

**CANADIAN DERIVATIVES CLEARING CORPORATION**

**CDCC**

**THE CHARACTERISTICS  
AND RISKS OF LISTED  
CANADIAN OPTIONS**

**SEPTEMBER 2010**

THIS DOCUMENT IS INTENDED FOR DELIVERY TO CUSTOMERS RESIDENT IN THE UNITED STATES  
PURSUANT TO RULE 9b-1(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

**CANADIAN DERIVATIVES CLEARING CORPORATION**

[www.cdcc.ca](http://www.cdcc.ca)

**OFFICES**

**Toronto**

The Exchange Tower  
130 King Street West  
5<sup>th</sup> Floor  
Toronto, Ontario  
Canada M5X 1J2  
Tel: (416) 367-2463  
Fax: (416) 367-2473

**Montréal**

800 Victoria Square  
Montréal, Québec  
Canada H4Z 1A9  
Tel: (514) 871-3545  
Fax: (514) 871-3530

**BOURSE DE MONTRÉAL INC.**

[www.m-x.ca](http://www.m-x.ca)

800 Victoria Square  
Montréal, Québec  
Canada H4Z 1A9  
Tel: (514) 871-2424  
Fax: (514) 871-3568

© Canadian Derivatives Clearing Corporation

## TABLE OF CONTENTS

	<u>Page</u>
<b>1. INTRODUCTION .....</b>	<b>1</b>
THE ROLE OF CDCC .....	1
THE ROLE OF THE EXCHANGE .....	2
<b>2. OPTIONS .....</b>	<b>4</b>
EQUITY OPTIONS .....	5
BOND OPTIONS .....	5
STOCK INDEX OPTIONS .....	6
<b>3. EXERCISE AND ASSIGNMENT.....</b>	<b>7</b>
EXERCISE .....	7
EXPIRATION .....	7
ASSIGNMENT .....	7
SETTLEMENT .....	8
<b>4. EXCHANGE RATE INFORMATION.....</b>	<b>9</b>
<b>5. TAX CONSIDERATIONS, TRANSACTION COSTS, AND MARGIN REQUIREMENTS .....</b>	<b>11</b>
CERTAIN U.S. FEDERAL INCOME TAX ASPECTS OF OPTIONS TRANSACTIONS .....	11
CANADIAN FEDERAL INCOME TAX CONSIDERATIONS APPLICABLE TO NON-RESIDENTS .....	12
TRANSACTION COSTS.....	13
MARGIN REQUIREMENTS .....	14
<b>6. RISKS OF OPTIONS TRANSACTIONS .....</b>	<b>15</b>
GENERAL .....	15
BUYING CALL OPTIONS .....	15
BUYING PUT OPTIONS .....	17
WRITING CALL OPTIONS.....	17
WRITING PUT OPTIONS.....	18
SPREAD POSITIONS .....	19
STRADDLES .....	20
STOCK INDICES .....	21
INDEX OPTIONS .....	21
CASH SETTLEMENT OF INDEX OPTIONS.....	21
SPECIAL RISKS OF INDEX OPTIONS .....	22
CHARACTERISTICS OF CANADIAN GOVERNMENT BOND OPTIONS.....	23
SPECIAL RISKS OF DEBT OPTIONS .....	24
MISCELLANEOUS RISKS.....	24
<b>7. RISKS RELATED TO THE SECONDARY MARKET IN OPTIONS.....</b>	<b>26</b>
<b>8. RISKS RELATED TO ADJUSTMENTS IN TERMS OF EQUITY OPTIONS .....</b>	<b>27</b>
<b>9. RISKS RELATED TO EXERCISE AND ASSIGNMENT.....</b>	<b>29</b>
INTRODUCTION.....	29

GENERAL RISKS .....	30
TENDER OF EXERCISE NOTICES.....	30
ASSIGNMENT OF EXERCISE NOTICES.....	31
DELIVERY AND PAYMENT .....	31
EXERCISE RESTRICTIONS .....	31
<b>10. RISKS RELATED TO CERTIFICATELESS TRADING .....</b>	<b>33</b>
<b>11. CONCLUSION .....</b>	<b>34</b>
<b>GLOSSARY OF TERMS.....</b>	<b>35</b>
<b>ANNEX I — SCHEDULE OF BOURSE DE MONTRÉAL INC. HOLIDAYS AND EARLY CLOSINGS .....</b>	<b>I-1</b>

## 1. INTRODUCTION

This document provides an overview of the characteristics and risks of exchange-traded Put and Call Options ("Options") that are cleared and settled by Canadian Derivatives Clearing Corporation.<sup>1</sup> The descriptions contained herein relate solely to Options issued by Canadian Derivatives Clearing Corporation (referred herein throughout as "CDCC" or the "Corporation"), and all references to Options refer only to such Options. As of the date of this document, Options are purchased and sold in transactions executed on Bourse de Montréal Inc.<sup>2</sup>

None of the Options issued by CDCC are listed or traded on any securities exchanges in the United States (U.S.), although certain of the underlying securities are traded on one or more U.S. exchanges. Several U.S. exchanges are currently trading standardized Options ("U.S. Options") on foreign securities listed on U.S. exchanges, including certain of the securities of Canadian issuers underlying the Options offered hereby. However, investors should be aware that U.S. Options are not fungible with CDCC Options. Although the terms and procedures applicable to the Options described herein and U.S. Options are similar, they are not identical in all respects, they are not interchangeable and there may be additional risks for U.S. investors as the result of trading in a foreign market and, in most cases, in a foreign currency. Investors should consult their U.S. registered brokers to determine whether such U.S. Options are available.

**The Options issued by CDCC may only be offered and sold to U.S. residents through broker-dealers who are registered with the Securities and Exchange Commission (or who are exempt from federal registration under Rule 15a-6 of the Securities Exchange Act of 1934 or other applicable exemption) and applicable state securities authorities (or who are exempt from such state registration) and only in those states where the Options have been registered or where an exemption from registration is applicable.**

<sup>1</sup> The Canadian Derivatives Clearing Corporation (CDCC) was formerly known as Trans Canada Options Inc. (TCO). The name was changed in January 1996.

<sup>2</sup> As of May 1, 2008, Bourse de Montréal Inc. became, through a series of amalgamations, a direct subsidiary of TMX Group Inc. TMX Group Inc. also controls the Toronto Stock Exchange which is the marketplace for senior equities in Canada, and the TSX Venture Exchange which is the marketplace for junior equities in Canada. Bourse de Montréal Inc. is the Canadian Derivatives Exchange for exchange-traded financial derivative products, including any type of option contracts.

This document has been designed to provide a simple explanation of the most common strategies employed in trading Options and the potential risks and rewards accompanying such strategies. Other risks that may, under certain circumstances, apply to Options trading in general, have also been highlighted. However, this document does not attempt, nor should it be considered, to be a complete discussion of all Options trading strategies or the risks accompanying such strategies.

Additional information concerning Options and trading strategies can be obtained from experienced Options brokers and from Bourse de Montréal Inc. The website of Bourse de Montréal Inc., [www.m-x.ca](http://www.m-x.ca), contains additional information about derivative products in Canada.

The description of Options contained in this document is based on the rules of Canadian Derivatives Clearing Corporation and Bourse de Montréal Inc. Reference is made to the full text of these rules for complete information. The current versions of the rules of both CDCC and Bourse de Montréal Inc. are available on their respective web sites ([www.cdcc.ca](http://www.cdcc.ca) and [www.m-x.ca](http://www.m-x.ca)). All examples in this document are based on hypothetical values that are not necessarily indicative of the values in an actual transaction nor do they include tax consequences, commissions or other transaction costs. Dollar amounts are expressed in Canadian dollars unless noted otherwise. A glossary of terms is provided towards the end of this document.

## THE ROLE OF CDCC

CDCC is the issuer, clearinghouse, and primary obligor to its Clearing Members for exchange-traded interest rate and equity derivative contracts traded in Canada. All Canadian exchange-traded interest rate and equity derivative contracts are traded on Bourse de Montréal Inc. The Corporation is subject to regulation by governmental authorities of various provinces of Canada. The Corporation's Registration Statement on Form S-20 containing the prospectus for Options filed pursuant to the U.S. Securities Act of 1933 is available for inspection at the Corporation offices or is available on the U.S. Securities and Exchange Commission's internet address: [www.sec.gov](http://www.sec.gov).

In addition to its role as a clearinghouse for exchange traded options on equities, bonds, stock indices and futures, the Corporation acts as a

clearinghouse for exchange-traded futures listed on the Bourse de Montréal Inc. and for over the counter equity options.

All of CDCC's clearing activities are ultimately supported by the Clearing Fund to which all Clearing Members contribute.

The obligations of the Corporation extend only to its Clearing Members and not to the general public or specific Option buyers, writers, or sellers. To qualify as a Clearing Member, a firm must meet minimum capital requirements designed to ensure its ability to meet its on-going obligations to the Corporation. In addition, Clearing Members must provide the Corporation with margin for each Option for which it represents the writer and must contribute to the Clearing Fund that protects the Corporation against the failure of a Clearing Member to discharge its obligations. Finally, CDCC employs Enhanced Capital Monitoring, a process to assess and mitigate a Clearing Member's credit risk to which CDCC is exposed. The credit risk component is required because Margin and Clearing Fund requirements are imposed without consideration for a Clearing Member's capital situation. The credit risk component considers a Clearing Member's capital to assess the risk of failing to respond to sudden increases in Margin and Clearing Fund requirements. The simulation of significant moves in the market may require the Clearing Member to deposit additional margin called "stress test margin."

The obligations of Option writers are to the Clearing Members rather than to any particular Option buyer. Every Option transaction involves both a buyer and a seller. Therefore, the aggregate rights of Option holders are matched by the aggregate obligations that Option writers owe to the Clearing Members. Further, the obligations of the Clearing Members are to the Corporation rather than to any other Clearing Member.

## THE ROLE OF THE EXCHANGE

Options issued by the Corporation are listed and traded on Bourse de Montréal Inc. Bourse de Montréal Inc. is an exchange recognized by the Autorité des marchés financiers ("AMF").

Bourse de Montréal Inc. is subject to regulation for the protection of investors. Bourse de Montréal Inc. and its approved participants are subject

to the Securities Act (Quebec) and the regulatory jurisdiction of the AMF, as well as the rules and policies of Bourse de Montréal Inc.

## Trading Rules

The rights and obligations of holders and writers of Options are subject to the rules of the Corporation and Bourse de Montréal Inc. Exchange rules govern such matters as Trading Hours, Expiration Times, Expiration Cycles, and Exercise and Position Limits.

## Trading Hours

The Options market is open during normal equity trading hours. As of the date of this document, Options are traded during the following hours:

Equity Options:	9:35 a.m. to 4:00 p.m.
Bond Options:	9:30 a.m. to 4:00 p.m.
Stock Index Options:	9:30 a.m. to 4:15 p.m.

All hours are Eastern Time. Bourse de Montréal Inc is open for trading each Monday to Friday, except for certain Canadian holidays. A list of the holidays and early closings of Bourse de Montréal Inc. appears on Annex I attached to this document. A current list of holidays and early closings of Bourse de Montréal Inc. is also posted on the Bourse's website at [www.m-x.ca](http://www.m-x.ca). U.S. investors might be disadvantaged by not having access to Canadian markets on those U.S. holidays when Canadian exchanges are open and U.S. brokers' offices are closed.

## Contract Specifications

Contract specifications for all Options traded on Bourse de Montréal Inc. can be found on its web site at [www.m-x.ca](http://www.m-x.ca).

## Expiration Times

Equity and Bond Options expire on the Saturday following the third Friday of the expiration month. Stock Index Options expire on the third Friday of an expiration month. At the current time, these Option types expire at 11:30 a.m. (Eastern Time) on the above noted days. Trading in Options ceases at 4:00 p.m. (Eastern Time) on the business day preceding the expiration date in the case of Equity and Bond Options, and at 4:15 p.m. (Eastern Time) on the business day preceding the expiration

date in the case of Stock Index Options. However, these times are subject to change. Up-to-date expiration times for all Options are listed in the contract specifications which can be found on the website of Bourse de Montréal Inc. at [www.m-x.ca](http://www.m-x.ca). Please note that expiration times are not the same as the brokers' cut-off times for exercising Options. See "Exercise and Assignment — Expiration" on page 7 for more information regarding broker cut-off times for exercise of Options.

### **Expiration Cycles**

There are various cycles (i.e., periodic expiration periods) that are customized by Bourse de Montréal Inc. Each customer should determine from his or her broker the particular cycle set by Bourse de Montréal Inc. for the Option class.

### **Position Limits**

Bourse de Montréal Inc. has limitations regarding the maximum number of puts and calls that may be purchased or written by a holder and the number of Options on a single stock which may be exercised by a holder within certain time periods. Investors may obtain more detailed information on these matters from their brokers.

Additional information about exchange functions is available in rulebooks obtainable from Bourse de Montréal Inc.'s website and in a number of Bourse de Montréal Inc. publications.

The contact information for Bourse de Montréal Inc. is as follows:

**Bourse de Montréal Inc.**

Tour de la Bourse  
P.O. Box 61  
800 Victoria Square  
Montréal, Québec  
Canada H4Z 1A9  
Phone : (514) 871-2424  
Fax : (514) 871-3568  
[www.m-x.ca](http://www.m-x.ca)

## 2. OPTIONS

There are two basic types of Options. Subject to certain limitations, a Call Option gives the holder the right to purchase a specified amount or value of a particular underlying interest (in accordance with the rules of Bourse de Montréal Inc. and the Corporation) at the exercise price prior to or at the fixed expiration time. Subject to certain limitations, a Put Option gives the holder the right to sell a specified amount or value of a particular underlying interest (in accordance with such rules) at the exercise price prior to, or at the fixed expiration time.

The writer of a Call Option is a person who, through his or her broker, has sold a Call on Bourse de Montréal Inc. in an opening sale transaction and has thereby undertaken the obligation to deliver to a Clearing Member a specified amount or value of a particular underlying interest represented by the Call upon the assignment of an exercise notice to him or her against payment of the aggregate exercise price. The writer of a Put undertakes the obligation to purchase from a Clearing Member, through his or her broker, a specified amount or value of a particular underlying interest represented by the Put at the aggregate exercise price upon the assignment of an exercise notice to him or her against delivery of the number of units of the underlying interest represented by the Put.

As consideration for the rights and obligations represented by an Option, the buyer of an Option pays and the writer receives an amount known as the "premium." The premium is determined by agreement between the buyer and the writer, or their agents, in Bourse de Montréal Inc.'s electronic auction market, and reflects considerations such as supply and demand, the duration of the Option, the difference between the exercise price and the market price of the underlying interest, interest rates and the price volatility and other characteristics (including dividend yield) of the underlying interest. In addition, buyers and writers of Options must pay transaction charges in every Options transaction.

