

**Proposed revisions to the rules pertaining to auctions of  
Government of Canada securities and the Bank of Canada's  
surveillance of the auction process**

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Discussion Paper 2

8 April 1998



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## **1. Summary**

The Bank of Canada and the Department of Finance have been working closely with market participants in a series of initiatives to maintain and enhance a well-functioning market in Government of Canada debt. In this context, plans were announced in a discussion paper dated 19 December 1996 to introduce measures designed to reinforce the integrity of the auction process for Government of Canada securities, and to encourage participation in it by reducing the potential for manipulative behaviour prior to and during auctions. Proposals for revisions to the administrative arrangements pertaining to auctions of Government of Canada securities were presented and comments on these proposals were received. This paper presents for further comment revisions to the terms and conditions for auctions after taking into account the comments received to date.

The proposals include both changes in auction rules and an increase in the Bank of Canada's auction-related monitoring activities. In broad terms, the proposed measures seek to ensure that the auction process is free of, and is perceived to be free of, manipulation. In this way, confidence in the auction process can be maintained and investor and dealer participation enhanced. This consultation process with interested parties is intended to assure all parties that the final measures are given due consideration and that they are appropriate.

The proposals include a new classification of government securities distributors and a subgroup called primary dealers, a definition of a bidding entity, procedures for the submission of bids, new bidding limits for government securities distributors, and bidding limits for customers of government securities distributors. In addition, the Bank of Canada intends to increase its auction-related monitoring activities and will require additional reporting by auction participants.

PROCESS: Comments on the draft revisions to the terms and conditions for auctions must be received on or before 31 May 1998.

ADDRESS: Comments should be sent to: Chief, Financial Markets Department  
Bank of Canada  
4th Floor, East Tower  
234 Wellington Street  
Ottawa, Ontario K1A 0G9  
or via e-mail: comment@bank-banque-canada.ca

Comments received will be available for public inspection and copying in early June 1998 at the Bank of Canada Library, 7th Floor, West Tower, 234 Wellington Street, Ottawa, Ontario, K1A 0G9. Comments received will also be available for public inspection on the Bank of Canada's Internet Home Page (<http://www.bank-banque-canada.ca>) in early June 1998.

FOR FURTHER INFORMATION CONTACT: Donna Howard, Assistant Chief, Financial Markets Department, Bank of Canada (613-782-8474; [dhoward@bank-banque-canada.ca](mailto:dhoward@bank-banque-canada.ca)) or Rob Stewart, Chief, Financial Markets Division, Department of Finance (613-992-4468; [stewart.rob@fin.gc.ca](mailto:stewart.rob@fin.gc.ca)).

## **2. Introduction**

The government and market participants share an interest in promoting the efficiency, liquidity and integrity of the market for Government of Canada debt. Canada's domestic debt market is generally very liquid, featuring active turnover and tight bid-offer spreads. Initiatives taken to maintain the liquidity and efficiency of this market include adjustments to the debt program and improvements in the transparency of the debt strategy. Because of a number of "squeezes", however, a concern has developed among participants about the rules and practices in the primary and secondary markets for Government of Canada securities. The increased frequency of such squeezes has brought into question the integrity of the market.

Ongoing questions about the efficiency, liquidity and integrity of a market have a negative impact on activity. For example, participants may be reluctant to take short positions if there is a significant risk that it will be difficult to cover those positions, and this affects the distribution process for securities. Over time, such questions could also affect the size of the investor base and, in turn, the price-discovery process. These implications have the potential to increase debt costs to the government and to a variety of other issuers.

Discussion Paper 1, which was issued in December 1996, highlighted concerns about the effectiveness of the current auction guidelines in an environment featuring a declining supply of securities, and a larger, more integrated financial services industry whose participants have increased leveraging capacity. It noted that manipulation can occur under the current system because participants are able to acquire control through the when-issued process and tender access, even though such activities are against the spirit of the existing rules, and because there is no effective limit on the amount of securities customers can acquire. The paper then presented a number of proposals designed to reinforce the integrity of the auction process by reducing the scope for manipulative behaviour. Finally, it requested comments from interested parties on the proposed rules and surveillance measures.

