrument.

ii. Impacts on Technology

The proposed changes should have no impact on the technological systems of CDCC, Clearing Members or other market participants.

iii. Impacts on trading functions

Not applicable.

iv. Public Interest

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

IV. PROCESS

The proposed amendments, including this analysis, must be approved by CDCC's board of directors and submitted to the Autorité des marchés financiers, in accordance with the regulatory self-certification process, and to the Ontario Securities Commission in accordance with the rules stated in Appendix "A" of Schedule "C" of CDCC Recognition Order dated April 8, 2014 (as amended from time to time). The proposed amendments and analysis will also be submitted to the Bank of Canada in accordance with the Regulatory Oversight Agreement. Subject to public comments, the proposed amendments will take effect during Q4 2020.

V. ATTACHED DOCUMENTS

Appendix 1: Proposed amendments to Rule C-16 of CDCC's Rules
Appendix 2: Extracts of Bourse de Montréal Inc.'s detailed analysis regarding the modifications to the CGZ nominal value

Appendix 1

Section C-1602 DELIVERY STANDARDS

(1)

(i) The delivery unit for the 2-year Canada Bond Futures expiring before December 2010 shall be Government of Canada Bonds which do not mature and are not callable for at least 1 year six months and no more than 2 years six months from the first calendar day of the Delivery Month, having a coupon rate of 4%, an aggregate face value at maturity of $200,000, an outstanding face value, net of all potential purchases by the Government of Canada up until the end of the delivery period of the corresponding Delivery Month, of at least $2.4 billion, are issued and delivered on or before the 15th calendar day preceding the first tender date corresponding to the Delivery Month of the contract, and which have been originally issued at 2-year, 5-year or 10-year Government of Canada bond auctions. All bonds in a delivery unit must be of the same issue.

(ii) The delivery unit for the December 2010 2-year Canada Bond Futures and for subsequent contract months shall be Government of Canada Bonds which do not mature and are not callable for at least 1 year six months and no more than 2 years six months from the first calendar day of the Delivery Month, having a coupon rate of 6%, an aggregate face value at maturity of $1~~2~~00,000, an outstanding face value, net of all potential purchases by the Government of Canada up until the end of the delivery period of the corresponding Delivery Month, of at least $2.4 billion, are issued and delivered on or before the 15th calendar day preceding the first tender date corresponding to the Delivery Month of the contract, and which have been originally issued at 2-year Government of Canada bond auctions. All bonds in a delivery unit must be of the same issue.

(2)

(i) Substitution - For the 2-year Canada Bond Futures expiring before December 2010, at the option of the Clearing Member holding the Short Position, bonds with coupon rates other than 4% are deliverable, at a discount for bonds with coupons less than 4%, and at a premium for bonds with coupons more than 4%. The amount of premium or discount for each different deliverable issue shall be determined on the basis of yield equivalency with a 4% bond selling at par. The price at which a bond having a particular maturity and coupon rate will yield 4% shall be determined according to bond tables prepared by the Exchange on which the Future trades. The Settlement Amount of such delivery unit shall be $2,000 multiplied by the product of such price and the Settlement Price of that series of 2- year Canada Bond Futures. Interest accrued on the bonds shall be charged to the Clearing Member taking delivery.

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(3) The Exchange on which the Future trades shall publish a list of deliverable issues prior to each Delivery Month. The time to maturity of a given issue is calculated in complete one-month increments (rounded

down to the entire one month period) from the first calendar day of the Delivery Month. New issues of Government of Canada bonds which satisfy the standards of this Section shall be added to the deliverable list as they are issued by the Government of Canada. In the event that, at any regular issue or auction, the Government of Canada reopens an existing issue which has not been originally issued at a 2-year Government of Canada bond auction but would otherwise meet the standards of this Rule, thus rendering the existing issue indistinguishable from the newly issued one, then the older issue is deemed to meet the standards of this Rule and would be deliverable if the reopening of such an existing issue has a total minimum face value amount of $2.4 billion during the last 12 month period preceding the first tender date of the contract month. The Exchange shall have the right to exclude any new issue from deliverable status or to further limit outstanding issues from deliverable status, whether or not they otherwise satisfy the standards of this Section.

(4) In the event the Corporation determines that there exists a shortage of deliverable Government of Canada Bond issues it may designate as deliverable on a 2-year Canada Bond Futures such other Government of Canada issues as it deems suitable, and may specify any adjustments in the settlement amount that it considers appropriate and equitable.