Options issued by the Corporation have standardized terms which are determined by Bourse de Montréal Inc. and include the expiration time and exercise price for each series of Options, leaving the premium and transaction costs as the only variables. Options terms were standardized in order to permit a secondary market in which an existing position as

holder or writer of an Option may be liquidated by an offsetting closing transaction.

There are basically two styles of Options. An American Style Option can be exercised at any time up to the expiration date or it can be closed out by an equal offsetting closing transaction. This closing or offsetting transaction eliminates any position held. European Style Options can only be exercised on the expiration date itself. Similar to an American Style Option, a European Style Option can also be closed out with an offsetting trade.

Options are usually available with exercise prices both above and below the current market price of the underlying interest. When the Option is listed for trading on Bourse de Montréal Inc., the exercise prices are set closely to the underlying interest's prevailing market price. Due to the possibility that the value of the underlying interest will move up or down before an Option expires, at least three different exercise prices are introduced for the same expiration month. As the value of the underlying interest moves upward or downward, Bourse de Montréal Inc. introduces additional Options with higher or lower exercise prices according to established policies.

Options can be classified as "in-the-money," "at-the-money," or "out-of-the-money." In the case of both Call and Put Options, an at-the-money Option is an Option whose exercise price is equal to the underlying interest (e.g. exercise price = \$25 and current market price = \$25). The criteria for an in-the-money or out-of-the-money Option, however, differ depending upon whether the Option is a Put Option or a Call Option.

In the case of a Call Option, an in-the-money Option is an Option whose exercise price is below the current market price of the underlying interest (e.g. exercise price = \$25 and current market price = \$30). In the case of a Put Option, an in-the-money Option is an Option whose exercise price is above the current market price (e.g. exercise price = \$30 and current market price = \$25).

In the case of a Call Option, an out-of-the-money Option is an Option whose exercise price is above the current market price (e.g. exercise price = \$30 and the current market price = \$25). In the case of a Put Option, an out-of-the-money Option is an Option whose exercise price is below the current market price (e.g. exercise price = \$25 and the current market price = \$30).



The intrinsic value of an Option is the amount by which the Option is in-the-money. For example, if XYZ traded at \$30, an XYZ Call Option with an exercise price of \$25 would have an intrinsic value of \$5 (\$30 minus \$25 = \$5). Conversely, if XYZ traded at \$20, this same Call Option would have no intrinsic value. Similarly, if XYZ traded at \$30, an XYZ Put Option with an exercise price of \$35 would have an intrinsic value of \$5 (\$35 minus \$30 = \$5). Conversely, if XYZ traded at \$40, this same put Option would have no intrinsic value.

When an underlying interest no longer meets requirements for Options trading, or if trading is discontinued for some other reason, Bourse de Montréal Inc. may stop introducing new Options on that underlying interest. Trading in Options series will normally continue until its expiration. However, restrictions may be imposed upon transactions that open new positions in Options series that were previously introduced.

There are two groups of Options: actual delivery Options (e.g., Equity and Bond Options) and cash delivery Options (e.g. Stock Index Options). An actual delivery Option requires the delivery of the underlying interest when the Option is exercised. That is, an Equity (or Bond) Call Option provides the holder with the right to buy a specified amount of the underlying equity (or Bond). Similarly, an Equity (or Bond) Put Option provides the holder with the right to sell a specified amount of the underlying equity (or Bond).

A cash delivery Option requires a cash settlement payment of the difference between the aggregate exercise price and the aggregate official settlement price of the underlying interest when the Option is exercised. In particular, subject to limitations, an Index Call Option allows the holder to receive in cash, 100 times the amount by which the official settlement value of the underlying index on the day of exercise exceeds the exercise value of the Option. Conversely, an Index Put Option allows the holder to receive in cash, 100 times the amount by which the underlying index on the day of exercise is less than the exercise value of the Option.

### EQUITY OPTIONS

As of the date of this document, CDCC offers Equity Options -- that is, Options on equity securities -- on approximately 140 separate

underlying securities listed and traded on a Canadian exchange.

Every Put or Call Option contract represents 100 shares or units of the underlying security. For example, an XYZ Call Option provides the holder the right to purchase 100 shares or units of the XYZ Company.

*Example:* "XYZ Mar 20 Call" means a Call Option covering 100 shares of XYZ Company stock which may be purchased at \$20 per share until the Option expires on the "expiration date" in March.

### BOND OPTIONS

Government of Canada Bonds are the foremost Canadian debt instruments. These bonds pay interest semi-annually and are actively traded "over the counter" on a principal basis by Canada's major investment dealers and the chartered banks. The Government of Canada issues bonds periodically to refund maturing issues and to provide for additional cash needs. Government of Canada Bond rates are determined based on the creditworthiness of the prime borrower (the Government of Canada), the liquidity of the market in which they trade and the size of the outstanding issues.

Each bond option contract is for an underlying interest of the particular Government of Canada Bond. Bond Options are quoted in minimum fluctuations of 0.01% of \$100 face value. The premium per contract is obtained by multiplying the quote by 250. Each contract is for an underlying interest of \$25,000 of the Government of Canada Bond. Government of Canada Bonds are no longer represented by actual certificates. These securities are maintained in a book-based system at CDS Clearing and Depository Services Inc., Canada's national clearing agency and central securities depository.

*Example:* As of the date of this document, Bourse de Montréal Inc. lists options on the Government of Canada Bond issue maturing in June 2012 (symbol: OBA). "OBA March 114 Call" means a Call Option covering one unit of trading (with a \$25,000 face value) of OBA which may be purchased at 114%, plus accrued interest, of its face value until the Option expires in March. If, for example, the OBA Bond Option has a premium of \$2.30, the aggregate premium will be \$575.00 (\$2.30 times 250 = \$575.00)

When Options on a particular issue of bonds are first introduced, exercise prices are fixed at levels bracketing the current market price of the underlying security. Additional higher or lower exercise prices are introduced as the market rises or declines.

### STOCK INDEX OPTIONS

A stock index is a method of reflecting in a single number the market values of many different stocks. An index may be designed to be representative of the stock market as a whole, of a broad market sector or of a particular industry. An index may be based on the prices of all, or only a sample, of the stocks whose value it is intended to represent.

Subject to limitations, Options on stock indices give a holder the right to receive a cash exercise settlement amount equal to the amount by which the fixed exercise price of the Option exceeds (in the case of a Put) or is less than (in the case of a Call) the settlement value of the underlying index on the date of exercise, multiplied by a specific index multiplier.

As of the date of this document, Bourse de Montréal Inc. offers Options on the S&P/TSX 60 Stock Index (symbol: SXO). This index is a capitalization-weighted index of the 60 largest and most liquid stocks in Canada. The S&P/TSX 60 Stock Index Option is settled in cash rather than by delivery of the securities in the index. Each Option contract represents \$100 times the value of the relevant Index. Whereas the majority of equity options are American Style, the S&P/TSX 60 Stock Index Options are European Style.

*Example:* "SXO Mar 715 Call" means a Call Option covering \$100 times the S&P/TSX 60 Index value which allows its holder to receive in cash 100 times the amount by which the official opening level of the S&P/TSX 60 Index on the day of exercise exceeds 715, on the "expiration date" in March (European Style Option).

### 3. EXERCISE AND ASSIGNMENT

#### EXERCISE

Once the Corporation has issued an Option, the contractual ties between the holder and the writer of the Option are severed. Instead, the holder of an Option looks to the Clearing Member and not to any particular writer for performance in the event of exercise. Each time an Option is issued to a holder, there is a writer of an Option of the same series contractually obligated to his or her respective Clearing Member. The aggregate obligations of the Clearing Members to holders of Options are backed up by the aggregate obligations which writers owe to their Clearing Members. Each Clearing Member looks to CDCC for performance in the event of exercise, and not to another Clearing Member.

#### EXPIRATION

The expiration time represents the latest time by which notice of exercise must be received from a Clearing Member in proper form at the Corporation. If an outstanding in-the-money Option is not properly exercised prior to its expiration, it will become worthless. The expiration time should not be confused with the broker's cut-off time for exercising Options. Generally, in order to exercise an Option, a customer must so instruct his or her broker to exercise prior to the broker's cut-off time for accepting exercise instructions (which will be earlier than the expiration time). Different brokers may have different cut-off times for accepting exercise instructions from customers and those cut-off times may be different for different types of Options. Customers must consult with their brokers to determine the applicable cut-off times for accepting exercise instructions.

Although an Option holder must assure that action is taken to exercise Options, CDCC's rules provide for the automatic exercise of in-the-money Options. Under CDCC's present rules, all Equity, Bond and Index Options in client accounts that are in-the-money by \$0.01 or more are automatically exercised at expiration. Since, at the present time, the minimum trading increment of the interests underlying Options is \$0.01, all in-the-money Equity, Bond and Index Options are exercised at expiration.

Although, under CDCC's current rules regarding automatic exercise of Options, all in-the-money Options are automatically exercised, a client

can advise his or her broker to notify CDCC not to auto exercise an Option. The client must consult with his or her broker to determine the time by which the broker must be advised to prevent automatic exercise of an Option.

#### ASSIGNMENT

Upon exercise of an Option, the Corporation uses a random assignment process to assign an exercise notice to a Clearing Member's account that contains Options of the same series as the exercised Option. The Clearing Member to whose account the exercise notice was assigned is obligated, in accordance with the by-laws and rules of the Corporation, to deliver the underlying interest in the case of a Call, or to purchase the underlying interest in the case of a Put. In the case of a cash delivery Option, the seller must, in lieu of delivery, pay the excess of the aggregate official settlement price over the aggregate exercise price of the underlying interest in the case of a Call, or the excess of the aggregate exercise price over the aggregate official settlement price of the underlying interest in the case of a Put. If the exercise notice is assigned to the Clearing Member's customers' account, the Clearing Member in turn allocates the exercise notice to one or more of its customers who are writers of Options of the same series as the exercised Option.

Subject to restrictions on trading of certain Options that might be imposed by Bourse de Montréal Inc., once an Option is opened for trading on Bourse de Montréal Inc., the Option remains open for trading until 4:00 p.m. (Eastern Time) on the third Friday of the expiration month, in the case of Equity and Bond Options, and until 4:15 p.m. (Eastern Time) on the Thursday before the third Friday of the expiration month in the case of Stock Index Options, notwithstanding that Options with different exercise prices may have been opened for trading at different times.

Notwithstanding the above, the Corporation and Bourse de Montréal Inc. may impose restrictions with respect to Options whenever such action is deemed advisable in the public interest or for the protection of investors or in the interest of maintaining a fair and orderly market. Such restrictions may involve the suspension of a particular type or types of transactions (such as opening purchase transactions, opening uncovered writing transactions, or all opening writing transactions) or of all types of transactions, with respect to one or more

classes or series of Options. In addition, the Corporation, Bourse de Montréal Inc., and Canadian provincial securities commissions may impose trading halts or suspensions in opening or closing transactions, or both, in one or more classes or series of Options whenever such action is considered advisable in the interest of a fair and orderly market, taking into consideration such factors as trading halts or suspensions or other trading irregularities in an underlying interest, or other unusual circumstances. Any of these restrictions, if imposed, could have a significant adverse effect on the liquidity of the secondary market on Bourse de Montréal Inc., in which event holders and writers of Options affected by such restrictions might find it difficult or impossible to liquidate their positions through closing transactions on Bourse de Montréal Inc.

### SETTLEMENT

All Options trades that are cleared by CDCC are matched by Bourse de Montréal Inc. before they are reported to CDCC. If a matched trade meets all the applicable criteria within CDCC's Rules, the trade is accepted and the positions of respective Clearing Members are updated immediately. Settlement of all Option trades occurs on the trade date plus one day (known as "T+1") via an irrevocable payment processing system.

Exercised Equity and Bond Options settle on the third business day after exercise. Delivery and settlement of exercised and assigned Equity and Bond Options are effected through the book-based systems of the CDS Clearing and Depository Services Inc. Settlement of exercised and assigned Stock Index Options is made by cash settlement on the business day following exercise, and is handled directly by the Corporation via an irrevocable payment processing system.

**4. EXCHANGE RATE INFORMATION**

All dollar amounts in this document are expressed in Canadian dollars. Although some contracts may be denominated in U.S. funds, the majority is in Canadian funds. Investors in CDCC Options should be aware that the price of any Option contract denoted in a foreign currency and, therefore, the potential profit and loss resulting therefrom, may be affected by any fluctuation in the foreign exchange rate between the time the order is placed and the time the Option contract is liquidated or exercised.

Since June 1, 1970, the Government of Canada has permitted a floating exchange rate to determine the value of the Canadian dollar against the U.S. dollar. The high and low rates of exchange of one Canadian dollar expressed in terms of U.S. dollars for the five years ended December 31, 2009,, as reported by the Bank of Canada, were as follows:

---

YEAR	HIGH	LOW
2009	0.9755	0.7653
2008	1.0298	0.7688
2007	1.0908	0.8437
2006	0.9100	0.8528
2005	0.8690	0.7872

---

On June 18, 2010, the rate of exchange of one Canadian dollar expressed in terms of U.S. dollars, as reported by the Bank of Canada, was \$0.9768 U.S. = \$1.00 Canadian.

Trading in the Canadian Options market requires U.S. investors to adjust to those stock prices, bond prices, index values, exercise prices and Option premiums that are quoted in Canadian dollars. To accurately determine the status of an account following a transaction in Canadian funds, U.S. investors should be familiar with a method for converting these transactions into U.S. dollars.

Although many of the CDCC Options underlying stocks are traded in both U.S. and Canadian markets, it is difficult to compare a stock

quote that is in U.S. dollars to the Option's exercise price and premium for those classes of Options which trade in Canadian dollars.

There are two methods for the required currency conversions. One method is to simply determine the stock price, bond price, index value, exercise price and Option premium quoted on Bourse de Montréal Inc. All these components would then be quoted in the same currency. The following example illustrates this method.

*Example:* XYZ August \$40.00 Call, with a current market value of \$39 and a Premium ranging from a bid price of \$2.65 to an ask price of \$2.80. Assume that the exchange rate is: \$1.00 CDN = **\$0.9768** U.S.

A buyer would pay \$280.00 CDN (100 times \$2.80 = \$280.00) for each contract. To calculate the equivalent value in U.S. funds, this amount is then multiplied by the current exchange rate (\$280.00 times **\$0.9768**= \$273.50 U.S.).