This second discussion paper is a continuation of the first and has the same underlying principles. The concerns raised in the first paper continue to be valid, and events since that time have provided further evidence of the scope for squeezes as a result of both primary and secondary market activity. Some aspects of these issues are reviewed in this paper, but readers requiring detailed background, such as a description of the current auction process, are referred to the 1996 paper. This paper reflects and addresses the comments received from interested parties in response to the first paper.

Through the proposals in this paper, the intention is to assure market participants that the auction process will not result in undue concentration. The new auction rules and surveillance procedures will also have a balanced and fair impact on market participants, both investors and intermediaries. However, these proposals cannot deal with attempts to accumulate large amounts of securities in ways that do not involve the auction process, such as in the secondary market. Concentration emerging from secondary market activity is being addressed by the Investment Dealers Association (IDA) which, in consultation with Finance

and the Bank, is developing a code of conduct for secondary market activity. This code of conduct, together with procedures to review situations in which market manipulation is suspected and to impose sanctions when warranted, will deal more generally with threats to the integrity of markets than is possible through auction rules. Together, the initiatives presented in this paper and those of the IDA will provide a broad-based approach to improve the functioning of debt markets.

This paper is organized into sections dealing with individual components of the new auction conditions. Each section starts with a summary of the current proposal. It then compares the proposal with that in the first discussion paper, summarizes the public feedback to the original proposal, and provides the rationale for the proposal being made. Interested parties are again invited to comment on this paper.

Of note is the introduction of a change in the nomenclature for those eligible to participate directly in the tender process, reflecting a change in their roles in recent years. Primary distributors will be called government securities distributors, and a subgroup of this broad class (those that maintain a certain threshold of activity) will be called primary dealers instead of jobbers (underlined terms are defined in Appendix 1). The primary dealer designation can be attained in either treasury bills or bonds, or both.

### **3. Principles and Rationale for Action**

As noted, the government and market participants share an interest in the development and maintenance of a well-functioning domestic capital market. In this regard, the guiding principles are that the market for Government of Canada debt should be transparent, active and competitive, and that there should be broad participation in the market by investors and intermediaries.

The primary concern addressed in this paper is the risk that the auction process may be used to manipulate or “squeeze” the market for Government of Canada securities. Squeezes occur when an auction participant, or group of participants, gains control of the stock of a security and withholds the supply from the cash or repo markets. In these situations, market participants who have entered into contracts to deliver a security at some future date are then unable to purchase or borrow that security for delivery. Such activities are possible under the current auction rules because an intermediary or customer who has accumulated large holdings in the when-issued or secondary markets can still acquire more supply through the auction process. Of note, there is currently no limit on auction orders that customers can place with intermediaries.

There are a number of indicators of a possible “squeeze” in the market. These indicators include special repo rates, how far specific issues trade off the theoretical yield curve, declines in market volume, and increases in concentration of specific issues. Any of these situations can occur under normal market conditions and, in and of themselves, are not a

cause for concern. There is a concern, however, with those situations in which price distortions are large and persistent and when liquidity in the relevant securities in the cash and repo markets is seriously impaired.

The negative consequences of having a system that allows squeezes are numerous and are related mainly to an undermining of the price-discovery process and a general loss of confidence in the system. Clearly, it is often very costly for those caught in a squeeze to meet their contractual obligations to deliver the security. If the system allows squeezes to persist, intermediaries will become reluctant to establish short when-issued positions, and reluctant to engage in other market-making activities or to participate in auctions. Investors also face a less liquid and less efficient debt market, and it is possible that investor participation in auctions and the secondary market could decline. These developments would tend to raise the cost of borrowing for various issuers, including the federal government and issuers of securities benchmarked relative to Government of Canada securities.