Appendix 2

EXTRACTS OF BOURSE'S DE MONTRÉAL INC.'S DETAILED ANALYSIS REGARDING AMENDMENTS TO THE NOMINAL VALUE OF THE TWO-YEAR GOVERNMENT OF CANADA BOND FUTURES (CGZ)

a. Background

The CGZ contract was listed in May 2004 and at that time, the contract size was C$100,000 with a notional coupon of 6%. The CGZ had been introduced in an effort to provide a tradable transparent GoC listed yield curve offering, thereby providing approved participants and their clients with increased spread trading opportunities.

On November 17, 2004[1], the Bourse amended the delivery terms by:

- Including originally issued 10-year GoC bonds in the basket of deliverables due to the limited amount outstanding of 2-year GoC bond issues.
- Reducing the minimum price fluctuation from 0.01 (C$10) to 0.005 (C$5)

On July 24, 2006[2], the Bourse amended the contract size from C$100,000 to C$200,000 to harmonize the contract with the 2-year US treasury bond futures contract. The notional coupon was also reduced from 6% to 4% and the minimum amount outstanding for GoC bonds eligible for inclusion in the basket of deliverables was reduced from C$3.5 billion to C$2.4 billion.

Finally, on September 1, 2010[3], the Bourse:

- Changed the notional coupon rate for the CGZ contract from 4% back to 6%.
- Excluded 5-year and 10-year GoC bonds from the basket of deliverable bonds.

All of the above changes were made to improve the attractiveness of the CGZ contract while fostering liquidity. However, these efforts proved to be relatively unsuccessful, as illustrated by figure 1 below. Note that the highest average daily volume on record, which was 872 contracts, coincided with the launch year of the CGZ. The contract continued to trade until 2007 following which, as of 2008 and until the end of 2009, it saw no volume; light trading resumed in 2010 and continued through to 2015.

The successful contract launch in 2004 could have been facilitated by the fact that two large Canadian banks were designated as market makers. The increase in volume in 2011, following zero volume in 2008 and 2009, could be attributable to the Bourse's launch of the Yield Curve Project, which saw the contracting of five firms, for a period of 5 years, regarding the market making of: 1) the BAX's second and third year quarterly expiries, 2) the CGZ, and 3) the CGF.

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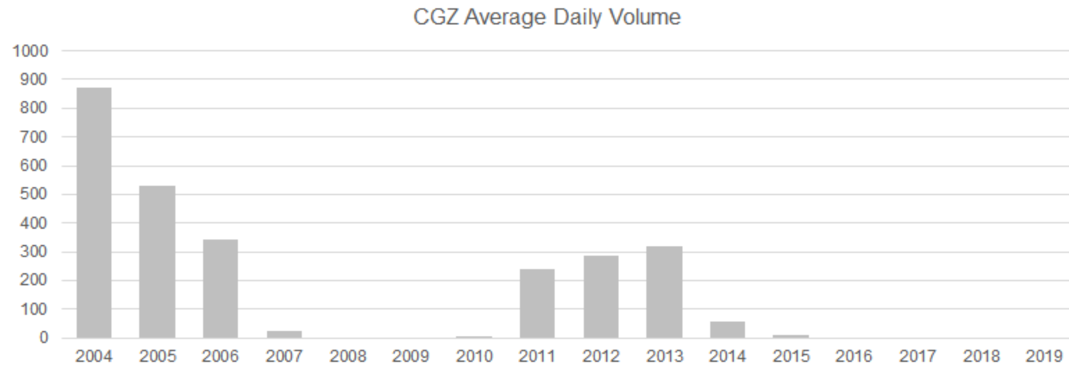
[1] https://www.m-x.ca/f_circulaires_en/150-04_en.pdf
[2] https://www.m-x.ca/f_circulaires_en/136-06_en.pdf
[3] https://www.m-x.ca/f_circulaires_en/105-2010_en.pdf

Figure 1: CGZ contract historical average daily volume ("ADV")