The alternate method for currency conversion is to convert the exercise price and Option quote into U.S. dollars, which could then be compared with the U.S. market price of a dual listed underlying stock. The three components would then all be in U.S. dollars.

*Example:* A dual listed stock is listed on a U.S. market with a current market price of \$30.00 U.S. The exercise price of the Option listed on Bourse de Montréal Inc. is \$40. The premium for the Option ranges from a bid of \$2.50 CDN to an ask of \$2.70 CDN. Assume that the exchange rate is \$1.00 CDN = **\$0.9768** U.S. To convert the terms of the Option into U.S. dollars, the investor would go through the following steps:

- (1) The exercise price is \$39.07 U.S. (\$40.00 times **0.9768** = \$39.07).
- (2) The Premium ranges from a bid of \$2.44 U.S. (\$2.50 times **0.9768** = \$2.44) to an ask of \$2.64 U.S. (\$2.70 times **0.9768** = \$2.64).

The second method will result in having to relate an Option premium and stock price to an irregular exercise price (\$39.07 in the above example).

U.S. investors trading CDCC Options will be dealing in Canadian dollars. Typically, U.S. broker-dealers will provide for U.S. clients the exchange rate that they will be applying to trading in CDCC Options.

Most U.S. broker-dealers will have both a buying rate and a selling rate for dealing in a foreign currency, i.e. a bid-ask spread. Accordingly, a potential risk of trading CDCC Options for U.S. investors is that they may receive payments for transactions in CDCC Options at less favorable exchange rates than the rates at which they are obligated to make payments in connection with CDCC Options. Therefore, in addition to foreign exchange fluctuations, investors are also exposed to foreign exchange bid-ask spreads.

## **5. TAX CONSIDERATIONS, TRANSACTION COSTS, AND MARGIN REQUIREMENTS**

### **CERTAIN U.S. FEDERAL INCOME TAX ASPECTS OF OPTIONS TRANSACTIONS**

The following is a limited summary of certain U.S. federal income tax considerations applicable to a U.S. holder of Options. For purposes of this summary, the term "U.S. holder" means a beneficial owner of Options that is for U.S. federal income tax purposes, (a) an individual who is a citizen or resident of the U.S.; (b) a corporation organized under the laws of the U.S., any state thereof or the District of Columbia; (c) an estate whose income is subject to U.S. federal income taxation; or (d) a trust that (1) is subject to the primary supervision of a court within the U.S. and the control of one or more U.S. persons for all substantial decisions or (2) has a valid election in effect under applicable Treasury regulations to be treated as a U.S. person.

The U.S. federal income tax consequences of Options transactions differ depending upon such factors as whether an Option is exercised or is the subject of a closing transaction; or whether it is written covered or uncovered. Because of the importance of tax considerations and the complexity of applicable rules, U.S. holders contemplating trading in Options should consult with their own tax advisers as to how taxes may affect the outcome of contemplated Options transactions.

The U.S. Internal Revenue Code of 1986, as amended (the "Code"), contains provisions that limit the recognition of losses realized with respect to various types of Straddles, which are broadly defined for that purpose. These provisions apply to most Straddles involving equity Options and Options on certain stock indices, regardless of where they are traded. The risks of dealing in Spreads and Straddles are discussed on pages 18 and 19.

In general, individual U.S. holders hold their Equity Options on individual stocks as capital assets for United States federal income tax purposes. A U.S. holder realizes no taxable gain or loss on the purchase of a put or call Equity Option, nor does he incur any deductible expenses. However, such purchase may trigger other tax consequences to the U.S. holder such as the application of "straddle," "wash sale," "constructive sale" or "conversion transaction" rules. Similarly, a writer of a put or call Equity Option

realizes no taxable income upon receipt of a "premium", and incurs no currently deductible expenses. Taxable gains and losses arise when Equity Options are subsequently sold, or on the date of their expiration. For most individual U.S. holders, such gains and losses will generally be capital in nature, and will be short-term or long-term depending on the relevant holding periods.

Gains and losses realized with respect to regulated futures contracts are treated as 40% short-term and 60% long-term capital gains and losses. Regulated futures contracts held at the end of the taxable year are taxed on a "mark-to-market" basis (as of the end of the year) and are subject to special deemed holding period rules. Several types of Options, including certain non-equity options and dealer securities futures contracts, if traded on a qualified foreign exchange (as determined by the Secretary of the Treasury to have rules adequate to carry out the purposes of the provisions), are similarly treated. (Bourse de Montréal Inc. is not currently seeking a determination that its rules are adequate for this purpose.) The Straddle rules described above do not apply to a Straddle comprised exclusively of the type of contracts or Options generally subject to the mark-to-market rules. Special rules apply in the case of, and certain elections may be made with respect to, certain "mixed Straddles," in which at least one, but not all, of the offsetting positions consist of the type of contracts or Options generally subject to the mark-to-market rules.

In addition, the Code contains provisions that require gain to be realized upon the "constructive sale" of an "appreciated financial position" (as each term is broadly defined) in certain circumstances. For example, a person who holds an in-the-money Equity Call Option may recognize gain upon entry into a short sale with respect to the same or substantially identical stock.

In addition, U.S. holders should also be aware that if they hold an option or other right to acquire stock of a foreign (non-U.S.) entity that is considered a "passive foreign investment company" under section 1297 of the Code ("PFIC"), such U.S. holder will be subject to special and adverse tax consequences under the PFIC rules of the Code. Such tax consequences generally include, but are not limited to, recharacterization of gains from the disposition of an option or other right to acquire stock as ordinary income taxed at the highest applicable rate, as well as an interest charge. Although certain

U.S. tax elections may be available to shareholders of a PFIC to mitigate the effect of the PFIC rules, these elections are unavailable to U.S. holders that only hold options or other rights to acquire stock in a PFIC. Each U.S. holder should consult its own tax advisor regarding the application of the PFIC rules to any option or other right to acquire stock of a foreign entity.

Under the Code and Treasury regulations, certain categories of U.S. holders must file information returns with respect to their investment in Options. For example, the recently enacted Hiring Incentives to Restore Employment Act of 2010 generally imposes new U.S. return disclosure obligations (and related penalties) on U.S. holders that hold certain specified foreign financial assets in excess of \$50,000. The definition of specified foreign financial assets includes not only financial accounts maintained in foreign financial institutions, but also, unless held in accounts maintained by a financial institution, any stock or security issued by a non-U.S. person, any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. person and any interest in a foreign entity. U.S. holders may be subject to these reporting requirements unless their Options are held in an account at a domestic financial institution. Penalties for failure to file certain of these information returns are substantial. U.S. holders should consult with their own tax advisors regarding the requirements of filing information returns, and, if applicable, filing obligations relating to the PFIC rules.

Notwithstanding the importance of tax considerations, for the sake of simplicity and because tax rules are subject to change, the examples which are contained in this document do not take into account the U.S. federal income tax consequences of Option transactions. It should be kept in mind that the omission of taxes from the illustrations may make them appear more profitable than actual transactions would be.

#### **CANADIAN FEDERAL INCOME TAX CONSIDERATIONS APPLICABLE TO NON- RESIDENTS**

The following is a summary of the principal Canadian federal income tax considerations generally applicable to a person who engages in Options transactions on Bourse de Montréal Inc. and who, at all relevant times for purposes of the *Income Tax Act* (Canada) (the "Tax Act") and any applicable income

tax treaty, is not, and is not deemed to be, a resident of Canada (and has never been, or been deemed to be a resident of Canada), who holds the Options as capital property, and who does not carry on, and is not deemed to carry on, business in Canada (a "Non-resident"). The Options will generally constitute capital property to a holder thereof unless the holder holds the Options in the course of carrying on a business or acquired the Options in a transaction or transactions considered to be an adventure or concern in the nature of trade. It is a question of fact as to whether Options are capital property to a particular Non-resident and investors should consult their own tax advisors. Special rules, which are not discussed below, may apply to a Non-resident which is an insurer which carries on an insurance business in Canada and elsewhere and such persons are advised to consult with their own tax advisors.

This summary is based on the provisions of the Tax Act and the regulations thereunder as of the date of this document, all specific proposals to amend the Tax Act and the regulations announced by or on behalf of the Minister of Finance (Canada) prior to the date of this document and on the current published administrative policies and practices of the Canada Revenue Agency. This summary does not otherwise take into account or anticipate any changes in law, whether by judicial, governmental or legislative decision or action, nor does it take into account provincial, territorial or foreign income tax considerations which may differ from the Canadian federal income tax considerations described herein.

Because of the importance of tax considerations and the complexity of applicable rules, it cannot be emphasized too strongly that investors contemplating trading in Options should consult with their tax advisers as to how taxes may affect the outcome of contemplated Options transactions.

#### **Taxable Canadian Property**

Any gains realized by a Non-resident in respect of Options transactions on Bourse de Montréal Inc. will not be subject to Canadian federal income tax unless the transactions are in Options which constitute taxable Canadian property (as defined in the Tax Act) to the Non-resident.

Where an Equity Option constitutes taxable Canadian property to a Non-resident, the Non-resident should consult their own professional advisers regarding the possibility of relief from



Canadian federal income tax under the provisions of the *Canada-U.S. Income Tax Convention* (1980), as amended, or other applicable double taxation conventions

### Equity Options

Subsequent to March 4, 2010, an Equity Option in respect of a share of the capital stock of a corporation that is listed on a designated stock exchange (which includes the Toronto Stock Exchange), a share of the capital stock of a mutual fund corporation or a unit of a mutual fund trust shall be considered to be taxable Canadian property where, at any particular time during the 60-month period that ends at that time, the taxpayer or the taxpayer and persons with whom the taxpayer did not deal at arm's length had an option in respect of, or an interest in, or for civil law a right in:

- 25% or more of the issued shares of any class of the capital stock of the corporation, or 25% or more of the issued units of the trust, as the case may be; and
- More than 50% of the fair market value of the underlying share or unit, as the case may be, was derived directly or indirectly from one or any combination of:
  - (a) Real or immovable property situated in Canada;
  - (b) Canadian resource properties;
  - (c) Timber resource properties; and
  - (d) Options in respect of, or interests in, or for the civil law rights in, property described in (a) to (c), whether or not the property exists.

Where the Non-resident holds a combination of options and shares that collectively exceed the 25% threshold, it is the Canada Revenue Agency's position that a disposition of either the shares or the option would be considered a disposition of taxable Canadian property.

In other cases, an Equity Option in respect of a share of a particular corporation that is listed on a designated stock exchange, a share of the capital stock of a mutual fund corporation or a unit in a mutual fund trust should not be considered to be

taxable Canadian property unless the underlying share or unit, as the case may be, was deemed to be taxable Canadian property.

### Bond Options

A Bond Option will not constitute taxable Canadian property to a Non-resident unless the underlying bond is convertible into property that would be considered taxable Canadian property. At the present time, the underlying Government of Canada Bonds are not convertible into property that is taxable Canadian property. Consequently, any gain realized by a Non-resident in respect of a Bond Option transaction will not be subject to Canadian federal income tax.

### Stock Index Options

A Stock Index Option does not constitute an option in respect of, an interest in, or a civil law right in shares of a particular corporation or units of a mutual fund trust, or any other taxable Canadian property, and therefore does not constitute taxable Canadian property to a Non-resident. Consequently, any gain realized by a Non-resident in respect of a Stock Index Option transaction will not be subject to Canadian federal income tax.

### TRANSACTION COSTS

Brokers may charge their customers commissions upon the purchase or writing of Puts and Calls and upon the exercise of either type of Option. It is likely that non-member U.S. brokers will pass on to their customers the commissions that they are charged by the Canadian members of Bourse de Montréal Inc. through which U.S. customer orders are transmitted. Transaction costs may therefore be higher because of the involvement of a Canadian correspondent broker. Commissions on Options transactions, including exercise transactions, are as agreed upon between each customer and his or her broker, although many brokers may be unwilling to negotiate modifications in commission rates established by them. In addition, as noted above, the commissions charged by U.S. brokers will likely be no less than, and may well exceed, the commissions charged by Bourse de Montréal Inc.'s approved participants.

The impact of transaction costs on profitability is often greater for Options transactions than for transactions in the underlying interests

because such costs are often greater in relation to Options premiums than in relation to the price of underlying interests. Transaction costs are particularly significant in Option strategies calling for multiple purchases and sales of Options, such as spreads and straddles. Investors should always discuss transaction costs with their brokers before engaging in Options transactions.

### MARGIN REQUIREMENTS

In the Options market, "margin" refers to the cash or securities required to be deposited by an Option writer with his or her broker as collateral for the writer's obligation to buy or sell the underlying interests if assigned an exercise notice. The rules of the Financial Institutions Regulatory Association ("FINRA") and any other self-regulatory organizations of which a U.S. broker may be a member, impose margin requirements with respect to a customer's position as an Options writer, and these rules also impose requirements as to the minimum amount of margin that must be maintained by a customer in his or her margin account. Further, Regulation T of the Federal Reserve Board governs the amount of credit (if any) which may be initially extended by a U.S. broker or dealer at the time a customer enters into any securities transaction. The margin requirements of FINRA and the other self-regulatory organizations are in addition to, and do not replace or modify, the requirements imposed by Regulation T. Accordingly, when any transaction occurs in a margin account (including the purchase, writing or exercise of an Option or the assignment of an exercise notice to an Option writer), the status of the account as a whole must be tested initially against the requirements of Regulation T and then the relevant self-regulatory organizations. It should be emphasized that the margin requirements of Regulation T and of the various self-regulatory organizations are minimum requirements, and many brokers impose more stringent requirements upon their customers.

Customers should determine the margin obligations that will be imposed upon them by their brokers before engaging in any Option transaction.

Writers of Options, other than certain covered call writers (discussed on pages 16 and 17) and certain writers of cash-secured puts (discussed below), must comply with applicable margin requirements, and Option writers are generally required to enter into margin agreements which give

their brokers a lien on securities and other assets held in their margin accounts. Uncovered writers of Options may have to meet calls for substantial additional margin in the event of adverse market movements unless they have sufficient equity in their margin accounts to cover the resulting increases in the margin required on their Options positions.

A put writer may eliminate the obligation to comply with margin requirements by depositing cash equal to the Option exercise price with his or her broker. Using such cash-secured put writing, an Option writer is not subject to any additional margin requirements regardless of what happens to the price of the underlying interest.

Changes in applicable margin requirements or in the availability of certain margin provisions may occur after an investor has purchased or written an Option and while he or she continues to hold the resulting position of holder or writer, and such changes could have a significant effect on an investor's opportunities and risks. Accordingly, investors should assure themselves that they have sufficient available capital for margin in case such changes occur.

## 6. RISKS OF OPTIONS TRANSACTIONS

### GENERAL

Before entering into any Option transaction, an investor should be aware of the risks involved and should determine whether the transaction is appropriate in light of his or her resources and financial objectives. In addition to evaluating the risks of trading in Options generally, an Option buyer or writer should be aware of the risks pertaining to the business and financial condition of the issuers of the underlying interests.

Buyers of Options generally hope for a "favorable" change in the market price of the underlying interest ("favorable" generally indicates an upward price movement in the underlying interest in the case of Call Options; however, "favorable" generally indicates a downward price movement in the underlying interest in the case of Put Options), whereas Option writers may profit if the underlying interest does not change in price. The risk of the Option writer generally increases with the volatility of the underlying interest. Further, because the maximum possible gain on any given writing transaction is the premium, whereas losses are potentially unlimited in the case of short call Options, the profits on a number of successful writing transactions may be more than offset by a single loss transaction.

The examples in the first half of this section generally illustrate the risks under discussion by reference to Equity Options. However, because many of these risks apply equally to Options on all types of underlying interests, the sections discussing the risk of "Buying Call Options," "Buying Put Options," "Writing Call Options," and "Writing Put Options" should be read by all Option investors. The remainder of this section discusses the special risks associated with Options on the particular types of underlying interests.

The examples contained in this document do not include commissions and other transaction costs and tax effects. Transaction costs and tax effects may be significant, and should be taken into account by anyone considering the buying or writing of Options. The examples also assume that transactions in underlying interests can be effected at current market prices, which may not always be the case. Finally, the reader should be aware of the special risks

presented by trading in securities whose prices are expressed in a foreign currency (see pages 9 - 10).

### BUYING CALL OPTIONS

The purchaser of a Call Option runs the risk of losing the entire investment in a relatively short period of time. Because the premium for a Call is considerably less than the cost of the underlying interest, a given amount of funds may purchase Calls covering a much larger quantity of such interest than could be purchased directly. By leveraging funds in this manner, the purchaser of Calls has the opportunity to benefit from any significant increase in the price of the underlying interest to a greater extent than had the underlying interest been purchased outright. However, if the Call is not sold while it has remaining value, and if the underlying interest does not appreciate during the life of the Call, the Call purchaser may lose the entire investment in the Call. Had the underlying interest been purchased directly instead of purchasing the Call, the purchaser might not have incurred a loss or, if the price of the underlying interest had declined, only a temporary paper loss.

This risk of purchasing Calls may be illustrated by comparing two investors, X and Y, who both have \$2,000 to invest. Investor X buys 100 shares of ABC Limited at \$20 per share for a total cost of \$2,000 (plus any transaction costs). Investor Y, on the other hand, purchases 10 ABC Call Options with an exercise price of \$21. The premium for this ABC Call Option is \$2.00, resulting in an aggregate premium of \$2,000 (\$2.00 times 10 contracts times 100 = \$2,000) plus any transaction costs. Both X and Y anticipate a rise in the market price of ABC Limited; however, if their expectations are not realized, Y's loss will be substantially greater than X's loss.

Assume that the price of the ABC shares has fallen to \$15 per share and that ABC has not paid any dividends. X's investment will be worth \$1,500, since X originally invested in 100 shares of ABC (\$15 times 100 = \$1,500). X's paper loss due to the decline in ABC's share price is equal to \$500 (\$2,000 minus \$1,500 = \$500). X will not be required to realize this loss, and may recover it if ABC shares later rise in price while X still owns the 100 shares.

On the other hand, if Investor Y has not sold the Call Options, he or she will have incurred a loss of the entire \$2,000 investment (plus any transaction costs) with no possibility for recovery. Given that the Call Options give Investor Y the right to purchase the ABC Company shares for \$21 each, and the shares are currently trading at \$15, there is no gain in exercising the Call Options. Furthermore, even if the market price of ABC had remained at \$20 until expiration, Investor X would have no gain or loss (other than transaction costs paid), but Investor Y would have lost the entire investment. Moreover, if ABC Limited had paid dividends, they would have been received by X as a Shareholder but not by Y as the holder of the Call Options.

Further, except where the value of the remaining life of a Call may be realized in the secondary market, for a Call purchase to be profitable, the total transaction costs paid in connection with selling or exercising the Call and initially purchasing the Call must be exceeded by the difference between the market price of the underlying interest and the exercise price. For example, if a Call covering 100 shares of ABC Limited at an exercise price of \$20 per share and a premium of \$6 per share is purchased, the aggregate premium would be \$600 (plus transaction costs). Before the Call can be exercised or sold at a profit, the price of the underlying security must increase so that the difference between the market value of the shares covered by the Call and the aggregate exercise price is sufficient to cover the premium of \$600, the initial transaction costs, the transaction costs payable on the sale or exercise of the Call and the commission payable on the sale of the securities that are received pursuant to the exercise of the Call.

One determinant of a Call's value is the amount by which the exercise price is below the market price of the underlying security. In addition, under certain circumstances, a call may have value in the secondary market without having intrinsic value. A call buyer may, in some circumstances, be able to realize this value in the secondary market with a closing sale transaction and offset part, or all, of the premium paid for the call.

For the above reasons, using Calls for leverage is extremely risky, and is unsuitable for investors who do not have the financial capability to withstand large losses.

## **Time Risks**

Unlike the stock investor, the Call purchaser must not only predict whether the price of the stock is going to rise, but when it will rise. If the stock price does not rise above the exercise price during the life of the Call, the purchaser of a Call will lose the entire investment (unless a portion of the premium is recoverable in a closing sale transaction). The stock investor, on the other hand, will have suffered no loss except for transaction costs (or if the stock price has declined, only an unrealized loss) until he or she chooses to sell the stock. Thus a Call investor does not have the choice of "waiting out" an unexpected downturn in the stock price beyond the expiration date of the Call. The more that an Option is out-of-the-money and the shorter its remaining term to expiration, the greater the risk that a purchaser of the Option will lose all or part of the investment.

Further, the very stock which might be considered more conservative from the standpoint of a direct purchase could be more risky as a Call investment. For example, a stable stock might be considered a safer investment than a more volatile stock because its price is less likely to fall, but the same stability factor also may mean that the stable stock's price is less likely to rise significantly during the relatively short duration of a Call. If the stock price does not rise during that period, the Call holder stands to lose the entire investment in such Calls.

There is also a time risk associated with European Style Options such as the Options offered on the S&P/TSX 60 Index. Prior to the expiration date of a European Style Option, the only way that the holder can realize any value from the Option is to sell it in the secondary market. If a secondary market for the Option were not available, the holder would not be able to sell the Option and make a profit from its value. It should be noted that while a liquid secondary market for a European Option may be available at the time of its purchase, the liquidity of the market is subject to change.

## **Exercise Risks**

The exercise provisions of an Option may result in certain risks for the Option holder. The Option holder has the ability to choose to override the automatic exercise feature of his or her Option contracts. However, if the holder does not take action to override the automatic exercise feature, an Option may be automatically exercised at a price at which the

holder would not choose. For example, the transaction costs associated with exercising the Option may exceed the cash settlement amount of the Option, resulting in a loss for the holder. It is up to the individual investor to be fully aware of the automatic exercise parameters (as shown on page 7), and his or her ability to prevent this automatic exercise.

At the present time, the minimum trading increment of the interests underlying Options is \$0.01 and, under CDCC's rules, all Equity, Bond and Index Options in client accounts that are in-the-money by \$0.01 or more are automatically exercised at expiration. Accordingly, at the current time, all in-the-money Equity, Bond and Index Options are exercised at expiration. However, if the minimum trading increment of the interests underlying Options subsequently is changed to an amount less than \$0.01, it may be possible for an Option to be in-the-money by an amount less than the minimum threshold at which the Corporation automatically exercises the Option. This scenario would also pose a risk. In this scenario, the holder's transaction costs may be such that the Option could be exercised profitably. However, given that the Option would not be exercised automatically by the Corporation, the holder would miss out on this profit if he or she neglects to exercise the Option. It is up to the individual investor to be fully aware of the automatic exercise parameters (as shown on page 7), and his or her ability to exercise Options that are in-the-money by an amount less than the automatic exercise parameters.

### **BUYING PUT OPTIONS**

As is the case of Call Options, the purchaser of a Put Option runs the risk of losing the entire investment in a relatively short period of time. This use contemplates the purchase of Puts by an investor who does not own the underlying interest. The Put buyer, like the short seller, seeks to benefit from a decline in the market price of the underlying interest. Unlike the short seller, the Put buyer is not subject to margin calls or to the theoretically unlimited risk of the short seller should the price of the underlying interest increase. On the other hand, if the Put is not sold when it has value prior to its expiration, and if at expiration the market price of the underlying interest is equal to or greater than the exercise price, the Put buyer will lose the entire investment in the Option. Further, in order for the purchase of a Put to be profitable, the market price of the underlying interest

must decline sufficiently below the exercise price to cover the premium and transaction costs. A Put buyer may, in some circumstances, be able to offset a potential loss by a closing sale transaction. The use of Puts for leverage is extremely risky and is unsuitable for investors who do not have the financial capability to withstand large losses.

The risk of losing one's entire investment in the purchase of Puts may be illustrated by comparing Investor X, who sells short 100 shares of ABC Limited at the market price of \$20 per share, with Investor Y, who does not own any shares of ABC Limited and who, for a premium of \$200, purchases a Put giving Y the right to sell 100 shares of ABC Limited at \$20 per share. Both X and Y anticipate a decline in the market price of ABC Limited, but should their expectations not be realized, X's results would be quite different from Y's. If at the time the Put expires, ABC Limited is trading at or above \$20, X will have had a paper loss (plus the obligation of maintaining increased margin on his short position) only to the extent the price moved above \$20. Investor Y, on the other hand, if he or she has not sold the Put, will have lost the entire \$200 investment in the Put (plus transaction costs) with no possibility for recovery. While the short seller's potential loss, excluding transaction costs, can range from zero to the theoretically unlimited amount by which ABC Limited may move above \$20, the buyer of the Put will lose the total amount paid for the Put (plus transaction costs), but no more than that amount, whenever ABC Limited is at \$20 or above at the time the Put expires.

### **WRITING CALL OPTIONS**

The writer of a Call Option may be assigned an exercise at any time during the life of the Option in the case of an American Style Option and on the Expiration Date in the case of a European Style Option. The writer of a Call assumes an obligation to deliver the underlying interest (or cash settlement amount in the case of a cash settled Option) represented by the Call against payment of the aggregate exercise price upon the assignment of an exercise notice. This means that the writer of an American Style Option is subject to being assigned an exercise at any time after the writing of an Option until the Option expires or until the closing out of the writer's position by the offsetting purchase of an identical Option in a closing transaction. Prior to the Expiration Date, the writer of a European Style Option can only close out his or her position by an

offsetting purchase of an identical Call in a closing transaction.

An Option writer should anticipate that the Option would be exercised if it were in the money, especially as expiration approaches. Once a call writer is assigned an exercise, he or she must deliver the underlying interest, or pay the cash settlement amount in the case of a cash settled Option. Risks related to being assigned an exercise depend upon whether the writer of the call Option is covered or uncovered, as discussed in the following two paragraphs.

A principal reason for writing Calls on a securities portfolio is to attempt to realize, through the receipt of premium income, a greater return than would be earned on the securities alone. The covered Call writer who owns the underlying interest has, in return for the premium, given up the opportunity to profit from a price increase in the underlying interest above the exercise price so long as the writer's obligation continues, but has retained the risk of loss should the price of the interest decline by an amount greater than the premium received for writing the Option. Unlike one who owns interests not subject to a Call, the covered Call writer of an American Style Option has no control over when he or she may be required to sell the underlying interests, since the Call writer may be assigned an exercise notice at any time prior to the expiration of his or her obligation as a writer. Indeed, the Call writer must assume that he or she may be assigned an exercise notice at any time, and that in such circumstances a loss may be incurred.

When the writer of a Call has no position related to the underlying interest, such a position is extremely risky, and subjects the Call writer to larger losses. Such an uncovered Call writer generally hopes to realize income from the writing transaction, but without the necessity of committing capital to the purchase of the underlying interest. (The uncovered Call writer is, however, required to maintain margin with his or her broker). As distinguished from the covered Call writer, the uncovered Call writer stands to incur an out-of-pocket loss if and to the extent that the price of the underlying interest increases above the exercise price. The uncovered Call writer's loss (which theoretically can be without limit) is represented by the extent to which the current market value of the underlying interest exceeds the aggregate exercise price, reduced by the premium and increased by transaction costs.

Because of the potentially large (theoretically unlimited) losses which may be incurred and the complexity of uncovered Call writing, such transactions are only suitable for sophisticated investors having the financial capacity to sustain such losses. Further, uncovered Call writers should have the financial capacity and liquid assets available to meet margin calls and to cover their positions by purchasing the underlying interest.

A covered writer who becomes uncovered is, of course, subject to the risks of uncovered Call writing. Similarly, the formerly uncovered Call writer who covers is, so long as he remains a covered writer, subject to the risks of that position.

### WRITING PUT OPTIONS

The writer of a Put Option may be assigned an exercise at any time during the life of the Option in the case of an American Style Option and on the Expiration Date in the case of a European Style Option. Every Put writer of an American Style Option is subject to being assigned an exercise notice at any time prior to the expiration of his or her obligation as a writer, in which event the writer will be obligated to pay for the underlying interest (or cash settlement amount in the case of a cash settled Option) at the exercise price. This obligation continues until the writer closes out the position or the Put expires. Put-writing transactions are only suitable for investors having the financial capacity and liquid assets available to pay the Exercise Price in the event of an exercise.

An Option writer should anticipate that the Option would be exercised if it were in-the-money, especially as expiration approaches. Once a put writer is assigned an exercise, the assigned writer must purchase the underlying interest, or pay the cash settlement amount in the case of a cash-settled Option. Risks related to being assigned an exercise depend upon whether the writer of the put Option is covered or uncovered, as discussed in the following paragraphs.

As with the writer of a Call, a Put writer generally hopes to realize premium income. If a Put writer does not have a short position in the underlying interest or a long position in another Put covering the same underlying interest that expires no sooner than the expiration of the Put written and that has an exercise price not less than the exercise price of the Put written, he or she stands to incur a loss if and to

the extent the price of the underlying interest falls below the exercise price of the Put written. Any such loss incurred would be reduced by the premium received by the Put writer and increased by transaction costs.