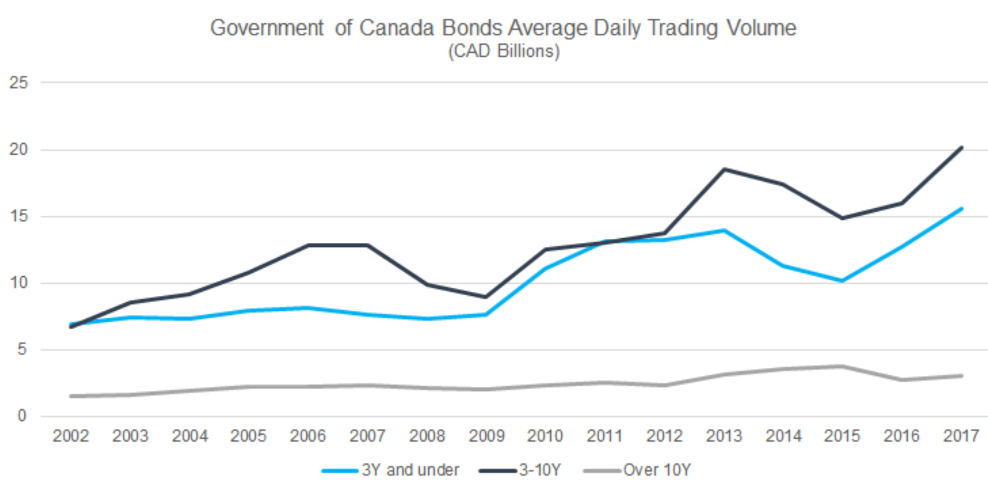
Source: Montreal Exchange

Following the successful revitalization of the CGF contract in December 2018, the Bourse believes that the conditions are right to undertake another attempt at developing the CGZ contract given that:

- Fixed income participants have no way of accessing the two year segment of the Canadian yield curve, nor hedge exposure or leverage a market view, via an efficient futures market.
- The two year segment of the Canadian curve is heavily traded in the cash market. GoC secondary market bond trading of maturities less than three years represent approximately 40% of the total GoC bond market.
- Providing a liquid two year bond futures will further foster the development of the CGF and CGB futures contracts, as well as the BAX futures contract and eventually CORRA futures. A liquid two year GoC bond futures will bridge the gaps between short-term products and the pivotal five year point of the curve (CGF), thereby enabling multiple trading strategies amongst MX fixed income futures products.
- The two year US Treasury futures are the fastest growing Treasury futures contracts in volume and open interest in the last five years.

Based on IIROC statistics, over C$16B of GoC bonds with maturities less than three years are traded on a daily basis. That figure has doubled in the last 10 years.

Figure 2: Government of Canada bonds average daily trading volume



Source: IIROC statistics

Table 1: 2019 Government of Canada bonds average daily trading volume (and %)

3 years and under	3-10 years	Over 10 years
16.24B (40%)	21.28B (52%)	3.48B (8%)

Source: IIROC statistics

Furthermore, as part of recent business development activities, the Bourse has received very positive feedback from market participants concerning a possible revitalization of the CGZ contract. The early interest for both trading the product and potential partnerships is encouraging. Target clients (buy-side, bank desks, proprietary traders, etc) are for the most part already trading the CGF and CGB contracts; we do not see any major impediment for them to also integrate the CGZ contract into their portfolio management practices.

b. Comparative Analysis

Table 2 demonstrates that many other major international short-term Government bond futures contracts have a nominal value equivalent to $100,000 in their own currency, which is aligned with the modification proposed by the Bourse. The CGZ tick value would become equivalent to five Canadian dollars, similar, not considering the currency type, to that of the well functioning Euro-Schatz contract[4].

Table 2: 2019 - Benchmarking of short-term Government bond futures

Exchange (Futures contract)	Nominal value of the contract	TIck size and tick value of the contract
MX (CGZ)	Current: C$200,000 nominal value of a Government of Canada bond Proposed: C$100,000 nominal value of a Government of Canada bond.	Current: 0.005 = C$10 Proposed: 0.005 = C$5
CME (2Y US Treasury futures)	U.S. Treasury notes having a face value at maturity of two hundred thousand dollars ($200,000)	(⅛) of (1/32) of one point= $7.8125
EUREX (Euro-Schatz)	EUR 100,000 Notional short-term debt instruments issued by the Federal Republic of Germany, the Republic of Italy, the Republic of France, the Kingdom of Spain or the Swiss Confederation	0.005 = EUR 5
ICE (Short-Gilt)	GBP 100,000 nominal value notional of short-term Gilt bonds	0.01 = GBP 10
ASX (3Y AUD bond futures	Commonwealth Government Treasury Bonds with a face value of A$100,000.	0.005 = approximately $15 per contract (varying with the level of interest rates)

Source: Exchanges websites

[4] Average daily volume and open interest in 2019 were 355,639 and 1,342,874 contracts respectively.

PART C – FUTURES

RULE C-16
2-YEAR CANADA BOND FUTURES (SYMBOL - CGZ)

The Sections of this Rule C-16 are applicable only to Futures where the Underlying Interest is Government of Canada bonds as defined in Section C-1602, herein referred to as “**2-year Canada Bond Futures**”.

[…]

Section C-1601
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