This risk of being an uncovered Put Writer may be illustrated by the following example. Assume that Investor Y writes a Put covering 100 shares of ABC Limited at an exercise price of \$30 when the market price of ABC Limited is \$30. Assume that the premium for the Put Option is \$2, giving Investor Y an aggregate premium income of \$200 (\$2 times 100 = \$200). If the market price of ABC Limited does not fall below \$30, it is unlikely that the Put will be exercised. On the other hand, if the market price of ABC Limited falls below \$30, the Put will be exercised and Investor Y will be required to purchase ABC Limited at \$30 per share. Investor Y's net cost of the shares (excluding transaction costs), however, would be reduced to \$28 per share after reflecting the \$2 per share premium.

If an investor writes a Put covering the underlying interest that he or she has sold short, the investor still hopes to realize premium income in the writing transaction, but his or her risk position is different from that of the Put writer without such a short position. In the former case, the investor may still incur a loss in his or her Put writing transaction if the price of the underlying interest falls below the exercise price, but this loss may be offset by a profit realized in the related short position.

This downside risk may be illustrated by the following example. Suppose that Investor Z writes an ABC November 30 Put Option when the market price of ABC is \$30. Assume that the premium of the Put Option is \$2, giving Investor Z an aggregate premium income of \$200 (\$2 times 100 = \$200). At the same time, Investor Z may sell short 100 shares of ABC for \$3,000. If ABC falls to \$25, Investor Z may be required to purchase 100 shares of ABC at \$30 pursuant to an exercise of the Put he wrote (excluding all transaction costs). If assigned an exercise notice, Investor Z may use the stock "put" to cover the short position, in which case, the resulting profit will be the \$200 originally received in the writing transaction.

However, the Put writer who is also a short seller of the underlying interest bears the risk of his or her short position in the underlying interest. Thus, if the price of the underlying interest should increase, such an investor stands to incur a loss in covering his

or her short stock position, offset to the extent of the premium received in the Put writing transaction.

There is unlimited upside risk, since if the underlying equity market price increases, the short sale of the equity will accrue potentially unlimited losses, while the profit from the writing of the Put is limited. This upside risk may be illustrated by continuing the preceding example. Assume that ABC increases to \$50 instead of decreasing to \$25. The profit resulting from the put sale will continue to be limited to the premium received (\$200 as demonstrated in the preceding example). However, the short sale of the stock accrues a loss of \$2,000 (100 times (\$50 minus \$30)).

Accordingly, writing Puts against short positions in the underlying interest carries a similar level of risk as writing an uncovered call, and is suitable only for sophisticated investors who have the means to meet margin calls (which can rise substantially if the market moves adversely to the writer's position) and to sustain large losses.

A Put writer may liquidate his or her position prior to the assignment of an exercise notice by purchasing a Put of the same series as the Put previously written. To the extent that the cost of such a liquidating purchase plus transaction costs exceeds the premium initially received, the Put writer will have incurred a loss in the Put transaction.

## SPREAD POSITIONS

A spread position is one in which an investor is the holder of one or more Options of a given class and concurrently maintains a position as a writer of one or more of the same type of Options (put or call) of different series within that same class. Spread positions are commonly used by Option writers to reduce risk. However, even when a writer has assumed a spread position, the risks may be significant, as described below.

Spread positions are subject to the same risks that are involved in the purchase and writing of Options as described throughout this disclosure document. In addition, they are subject to certain special risks, including the difficulty of simultaneously executing two or more buy or sell orders at the desired prices, the possibility that a loss could be incurred on both sides of the transaction, and in the case of American Style Options the increased risk exposure that would result from the exercise or

liquidation of one side of the trade while the other side of the trade remains outstanding. In addition, because spreads involve two or more components that may require several transactions, the transaction costs associated with spreads may be significant. These costs can have the effect of requiring a substantial favorable change in the value of the underlying interest before a profit can be realized.

Combination Option transactions, such as spreads, are considerably more complex than the purchase or writing of a single Option. Moreover, as in any area of investing, a complexity not well understood is, in itself, a risk factor. While this is not to suggest that combination strategies should not be considered, consultation with an experienced and knowledgeable Option broker as to the risks and potential rewards under various market circumstances should be an integral part of any such consideration.

### STRADDLES

A straddle consists of purchasing or writing an equivalent number of Puts and Calls covering the same underlying interest and having the same exercise price and expiration date. (Similar combinations of Puts and Calls covering the same underlying interest but differing as to exercise price or expiration date or both do not come within the definition of a straddle, but they involve much the same risks as are described below with respect to straddles). An investor may buy or write a straddle. In addition, because of their complexity, investors should understand that the transaction costs involved in straddles could be substantial.

Because the purchase of a straddle represents the purchase of two Options, the premium for a straddle is greater than that for a Put or a Call alone. This higher premium means that the price of the underlying interest must rise or fall enough to permit the investor to recover the premium paid for the straddle and transaction costs before a profit may be realized. Thus a straddle involves all of the risks of the purchase of a Put or a Call alone, plus the added risk that the underlying interest must change in value to a greater degree in order for the transaction to be profitable. Of course, as with the purchase of Puts or Calls alone, timing is important for an investor to realize any profit through the purchase of a straddle. That is, not only must the value of the underlying interest move upwards or downwards for a straddle to become profitable, but the investor must correctly determine when to exercise an American Style Option

to realize a profit, or when to enter into a closing sale transaction in order to realize a profit or minimize a loss.

Because a straddle writer is the writer of both a Put and a Call, he or she is subject to the risks of both such writing positions. Where the investor writes both a Put and a Call on the same underlying interest at the same exercise price in exchange for a combined premium on the two writing transactions, the potential risk is unlimited. To the extent that the price of the underlying interest is either below the exercise price by more than the combined premium, or above the exercise price by more than the combined premium, the writer of a straddle will incur a loss when one of the Options is exercised. Indeed, if the writer of an American Style Option is assigned an exercise in one Option position in the straddle and fails to close out the other position, subsequent fluctuations in the price of the underlying interest could cause the other Option to be exercised as well, causing a loss on both writing positions. These risks may be somewhat moderated if the investor buys the underlying interest at the same time as he or she writes a straddle covering that interest, which serves to cover the investor's obligation as a writer of the Call component of the straddle. Of course, such an investor must be willing to assume the risk of holding the underlying interest, not only in respect of the interests purchased at the time he or she wrote the straddle, but also in respect of the additional interests which the investor may be required to purchase in the event the Put component is exercised.

As in the case of other Options transactions, the purchasers and writers of straddles are subject to applicable margin requirements. Like spreads, straddles are complicated and should not be undertaken unless an investor thoroughly understands the mechanics and risks of the strategy and is financially able to bear such risks.

See also the discussion on "Miscellaneous Risks" on page 23 which explains the implications of: (a) the possible unavailability of a secondary market in the Options in which an investor has positions; (b) possible disruptions in the markets for underlying interests; (c) possible exercise restrictions imposed by CDCC or the Options markets; and (d) possible insolvency by brokerage firms or clearing members of CDCC on multiple Options strategies such as spreads and straddles. Any of the above would affect an investor utilizing a multiple Options strategy to a



greater extent than they would an investor engaged in only single Options transactions.

### **STOCK INDICES**

An index is a measure of the changes over a given period of time in the prices of a group of stocks or other interests. An index is a type of financial short-hand to consider a wide variety of prices from a range of sources and synthesize the data into one simple, meaningful number.

Stock indices are defined by the stocks from which they are constituted. For example, the S&P/TSX 60 Index (or "Index") is a capitalization weighted index of the sixty largest and most liquid securities in Canada. This is a broad-based index, meaning that it has representation from a wide variety of industry groups traded on the Toronto Stock Exchange. However, the Index only reflects price movements in the stocks which comprise the Index, and is therefore only an approximation of the movements of the overall market.

Stock indices are calculated in different ways. One common factor they have is that stock indices are ordinarily expressed in relation to a base established when the index is created. Increases or decreases in the value of the original components are then compared against the value of the base to measure changes in the index. The base is adjusted from time to time to reflect changes to the portfolio such as additions, deletions, or large cash or stock distributions. All other changes such as stock splits, stock dividends, and consolidations are made by adjusting the shares of the affected stock when necessary. The S&P/TSX 60 Index is re-balanced and adjusted on a quarterly basis on the contract expiration dates in March, June, September and December. The S&P/TSX 60 Index Option is calculated in a manner designed to measure the average price change for the stocks in the Index in accordance with their weighting within the Index. The Index is calculated by multiplying the price of each stock by its predetermined number of shares, adding these values, then dividing by the Index base value to arrive at the Index level.

The stocks in the Index group may change from time to time to reflect corporate changes such as mergers and liquidations or to reflect generic changes such as a particular stock no longer being representative of an industry segment. Particular stocks may also be added to or deleted from the

Index. Such changes are discretionary with the publisher of the Index. Such events, as well as others, may also result in adjustments to the terms of Options. See "Risks Related to Adjustment in Terms of Equity Options" on pages 26-27.

Certain arbitrage strategies may influence the price of a stock index. Such strategies involving the purchase and sale of Index Options and portfolios of certain of the stocks in an index group can affect the value of the stock index, and, therefore, the prices of the Options based on that index. Index Option traders should be aware of such trading strategies and the possible impact of such strategies on the values of Index Option positions.

### **INDEX OPTIONS**

Many of the specific Option uses described above are equally applicable to Index Options. In addition, because Index Options are designed to respond to price movements in the stock market generally or in defined segments, rather than in individual stocks, Index Options may be used to adjust the risk characteristics of stock positions in ways that cannot be accomplished with other kinds of Options.

### **CASH SETTLEMENT OF INDEX OPTIONS**

The principal difference between Equity Options and Index Options is the nature of settlement upon exercise. The exercise of an Equity Option requires delivery of the underlying security within the standard settlement cycle for equities following the tender of an exercise notice, whereas in the case of CDCC Index Options, settlement is in cash one business day following the Expiration Date. As of the date of this document, the S&P/TSX 60 Index Options are European-style.

Exercise of a Call gives the Index Option holder the right to the (cash) amount which is equal to the exercise settlement value of the index less the exercise price of the Option, multiplied by the applicable index multiplier.

Exercise of a Put gives the Index Option holder the right to the (cash) amount which is equal to the exercise price of the Option less the exercise settlement value of the index, multiplied by the applicable index multiplier.

The multiplier for a Stock Index Option is like the unit of trading for a stock Option. It determines the total dollar value of each point differential between the exercise price of an in-the-money Option and the current level of the underlying index, e.g. a multiplier of 100 would cause a one-point difference to result in \$100 of intrinsic value. The multiplier for Options on a particular index is fixed by Bourse de Montréal Inc. when the Options are first opened for trading.

Bourse de Montréal Inc. currently uses a multiplier of \$100 for the S&P/TSX 60 Index.

To illustrate (assuming a multiplier of \$100):

- a) An investor holds a March 705 Call Option on the S&P/TSX 60 Index when the Index is at 709. The March Option is 4 points in-the-money, or \$400. (The aggregate current value of the Index less the aggregate exercise price, i.e.,  $(709 \text{ minus } 705) \times \$100 = \$400$ ).
- b) An investor holds a March 710 Put Option on the S&P/TSX 60 Index when the Index is at 709. The March Option is 1 point in-the-money, or \$100. (The aggregate exercise price minus the aggregate current value of the Index, i.e.,  $(710 \text{ minus } 709) \times \$100 = \$100$ ).

#### **SPECIAL RISKS OF INDEX OPTIONS**

In addition to the risks described above which apply generally to the buying and selling of Options, there are other risks unique to Options that are settled in cash.

S&P/TSX 60 Index Options are European Style Options and may only be exercised on Expiration Date (the third Friday of the expiration month). Exercise and assignment of Index Options are settled in cash by the particular Clearing Members to the Corporation. The exercise of cash delivery Options does not result in cash payment directly from the Option seller to the Option purchaser.

Because exercises of Index Options are settled in cash, call writers cannot provide in advance for their potential settlement obligations by acquiring and holding the underlying securities. Except where the underlying index is based on relatively few stocks, most investors, as a practical matter, cannot acquire a

portfolio containing exactly the same stocks as the index.

Most index call writers will therefore bear the risk that the value of their particular stocks will not increase as much as the index. Even if the writer of an index call holds stocks that exactly match the composition of the underlying index, he or she will not be able to satisfy assignment obligations by delivering those stocks against payment of the exercise price. Instead, the writer will be required to pay cash in an amount based on the opening index value on the day after the last day of trading; and by the time the writer learns that he or she has been assigned, the index may have declined, with a corresponding decline in the value of his or her stock portfolio.

The exercise of Index Options settled in cash results in a cash payment from the seller to the purchaser based on the difference between the exercise price of the Index Option and the opening value (regardless of the actual time of exercise) of the underlying index on the day after the last day of trading.

S&P/TSX 60 Index Options cease trading at the close on the Thursday preceding the third Friday of the expiration month. CDCC Index Option settlements are based on the level of the underlying Index at the opening of trading on the Expiration Date and not the closing price on the Expiration Date as in the case of Equity Options.

The seller of an Index Option is not informed that he or she has been assigned an exercise notice, at the earliest, until the business day following exercise. Therefore, the seller will be subject to a "timing risk" from any unfavorable change in the value of the underlying index from the close of trading, when the value of the underlying index on the day of the exercise is disseminated to the time the seller learns that he or she has been assigned. Unlike the seller of a physical delivery Option, the seller of a cash settlement Option cannot satisfy assignment obligations by delivery of the lower valued underlying interest, but must pay cash in an amount determined by the price of the underlying index on the exercise date.

The "timing risk" discussed above makes Spread positions and certain other combined Option strategies involving cash settlement Options substantially more risky than similar strategies

involving physical delivery Options since they may not be as readily hedged because the writer may be temporarily unaware that an obligation has arisen.

Investors intending to use Index Options as a hedge against market risk of particular securities should be aware of the complexities of this strategy. Market risk is the risk that factors such as macroeconomic influences, which affect the stock market as a whole, may similarly affect the market prices of particular equities. Some equities are highly sensitive to factors influencing the stock market as a whole, while others are less so. In addition, an equity's sensitivity to broad market influences may change over time.

While Index Options may be used in an attempt to hedge against market risk, investors should realize that company specific risk might cause the company's shares to perform differently than the market as a whole. For example, a company in the process of litigation may have a sharp decline in the market value of its shares, even though the market in general is increasing in value.

The use of Index Options for hedging involves special risks, which are not present for hedges composed of Equity Options on their respective equities. This special risk occurs when the equities in the portfolio being hedged do not exactly mirror the equities in the underlying index. Unless the portfolio is of the exact same composition as the index constituents, the portfolio and the index may respond differently to the same market influence. Therefore, investors should understand that Index Options might be used as a strategy attempting to reduce some, but not all, of the market risks inherent in an equity portfolio.

Reported index levels may at times be based on non-current price information as a result of trading halts in some of the stocks in an index group. In this case the index continues to be calculated using the last board lot price of the halted stock(s) and the current market price of those stocks that are still being traded. If a majority of the stocks in an index group were to be halted it would be necessary to halt trading in the Index Option.

If a trading halt occurs, whether for these or for other reasons, holders and writers of Index Options will be unable to close out their positions (although holders of the Options may be able to exercise those Options on Expiration Date), and may

be faced with substantial losses if the underlying index moves adversely before trading resumes. If the trading of Options on an underlying index is halted, a market may impose restrictions prohibiting the exercise of such Options.

If the index level underlying any series of Index Options is unreported, CDCC may do any or all of the following: (1) suspend the settlement obligations of exercising and assigned Clearing Members; and (2) fix the exercise settlement values for exercised contracts of an affected series. Similarly, if CDCC determines that there is a material inaccuracy in the reported index level, it may take such action as it deems fair and appropriate in the circumstances. For example, CDCC may require an amended index level to be used for settlement purposes.

### **CHARACTERISTICS OF CANADIAN GOVERNMENT BOND OPTIONS**

Bond prices move in the opposite direction to the changes in prevailing levels of interest rates. Because the income from a bond is fixed, decreases in interest rates generally cause outstanding bonds to be more attractive and their prices rise. Similarly, when interest rates move up, outstanding bond issues become less attractive and their prices decline.

Exercises of Bond Options will result in the delivery of the underlying Bonds at the predetermined exercise price (plus accrued interest). More usually, positions are closed out, by matching a purchase and a sale of the same Option series, before the expiration.

Bond prices are quoted on the basis of "\$100.00" par value, with it being understood that settlement is "plus accrued interest." Accrued interest must be paid from, but not including, the latest coupon date, or if no coupon has yet been paid, interest must be paid from the date of issue of the bond. In the case of Bond Options the unit of trading is 250, which represents a contract size of \$25,000 ( $\$100 \times 250 = \$25,000$ ).

As an example, suppose an investor purchases in March, an OBA call Option with an exercise price of \$124 and which expires on the third Friday in June. At the time of this purchase, the underlying bond has a market price of \$123 but the investor believes that interest rates will decline and bond prices rise. Further assume that the premium paid by the investor is \$0.65 (per \$100 face value) for

a total cash outlay of \$162.50 ( $\$0.65 \times 250 = \$162.50$ ). This premium is his or her maximum risk.

By the end of May interest rates have declined, according to the investor's expectations, and the underlying bond has risen to \$131.25. The Option is now worth at least \$7.25 (i.e., its intrinsic value:  $\$131.25 \text{ minus } \$124 = \$7.25$ ) and can be resold for at least \$1,812.50 ( $\$7.25 \times 250 = \$1,812.50$ ).

In the purchase of call or put Options, the investor has limited the risks involved to a maximum of the premium paid. The writer of a call or put Option assumes the obligations to either deliver or receive the underlying bond in the case that his or her position is assigned, due to an adverse movement in the price of the underlying bond. The writer of call or put Options therefore has a risk, which is potentially as great as that of the underlying bonds. In return for assuming this position of risk, the writer of an Option receives the premium.

Various strategies exist which involve the combination of positions in order to minimize this risk while preserving a degree of profit potential.

#### **SPECIAL RISKS OF DEBT OPTIONS**

Most of the special risks associated with trading in debt Options arise from the nature of the markets in which the underlying debt instruments are issued and traded and the character of the instruments themselves.

Bond trading in Canada is conducted by dealers in non-exchange trading. At this time, there is no comprehensive consolidation of bids and offers or public reporting of transaction prices in those securities. The absence of last sale information and limited availability of quotations may make it difficult for investors other than dealers to obtain accurate or comprehensive information regarding the underlying cash market. Dealers in the underlying securities may have a significant advantage over other investors because of their access to private quotation networks.

Trading hours for debt Options may not conform to the trading hours for the underlying debt instruments. To the extent that the Options markets open after or close before the markets for the underlying instruments, significant price and rate movements can take place in the underlying markets that cannot be timely reflected in the Options market. Accordingly, an investor might consider, for example,

whether to close out a short position in the debt Option to avoid being assigned an exercise on the basis of underlying debt instrument price movements that occur after the Options market is closed.

The unit of trading for many debt Options involves larger dollar amounts of the underlying interest than is the case with stock Options. In general, this means that: (1) premiums for a single debt Option contract may be higher than for stock Options; and (2) the gain or loss in the value of a debt Option associated with any given change in the price of the underlying security will tend to be larger than for other Options.

In the event of a shortage of the underlying security deliverable on exercise of a debt Option, the Corporation has the authority to impose special exercise settlement procedures to protect investors who would otherwise be unable to meet their settlement obligations.

#### **MISCELLANEOUS RISKS**

In addition to the market risks inherent in Options transactions, there are special risks relating to the systems and procedures of Bourse de Montréal Inc. and the Corporation. Some of these risks relate to the secondary market in Options and are discussed in the following section. Other risks relate to the ability of the Corporation, Bourse de Montréal Inc., and brokers to deal with unforeseen volume increases or other circumstances tending to disrupt normal procedures.

Investors should also be aware that, although the Corporation has developed a system of safeguards which stands behind its obligations with respect to exercises, the capital of the Corporation may not, by itself, be sufficient to permit the Corporation to honor exercises, and it might be unable to honor exercises if its system of safeguards were to fail. In addition, the insolvency of a Clearing Member or other broker might affect the ability of its customers (including customers who are brokers and the customers of such brokers) who hold Options to sell or exercise their Options while any insolvency proceeding is pending. Further, the writers' positions (other than certain covered Call writing positions) of customers of an insolvent Clearing Member or other broker may be closed out without their consent.

Additional risk is present in Equity Options transactions by virtue of the fact that trading may be

interrupted or stopped in the underlying security, in which event the holder of an American Style Option may not be able to ascertain the current market price of the underlying security in making a decision whether or not to exercise the Option, and may not be able to purchase the underlying security required to be delivered in order to exercise a Put, or to sell the underlying security acquired upon exercise of a Call. The uncovered Call writer in such circumstances would be unable to cover his or her writer's position by purchasing the underlying security for delivery. Cessation of trading in an underlying security may also preclude Option writers from acquiring or disposing of the underlying security in connection with the assignment of an exercise to them. Bourse de Montréal Inc. or the Corporation may restrict the exercise of an Option, or the Corporation may impose a restriction on delivery of the underlying security by a holder of a Put or by an uncovered writer of a Call in which event an uncovered Call writer who is assigned an exercise notice, and the writer of a Put who does not receive delivery of the underlying security upon exercise, may be required to pay a prescribed settlement value in lieu of the ordinary delivery or payment upon exercise.

In addition to the risk posed by changes in the price of the underlying interest, investors should note the risk inherent in possible fluctuations in the value of the currency used to effect the trade. The value of any particular Options position will vary according to changes in the rate of exchange between U.S. and Canadian dollars. See the discussion of currency conversions on pages 9 and 10 herein.

Holders and writers of Options with automatic exercise features bear the risk that an automatic exercise value will be reported erroneously.

## 7. RISKS RELATED TO THE SECONDARY MARKET IN OPTIONS

Bourse de Montréal Inc. has advised the Corporation that its secondary market in Options is designed ordinarily to permit investors with existing positions as holders or writers of Options traded on Bourse de Montréal Inc. to liquidate their positions in offsetting "closing" transactions. Since holders and writers of Options are not contractually linked to each other, but instead have rights or obligations running to the Clearing Members, the secondary markets in Options do not operate in the same manner as the secondary markets in stocks, in that Option positions are not actually transferred from one holder or writer to another in a closing transaction. However, the effect is much the same from the point of view of the liquidating holder or writer whose position with a Clearing Member is cancelled in a closing transaction. Closing transactions are placed and executed in the same manner as opening transactions, but must be placed through the broker who maintains the account in which the position to be closed is held. A closing transaction may be executed only on Bourse de Montréal Inc., which provides a market for Options having identical terms to the Option position to be liquidated.

Bourse de Montréal Inc. has advised the Corporation that, although its trading mechanism is designed to provide market liquidity for the Options traded on Bourse de Montréal Inc., it must be recognized that there can be no assurance that a liquid secondary market on Bourse de Montréal Inc. will exist for any particular Options, or at any particular time, and for some Options no secondary market on Bourse de Montréal Inc. may exist at all. Among the reasons why a secondary market might not exist are the following:

- (i) there may be insufficient trading interest in certain Options;
- (ii) restrictions may be imposed on opening transactions or closing transactions or both;
- (iii) trading halts, suspensions or other restrictions may be imposed with respect to particular classes or series of Options or underlying interests;
- (iv) unusual or unforeseen circumstances and systems interruptions may interrupt normal Bourse de Montréal Inc. operations;

(v) the facilities of Bourse de Montréal Inc. or the Corporation may not at all times be adequate to handle current trading volume; or

(vi) Bourse de Montréal Inc. could, for economic, regulatory or other reasons, decide or be compelled at some future date to discontinue the trading of Options (or a particular class or series of Options), in which event the secondary market on Bourse de Montréal Inc. (or in that class or series of Options on Bourse de Montréal Inc.) would cease to exist, although outstanding Options that had been issued by the Corporation as a result of trades on Bourse de Montréal Inc. would continue to be exercisable in accordance with their terms (subject to the imposition of exercise restrictions by Bourse de Montréal Inc. or the Corporation).

In any of the foregoing events, it might not be possible to effect closing transactions in particular Options, with the result that a holder of an American Style Option would have to exercise his or her Option (requiring the holder to pay for the underlying interest or meet margin requirements in connection with its purchase) in order to realize any profit, and a writer would be unable to terminate his or her obligation until the Option expired or the writer performed upon being assigned an exercise notice. In addition, in the event of circumstances (e.g., a tender offer for an underlying interest) that have the effect of impairing liquidity in the market for an underlying interest, or for other reasons Bourse de Montréal Inc. might suspend or restrict trading in a class of Options. Such circumstances might also cause Bourse de Montréal Inc. or the Corporation to impose exercise restrictions on the affected class of Options. If trading is suspended or restricted at the same time that exercise restrictions are imposed, holders and writers of Options of the affected class would be unable to liquidate their positions in closing transactions and such Options could not be exercised. It should also be noted that a secondary market would not be beneficial to the holder of an Option that has lost all of its value.

## 8. RISKS RELATED TO ADJUSTMENTS IN TERMS OF EQUITY OPTIONS

Each Equity Option contract generally covers 100 shares or units of the underlying security. However, the number of shares or units may be adjusted as the result of certain events. The following is a brief description of some general adjustment rules applicable to Equity Options as at the date of this document. These rules may be changed from time to time subject to regulatory approval. Investors should obtain the most recent information regarding Equity Option adjustments from their broker.

The number of shares or other units underlying Equity Options and/or the exercise price are subject to adjustments in the event of dividends, distributions, stock splits, recapitalizations or reorganizations with respect to the underlying security or the issuer thereof. However, no adjustment is made to any of the terms of Equity Options to reflect the declaration or payment of "ordinary cash dividends or distributions." A cash dividend or distribution declared by the issuer of the underlying security will be deemed to be "ordinary cash dividends or distributions" if it is declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. Cash dividend or distribution paid outside such practice will be deemed to be either: 1) "ordinary cash dividends or distributions" if the declaration or payment is less than or equal to \$0.15 per share, or 2) "special cash dividends or distributions" if the declaration or payment exceeds the threshold of \$0.15 per share. The "special cash dividends or distributions" qualify for adjustment.

No adjustment is made to any of the terms of Equity Options to reflect the declaration or payment of "ordinary stock dividends or distributions". Stock dividends or distributions, or trust unit dividends or distributions declared by the issuer of the underlying security in an aggregate amount that per dividend or distribution does not exceed 10% of the number of shares of the underlying securities outstanding as of the close of trading on the declaration date, declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis will, as a general rule, be deemed to be "ordinary stock dividends or distributions".

Stock dividends or distributions, or trust unit dividends or distributions declared by the issuer of the underlying security in an aggregate amount that per

dividend or distribution do exceed 10% of the number of shares of the underlying securities outstanding as of the close of trading on the declaration date, regardless if it is declared pursuant to or outside a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis will, as a general rule, be deemed to be "special stock dividends or distributions". The "special stock dividends" qualify for adjustment.

Due to the fact that Equity Options are not generally adjusted for normal cash dividends and distributions, covered call writers are entitled to retain any dividends and distributions earned on the underlying equity prior to the exercise of the Option. If the Option is exercised prior to the ex-dividend date, the call holder is entitled to the dividend. However, the assigned writer may not be notified of this assignment until *after* the ex-date. Further, call holders may try to gain an impending dividend by exercising their Options. Therefore, a call writer's chances of being assigned an exercise may increase as the ex-date for a dividend on the underlying equity approaches.

Adjustments to the terms of Options are effective as of the "ex-date" of the event giving rise to the adjustment. Stock splits, stock dividends and other stock distributions which increase the number of outstanding shares of the issuer of the underlying security have the effect of proportionately increasing the number of shares of underlying stock covered by the Option and proportionately decreasing the exercise price. Where a stock split, stock dividend or stock distribution results in the issuance of one or more whole shares of underlying stock (or a whole multiple thereof) for each outstanding share of underlying stock, the number of shares covered by the Option is not adjusted. Instead, the number of outstanding Options is proportionately increased and the exercise price is proportionately decreased.

The foregoing may be illustrated by comparing the adjustments to a single Option covering 100 shares of stock at an exercise price of \$30 resulting from a 3-for-2 stock distribution and a 2-for-1 stock distribution. In the former case, after adjustment the Option will cover 150 shares at an exercise price of \$20, while in the latter case, after adjustment there will be two Options covering 100 shares each at an exercise price of \$15. It is important to note that if, as a result of an adjustment in terms, an Option covers more than 100 shares, the aggregate premium for the Option is determined by multiplying

the premium per share by the number of shares covered by the Option. For example, if an Option covers 115 shares as a result of a 15% stock dividend, and the premium is quoted at \$3 per share, the aggregate premium for that Option will be \$345 ( $\$3 \times 115 = \$345$ ).

In the event that stock splits, stock dividends or other stock distributions result in either one or more additional whole shares of the underlying security being issued with respect to each outstanding share (e.g. a 2 for 1 or a 4 for 1 stock split), each equity options contract shall be increased by the same number of additional contracts to reflect the same number of additional shares issued with respect to each share of the underlying security. As a general rule, the exercise price shall be proportionately reduced and the multiplier remains the same.

In the event that stock splits, stock dividends or other stock distributions result in other than either one or more additional whole number of shares of the underlying security being issued with respect to each outstanding share (e.g. 3 for 2 or 5 for 3 stock split), each equity options contract shall be adjusted by increasing (or decreasing, as the case may be) the deliverable to include (or eliminate, as the case may be) the number of shares distributed. As a general rule, the exercise price shall be proportionately reduced, the number of contracts remain unchanged and the multiplier shall be proportionally changed. In the case of a reverse stock split, consolidation, or combination of shares or similar event, the exercise price shall be proportionately increased, the number of contracts remain unchanged, and the multiplier shall be proportionally reduced.

In the case of other distributions (other than ordinary cash dividends for which no adjustment is made), recapitalizations or reorganizations by the issuer of the underlying security, or in the case of distributions where the adjustments described in the two preceding paragraphs are not considered by the Corporation to be appropriate in the circumstances, the exercise price of the Options with respect to such security may be reduced by the value per share of the distributed property, in which case the multiplier shall not be adjusted; or such Options may be equitably adjusted so as to include the equivalent property which a holder of the underlying security would be entitled to receive, in which case the exercise price shall not be adjusted.

Adjustments may also be made for events other than distributions. For example, if all the outstanding shares of an underlying equity are acquired in a merger or consolidation, outstanding Options may be adjusted to reflect this event. As a result of the acquisition, cash, equities, or other property may be deemed payable to holders of the underlying interest. For example, the Option on the underlying equity may be converted into a right to receive a fixed amount of cash rather than the underlying interest itself. In this case, trading in the Options will normally cease when the merger is completed.

The foregoing description of adjustments to Options is not comprehensive. Due to the fact that there are many, unique types of distributions and reorganizations, the resulting adjustments to the related Options also may be similarly unique.



## **9. RISKS RELATED TO EXERCISE AND ASSIGNMENT**

### **INTRODUCTION**

#### **Exercise**

Once the Corporation has issued an Option, the contractual ties between the holder and the writer of the Option are severed. Instead, the holder of an Option looks to the Clearing Member, and not to any particular writer for performance in the event of exercise. Each time an Option is issued to a holder, there is a writer of an Option of the same series contractually obligated to his or her respective Clearing Member. The aggregate obligations of the Clearing Members to holders of Options are backed up by the aggregate obligations which writers owe to their Clearing Members. Each Clearing Member looks to CDCC for performance in the event of exercise, and not to another Clearing Member.

#### **Expiration**

The expiration time represents the latest time by which notice of exercise must be received from a Clearing Member in proper form at the Corporation. If an outstanding in-the-money Option is not properly exercised prior to its expiration, it will become worthless. The expiration time should not be confused with the broker's cut-off time for exercising Options. Generally, in order to exercise an Option, a customer must so instruct his or her broker to exercise prior to the broker's cut-off time for accepting exercise instructions (which will be earlier than the expiration time). Different brokers may have different cut-off times for accepting exercise instructions from customers and those cut-off times may be different for different types of Options. Customers must consult with their brokers to determine the applicable cut-off times for accepting exercise instructions.

Although an Option holder must assure that action is taken to exercise Options, CDCC's rules provide for the automatic exercise of in-the-money Options. Under CDCC's present rules, all Equity, Bond and Index Options in client accounts that are in-the-money by \$0.01 or more are automatically exercised at expiration. Since, at the present time, the minimum trading increment of the interests underlying Options is \$0.01, all in-the-money Equity, Bond and Index Options are exercised at expiration.

Although, under CDCC's current rules regarding automatic exercise of Options, all in-the-money Options are automatically exercised, a client can advise his or her broker to notify CDCC not to auto exercise an Option. The client must consult with his or her broker to determine the time by which the broker must be advised to prevent automatic exercise of an Option.

#### **Assignment**

Upon exercise of an Option, the Corporation uses a random assignment process to assign an exercise notice to a Clearing Member's account that contains Options of the same series as the exercised Option. The Clearing Member to whose account the exercise notice was assigned is obligated, in accordance with the by-laws and rules of the Corporation, to deliver the underlying interest in the case of a Call, or to purchase the underlying interest in the case of a Put. In the case of a cash delivery Option, the seller must, in lieu of delivery, pay the excess of the aggregate official settlement price over the aggregate exercise price of the underlying interest in the case of a Call, or the excess of the aggregate exercise price over the aggregate official settlement price of the underlying interest in the case of a Put. If the exercise notice is assigned to the Clearing Member's customers' account, the Clearing Member in turn allocates the exercise notice to one or more of its customers who are writers of Options of the same series as the exercised Option.

Subject to restrictions on trading of certain Options that might be imposed by Bourse de Montréal Inc. (see the following paragraph), once an Option is opened for trading on Bourse de Montréal Inc., the Option remains open for trading until 4:00 p.m. (Eastern Time) on the third Friday of the expiration month, in the case of Equity and Bond Options, and until 4:15 p.m. (Eastern Time) on the Thursday before the third Friday of the expiration month in the case of Stock Index Options, notwithstanding that Options with different exercise prices may have been opened for trading at different times.

Notwithstanding the above, the Corporation and Bourse de Montréal Inc. may impose restrictions with respect to Options whenever such action is deemed advisable in the public interest or for the protection of investors or in the interest of maintaining a fair and orderly market. Such restrictions may involve the suspension of a particular type or types of transactions (such as opening

purchase transactions, opening uncovered writing transactions, or all opening writing transactions) or of all types of transactions, with respect to one or more classes or series of Options. In addition, the Corporation, Bourse de Montréal Inc., and the Canadian provincial securities commissions may impose trading halts or suspensions in opening or closing transactions, or both, in one or more classes or series of Options whenever such action is considered advisable in the interest of a fair and orderly market, taking into consideration such factors as trading halts or suspensions or other trading irregularities in an underlying interest, or other unusual circumstances. Any of these restrictions, if imposed, could have a significant adverse effect on the liquidity of the secondary market on Bourse de Montréal Inc., in which event holders and writers of Options affected by such restrictions might find it difficult or impossible to liquidate their positions through closing transactions on Bourse de Montréal Inc.

#### **Settlement**

All Options trades that are cleared by CDCC are matched by Bourse de Montréal Inc. before they are reported to CDCC. If a matched trade meets all the applicable criteria within CDCC's Rules, the trade is accepted and the positions of respective Clearing Members are updated immediately. Settlement of all trades occurs on the trade date plus one day (known as "T+1") via an irrevocable payment processing system.

Exercised Equity and Bond Options settle on the third business day after exercise. Delivery and settlement of exercised and assigned Equity and Bond Options are effected through the book based systems of CDS Clearing and Depository Services Inc.. Settlement of exercised and assigned Index Options is made by cash settlement on the business day following exercise, and is handled directly by the Corporation via an irrevocable payment processing system.

#### **GENERAL RISKS**

If the holder of an Option does not liquidate his or her position in the secondary market by a closing sale transaction, the holder can generally realize its value only by exercising it before its expiration. An Option that expires unexercised becomes worthless. Exercise instructions submitted to the Corporation by Clearing Members are irrevocable.

#### **TENDER OF EXERCISE NOTICES**

Subject to limitations on exercise, Clearing Members may exercise American Style Options by giving proper notice to the Corporation during the regular trading hours of Bourse de Montréal Inc. on days other than the Expiration Date, and prior to the expiration time on the Expiration Date. The expiration time will not be extended. European Style Options may only be exercised on the Expiration Date.

Options holders wishing to exercise Options must instruct their brokers as required prior to an earlier exercise cut-off time of their brokers. While the cut-off time for Bourse de Montréal Inc. is 5:30 p.m. (Eastern Time) on any business day, brokers may set earlier exercise cut-off times which vary from Bourse de Montréal Inc. cut-off times. Each customer should determine from his or her broker the applicable exercise cut-off time, since a customer's failure to instruct his or her broker to exercise an Option prior to that time will mean that the Option may not be exercised.

In order to exercise an outstanding Option, an exercise notice in acceptable form must be tendered to the Corporation no later than the deadline by the Clearing Member in whose account with the Corporation the Option is held. This means that a holder of an Option may only exercise it by notifying the broker handling the account in which the Option is held who, if not itself the Clearing Member, must forward the exercise notice to the Clearing Member.

Every tender of an exercise notice to the Corporation is irrevocable. Upon the proper and timely tender of an exercise notice, the exercising holder will be under a contractual obligation to pay the aggregate exercise price for the underlying interest, in the case of a Call, or to deliver the underlying interest, in the case of a Put, on the "exercise settlement date," even though the underlying interest may change in value after the exercise notice has been tendered. When a Call is exercised, the exercising holder becomes subject to all of the risks of a holder of the underlying interest and to the applicable margin requirements. In the case of a cash delivery Call Option, the seller must, in lieu of delivery, pay an amount which is equal to the aggregate official settlement price of the underlying interest less the aggregate exercise price, multiplied by the appropriate multiplier. In the case of a cash delivery Put Option, the seller must, in lieu of

delivery, pay an amount which is equal to the aggregate exercise price less the official aggregate settlement price of the underlying interest, multiplied by the appropriate multiplier.

Although an Option holder must assure that action is taken to exercise most Options, under CDCC's present rules, Equity, Bond and Index Options in client accounts that are in the money by \$0.01 or more are automatically exercised at expiration (see page 7).

#### **ASSIGNMENT OF EXERCISE NOTICES**

The exercise notice will be assigned to a randomly selected Clearing Member account with the Corporation that reflects the writing of an Option or Options of the same series as the exercised Option.

If the Corporation assigns an exercise notice to the client (customer) account of a Clearing Member, that Member is required to re-assign the exercise notice to a customer maintaining a position as a writer in the account, or to the client (customer) account of a broker who has cleared a writing transaction through the Clearing Member.

The latest assignments of exercise notices to Clearing Members are prior to 12:00 midnight on the expiration date. Each writer should determine from his or her broker the latest time prior to which the broker may notify the writer that an exercise notice has been re-assigned to him or her, since a writer may receive such notification as late as two business days following the Expiration Date. If an exercise notice is assigned to the writer of a Put, that writer becomes subject to all of the risks of a holder of the underlying interest and to the applicable margin requirements.

Clearing members with assignments receive a report from the Corporation on the morning of the business day immediately following the assignments. However, the time at which the Clearing Member then informs individual clients of their respective assignments varies according to the procedures of the individual brokerage firm. An investor should consult with his or her broker to be aware of any time delay, which may occur from the time of assignment to the time of being informed of the assignment.

#### **DELIVERY AND PAYMENT**

In the case of a Call, the Clearing Member to whom an exercise notice is assigned, and in the case

of a Put, the Clearing Member who is exercising the Put, is required to deliver the underlying interest represented by the Option in good deliverable form (as defined in the rules of the Corporation and Bourse de Montréal Inc.), or, in the case of a cash delivery Option, pay the amount described on page 20. In either case, such delivery is to be made on or before 3:00 p.m. (Eastern Time) on the "exercise settlement date" against payment of the aggregate exercise price. However, this time may change and should be verified with the broker. Clearing of transactions in underlying securities arising from exercise notices will be through the systems presently used for settlement of transactions in underlying securities.

If an exercise notice for an Equity Option is properly tendered to the Corporation prior to the ex-date for any distribution, including distributions for which there is no adjustment to the terms of the Option (such as an ordinary cash dividend), the distribution will go to the assigned writer of a Put or to the exercising holder of a Call, notwithstanding that notice of the assignment may be received by the writer on or after the ex-date for the distribution. This means that the assigned writer of a Call or the exercising holder of a Put may be required to deliver the underlying security together with the property included in a distribution at a time when the underlying security, if he or she does not already own it, may then be acquired only on an ex-distribution basis.

#### **EXERCISE RESTRICTIONS**

Options are generally exercisable at any time prior to their expiration except that European Style Options may be exercised only on expiration date. However, both the Corporation and Bourse de Montréal Inc. have the authority to temporarily prohibit the exercise of particular Options. Bourse de Montréal Inc. has imposed exercise limits and position limits on the number of Options which may be exercised by a holder or group of holders within any five consecutive business days. Bourse de Montréal Inc. may restrict the exercise of particular Options if such action is advisable in the interest of maintaining a fair and orderly market in the Options or the underlying interests, or is otherwise in the public interest. (No such restriction will remain in effect during the ten business days prior to an Option's expiration.)

The Corporation is also empowered to restrict the exercise of particular Options except

during the ten business days prior to the Option's expiration. For the duration and to the extent of any such restriction, the holder of any such Option will be unable to exercise it in contravention thereof. During the ten business days prior to an Option's expiration or thereafter, the Board of Directors of the Corporation may impose a restriction on delivery of underlying interests not owned by a writer of a Call to whom an exercise notice is assigned, or by a holder of a Put who has exercised it. In the event such a restriction is imposed on writers of Calls, the Corporation shall, and in the event such a restriction is imposed on holders of Puts, the Corporation may, fix a daily settlement value (which may be zero) for the Option subject to the restriction. If daily settlement values are fixed, the parties to the exercise will be obligated to pay and accept the settlement value fixed for the day the exercise notice is assigned, in lieu of receipt or delivery of the underlying interest. Since it is within the discretion of the Corporation to fix a daily settlement value when delivery restrictions are imposed on holders of Puts, if a daily settlement value is not fixed, the restriction on Put holders may remain in effect so long as trading in the underlying interest remains suspended. However, the Corporation may fix a settlement value whenever it determines that the underlying securities have no value.

**10. RISKS RELATED TO CERTIFICATELESS  
TRADING**

Certificates for Options will not be issued by the Corporation to evidence the issuance of Options. The ownership of Options is evidenced by the confirmations and periodic statements which customers receive from their brokers, and which show for each Put or Call held or written the underlying interest and the number of shares or other units thereof subject to the Option, the exercise price and the expiration month. Confirmations and statements of account furnished to customers are matters between brokers and their customers, and although Bourse de Montréal Inc. has general regulatory authority over its members, neither Bourse de Montréal Inc. nor the Corporation is responsible for inaccuracies or omissions in confirmations or statements of account.

Since the only evidence of a customer's position as a holder or writer of an Option is found in the records of his or her broker, the customer must continue to maintain an account with the broker so long as the customer has an Option position, and the Option may only be exercised, or the position liquidated in a closing transaction, through the broker handling the account in which the Option position is held. A customer may transfer an account to another broker by making a written request to the original broker to transfer his or her account to a new broker who has agreed to accept the account, but the transfer process may involve delays, and until the transfer is completed, exercises and closing transactions may be effected only through the original broker.

## 11. CONCLUSION

This document is not intended to be a complete discussion of the characteristics and risks of Options transactions, but rather should serve as an introduction to Options trading and provide a brief overview of the Canadian Options market. It was prepared by the Corporation for distribution pursuant to the requirements of the Securities and Exchange Commission, and is only intended to meet this requirement. This document should not be relied upon for investment advice. Further, nothing in this document should be construed as a recommendation to buy or sell any Option or any other security. The examples herein are for illustrative purposes only. Investors considering investments in Options issued by CDCC should carefully discuss the risks and opportunities of such trading with their brokers.

While there are numerous risks associated with the buying and selling of exchange-traded Options, there are other risks related to investing in Options which are not discussed in depth in this document. These risks include, but are not limited to, risks related to the investment in the underlying interest itself, the condition of the economy, the infrastructure of the financial markets, policies of individual exchanges, and policies of individual brokerage firms. These risks are briefly described below.

In addition to the risks inherent in buying and selling Options are the risks that may be inherent in an investment in the underlying interest itself. The investment potential of an Option is largely dependent upon the performance of the underlying interest. Therefore, investors in Options are subject to the risks that may affect the market value of such an underlying interest. For example, a risk assumed by a purchaser of a call Option (or writer of a put Option) is that the underlying interest may decline in price during the life of the Option. This price decline may be due to company specific events or to general market conditions. While these types of risks were briefly discussed in this document, their specific nature is outside of the scope of this document and a more thorough description of risks affecting a particular underlying interest are available from other sources.

Similarly, systematic risks, which may affect the Options market, are not described in this document. Economic and political factors affect the overall market conditions, which lead to market risks

for investors. Investors in Canadian Options should be aware that economic and political conditions in Canada would affect the Options market and underlying securities thereon. Investors should remain informed as to economic and political condition in the Canadian marketplace on an ongoing basis.

The infrastructure of the financial markets may be subject to disturbance. Bank failures, payments breakdowns, market or clearinghouse breakdowns, or other such event, may cause other failures and affect the liquidity of the Options market. Specific causes of systematic breakdowns are difficult to predict and are not discussed in this document.

The risks to investors which may be associated with the way trading is conducted in the Options market or on the stock exchanges for an underlying interest is beyond this document. Investors should not assume that either the Options market or the stock exchanges, which underlying interests are traded upon will be liquid, continuous, orderly, or open during normal trading hours. Even on normal trading days, there may be variances in the performance of market makers, thereby affecting an investor's ability to engage in Options transactions. During periods of high volume or volatility, for example, the performance of market makers may be affected.

In general, an exchange may take such action as deemed necessary to restore order in the market at particular times, such as when there are substantial or volatile price movements in the market in general or in specific underlying interests. Actions which may be taken, but which are not limited to, include: halting trading in particular Options; extending trading hours for particular Options; restricting the types of orders that may be submitted; and modifying the bid/ask spread which is quoted. Although such actions are normally publicly reported to member firms of the Options market, and/or to price vendors, there is no guarantee nor is it CDCC's responsibility to ensure that this disclosure will reach the individual investor in a timely manner.

The handling of client accounts by Clearing Members is not discussed in this document. Brokerage firms have their own rules and procedures regarding such matters as: approval and opening of client accounts; the handling and execution of orders; the timeliness in which writers of Options are notified of assignment; the handling of clients' funds,

securities, or accounts; the safeguarding of clients' assets; or any other such matter relating to the handling of Options transactions. Investors should be aware that policies regarding such matters vary from brokerage firm to brokerage firm, and should ensure that they are aware of their firm's own rules and procedures.

Finally, any examples in this document do not include commissions, transaction costs, margin requirements, or tax consequences. These items can make a significant impact on the profitability of Options transactions and should be taken into account by the investor when he or she is considering the merits of a particular Options strategy. Further, the examples in this document are based upon market values, which are subject to change. In particular, investors should not assume that Options premiums are fixed, or that Options will be priced similarly to any examples offered herein.

## GLOSSARY OF TERMS

**Actual Delivery Option** -- An actual delivery Option gives the holder the right to receive delivery (in the case of a call Option), or to make delivery (in the case of a put Option), of the underlying interest when the Option is exercised.

**American Style Option** -- An Option, which can be exercised at any time from its issuance until its Expiration Date.

**Assignment** -- Designation of a Member having a short Option position to deliver (in the case of a call Option) or receive (in the case of a put Option) a given quantity of the underlying interest to another Member.

**Call Option (or Call)** -- These Options (subject to certain exceptions summarized under "Exercise Restrictions") give a holder the right to buy from a Clearing Member to whom the obligation is assigned by the Corporation, a specified amount or value of a particular underlying interest covered by the Option at the stated exercise price by the proper filing of an exercise notice prior to the fixed expiration time of the Option.

**Cash Delivery Option** -- A cash settled delivery Option gives the holder the right to receive the Cash Settlement Amount when the Option is exercised.

**Cash Settlement Amount** -- The amount of cash that the holder of a cash settled Option is entitled to receive upon exercise. It is the amount by which the exercise settlement value of the underlying interest of a cash settled call exceeds the exercise price, or the amount by which the exercise price of a cash settled put exceeds the exercise settlement value of the underlying interest, multiplied by the multiplier for the Option.

**Class of Options** -- All Options (Put or Call) covering the same Underlying Interest.

**Clearing Corporation** -- A Corporation which acts as an intermediary in all derivative security transactions traded on Bourse de Montréal Inc. through which financial settlement is made.

**Clearing Fund** -- A fund to which all Members are required to contribute in order to protect CDCC and its Members in the event of a default or failure of a Member.

**Clearing Member** -- An approved participant of Bourse de Montréal Inc. or a Bank as described by the Bank Act of Canada, who has become a clearing member of the Corporation and who is authorized to clear transactions in Options.

**Closing Purchase Transaction** -- A transaction in which an investor who is obligated as a writer of an Option intends to terminate his or her obligation as a writer. This is accomplished by "purchasing" in a closing purchase transaction an Option of the same series as the Option previously written. Such a transaction has the effect, upon payment of the premium, of cancelling the investor's pre-existing position as a writer, instead of resulting in the issuance of an Option to the investor.

**Closing Sale Transaction** -- A transaction in which an investor who is the holder of an outstanding Option intends to liquidate his or her position as a holder. This is accomplished by "selling" in a closing sale transaction an Option of the same series as the Option previously purchased. Such a transaction has the effect, upon acceptance by the Corporation, of liquidating the investor's pre-existing position as a holder of the Option, instead of resulting in the investor assuming the obligations of a writer.

**Constructive Sales** -- "Constructive sales of appreciated financial positions" result in a deemed sale with immediate recognition of gain (and a corresponding increase in basis in the property deemed sold), as well as the start of a new holding period. For purposes of the constructive sales rules, an *appreciated financial position* is any *position* with respect to any stock if there would be a gain were the position sold, assigned, or otherwise terminated at its fair market value. The term "position" is further defined as an interest, including an Option.

A taxpayer is generally treated as having made a constructive sale of an appreciated financial position if the taxpayer enters into a short sale of the same or substantially identical property.

**Corporation** -- Canadian Derivatives Clearing Corporation.

**Covered Call Writer** -- A writer of a call who, so long as he or she remains obligated as a writer, owns the shares or other units of the underlying interest.

**Covered Put Writer** -- A writer of a Put who, so long as he or she remains obligated as a writer, is



short the shares of other units of underlying interest covered by the Put.

**Conversion Transaction** -- A transaction from which substantially all of the taxpayer's expected return is attributed to the time value of the taxpayer's net investment in the transaction, and which is: a transaction that encompasses an acquisition of any property and a substantially contemporaneous agreement to sell such property (or substantially identical property) at a price determined in accordance with the agreement.

**European Style Option** -- An Option that can be exercised only on its Expiration Date.

**Exchange** -- Bourse de Montréal Inc.

**Exchange Traded Option ("Option")** -- A put Option ("Put Option" or "Put") or a call Option ("Call Option" or "Call") traded on Bourse de Montréal Inc.

**Exercise** -- The holder of an actual delivery Option buys (in the case of a call Option) or sells (in the case of a put Option) a specified amount of the underlying interest at the Exercise Price. In the case of a cash delivery Option, the holder receives the Cash Settlement Amount.

**Exercise Price** -- In the case of a Call Option, the price at which the buyer of the Option has the right to purchase the underlying interest. In the case of a Put Option, the price at which the buyer of the Option has the right to sell the underlying interest. The exercise price is also sometimes called the "strike price." In the case of Index Options, exercise is settled by the payment of cash, not by the delivery of stock. The holder of a cash delivery Index Option has the right to receive the Cash Settlement Amount upon exercise.

**Expiration Date** -- The last day on which an Option may be exercised by a Clearing Member. Holders of Options should determine from their brokers the earlier exercise cut-off time, which is the latest time a customer may instruct his or her broker to exercise an Option so that the exercise notice may be received at the Corporation prior to the expiration time. Options expire on the Saturday following the third Friday of the expiration month, except that Index Options expire on the third Friday of the expiration month.

**Expiration Time** -- The time on the Expiration Date as fixed by the Corporation, at which the Option expires.

**Holder** -- The person who has purchased an Option and thereby has the right to purchase the underlying interest from, in the case of a Call, or sell the underlying interest to, in the case of a Put, a clearing member to whom the obligation is assigned by the Corporation, or to receive the Cash Settlement Amount in the case of an Index Option, in accordance with the terms of the Option.

**In-The-Money Option** -- A call Option with an Exercise Price that is less than the Market Price of the Underlying Interest or a put Option where the Exercise Price exceeds the Market Price of the underlying interest.

**Intrinsic Value** -- The amount by which a call or put Option is In-the-Money.

**Margin** -- The cash or securities required to be deposited by an Option writer with his or her broker as collateral for the writer's obligation to buy or sell the underlying interests (or Cash Settlement Payment in the case of cash settled Options) if assigned an exercise notice.

**Market Price** -- The aggregate price of the Unit of Trading of the Underlying Interest as determined by the stock exchange.

**Opening Purchase Transaction** -- A transaction in which an investor establishes or increases a position as the holder of an Option.

**Opening Sale Transaction** -- A transaction in which an investor intends to become the writer of an Option.

**Option Holder** -- The person owning the Option.

**Option Writer** -- The seller of the Option.

**Out-Of-The-Money Option** -- A call Option with an Exercise Price that exceeds the Market Price of the Underlying Interest or a put Option where the Exercise Price is less than the Market Price of the underlying interest.

**Premium** -- The aggregate price of an Option agreed upon between the buyer and writer or their agents in a transaction through the facilities of Bourse de Montréal Inc.

**Put Option (or Put)** -- These Options (subject to certain exceptions summarized under "Exercise Restrictions") give a holder the right to sell to a

Clearing Member to whom the obligation is assigned by the Corporation, a specified amount or value of a particular underlying interest covered by the Option at the stated exercise price by the proper filing of an exercise notice prior to the fixed expiration time of the Option.

**Series of Options** -- All Options of the same type (Put or Call) and style (American or European Option) covering the same underlying interest and having the same exercise price and expiration date.

**Spread Position** -- A simultaneous position as both the buyer and Writer of the same type of Option (put or call) on the same underlying interest with the Options having different exercise prices and/or expiration dates.

**Straddle Position** -- The simultaneous purchase or writing of both a put and a call on the same underlying interest, with the Options having the same exercise price and expiration date.

**Style of Option** -- The classification of an Option as either an American Style Option or a European Style Option.

**Type of Option** -- The classification of an Option as either a Put or a Call.

**Uncovered Call Writer** -- A writer of an actual delivery call Option who does not own the amount of the underlying interest that is deliverable upon the exercise of the call.

**Uncovered Put Writer** -- A writer of an actual delivery put Option who does not have a corresponding short position in the underlying interest.

**Underlying Interest** -- The property interest subject to being purchased or sold upon the exercising of an Option.

**Unit of Trading** -- The number of units of the Underlying Interest which have been designated by Bourse de Montréal Inc. as the number to be the subject of a single Option in such series of Options.

**Wash Sale** -- A sale or other disposition of stock or securities in which the seller, within a 61-day period (which begins 30 days before and ends 30 days after the date of such sale or disposition), replaces those shares of stock or securities. This replacement can

occur by acquiring by way of a purchase, or entering into an option to acquire substantially identical stock or securities.

**Writer** -- The person who has written an Option, and has thereby undertaken to deliver, in the case of a Call, or to purchase, in the case of a Put, the underlying security, or to deliver the Cash Settlement Amount in the case of an Index Option, in accordance with the terms of the Option.

**SCHEDULE OF BOURSE DE MONTRÉAL INC. HOLIDAYS  
AND EARLY CLOSINGS — 2010**

**Subject to Change.**

**Please consult [www.m-x.ca](http://www.m-x.ca) for the latest list of Bourse de Montréal Inc. holidays and early closings.**

2010	
<b>Friday, January 1</b> New Years' Day	<b>Closed</b>
<b>Monday, February 15</b> Family Day	<b>Closed</b>
<b>Thursday, April 1,</b> Day preceding Good Friday	<b>Bond Options:</b> Closing at 1:00 p.m. ET <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Friday, April 2</b> Good Friday	<b>Closed</b>
<b>Friday, May 21</b> Day preceding Victoria Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Monday, May 24</b> Victoria Day	<b>Closed</b>
<b>Wednesday, June 30</b> Day preceding Canada Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Thursday, July 1</b> Canada Day	<b>Closed</b>
<b>Friday, July 30</b> Day preceding Civic Holiday	<b>Bond Options:</b> Closing at 1:00 p.m. ET <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Monday, August 2</b> Civic Holiday	<b>Closed</b>

**SCHEDULE OF BOURSE DE MONTRÉAL INC. HOLIDAYS  
AND EARLY CLOSINGS — 2010**

Subject to Change.

Please consult [www.m-x.ca](http://www.m-x.ca) for the latest list of Bourse de Montréal Inc. holidays and early closings.

<b>Friday, September 3</b> Day preceding Labour Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET  <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Monday, September 6</b> Labour Day	<b>Closed</b>
<b>Friday, October 8</b> Day preceding Thanksgiving Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET  <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Monday, October 11</b> Thanksgiving Day	<b>Closed</b>
<b>Wednesday, November 10</b> Day preceding Remembrance Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET  <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Thursday, November 11</b> Remembrance Day	<b>Bond Options:</b> Closed  <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Friday, December 24</b> Day preceding Christmas	<b>Bond Options:</b> Closing at 1:00 p.m. ET  <b>Equity and Stock Index Options:</b> Normal Schedule
<b>Monday, December 27</b> Observing Christmas Holiday	<b>Closed</b>
<b>Tuesday, December 28</b> Boxing Day	<b>Closed</b>
<b>Friday, December 31</b> Day preceding New Year's Day	<b>Bond Options:</b> Closing at 1:00 p.m. ET  <b>Equity and Stock Index Options:</b> Normal Schedule