Recent examples indicate that the problem of auction-related squeezes has persisted since Discussion Paper 1 was released in 1996, and it is unlikely that this trend would improve without changes to the auction process. In fact, these problems could intensify given the environmental changes identified in the earlier paper, including the further integration of the financial industry and prospective declines in the federal debt stock. The experience to date with squeezes and the ongoing risk of such events occurring are inconsistent with the objectives of the government and market participants for the market in Government of Canada debt. The implication is that the existing auction rules, for which the Government of Canada and Bank of Canada have responsibility, need to be revised.

#### **Examples of Recent Squeezes**

Case 1: 4% bonds due 15 March 1999

- *In August 1997 a very large amount of these bonds was tightly held and some large short positions existed.*
- *The issue traded as much as 50 basis points below the yield on bonds with a similar maturity, and repo rates occasionally fell well below 1% (general repo rates were about 3.25%).*
- *The Bank of Canada exchanged \$600 million of this issue from its portfolio (through an auction) for bonds with a similar maturity.*

Case 2: 1-year treasury bill due 6 August 1998

- *The problem developed through the auction process in August 1997.*
- *The issue was reopened as part of the normal auction cycle in the amount of \$1 billion but was still held by only a few parties and there was no available supply to be traded.*
- *A further reopening of \$500 million outside of the regular auction cycle was needed to make some market supply available.*



## **4. Overview of Proposals**

Consistent with the desire to ensure that the auction process for Government of Canada debt will not aggravate squeezes in the market, the objectives with respect to the proposals for new auction rules and surveillance requirements are the following:

- To assure market participants that undue amounts of Government of Canada securities cannot be accumulated at auctions by either investors or market intermediaries.
- To assure the market that the Bank of Canada, on behalf of the government, maintains oversight of the auction process in order to ensure that Government of Canada auctions function in the public interest.

The proposals detailed in this paper fall into three categories:

- A more precise definition of bidders at auction.
- New bidding limits for distributors and the introduction of limits for customers.
- Careful monitoring of auction participation through reporting requirements.

### **4.1 The Definition of a Bidder**

All bidders must certify that they will not bid in concert with any other bidder, and entities not at arm's length will be considered to be a single bidder for the purpose of auction bidding limits. There will be a provision to allow affiliated parties to be separate bidders if they are organized so that there is no exchange of information on auction bidding and strategies.

### **4.2 Bidding Limits for Distributors and Customers**

Under the new bidding limits, limits for government securities distributors will apply only to bids on their own behalf, and customers will bid separately through distributors under their own bidding limits. New bidding limits for primary dealers will be set at 25 per cent for treasury bills and from 10 to 25 per cent for bonds. Primary dealer bidding limits for bond auctions will be tiered in line with their performance in the primary and secondary markets. The less-active distributors will have a 10 per cent limit for treasury bill auctions, and limits ranging from 1 to 9 per cent for bond auctions, again tiered in line with their market performance. Bidding limits for customers will be 25 per cent for both treasury bills and bonds.

In addition, under the present system, customer bids are included in the dealers' bidding limits, and there is no restriction on the overall bidding or winnings of customers. It would thus be possible for a customer to obtain virtually all of an issue by placing bids through three or more dealers, or through a combination of auction bidding and when-issued trading. In contrast, dealers have bidding limits that restrict the amount for which they can bid. The new

rule means that a customer's ability to purchase securities through the auction process would be limited in the same way as a distributor's.

The new bidding limits will also account for the bidder's net position in the when-issued market and in previously-issued securities. At present, a bidder holding a large amount of the security outstanding (in the case of a reopening) and/or holding a large long position in the when-issued market could still use its full bidding limit, thus permitting one participant to control an issue. Under the new rules, this will no longer be possible: the maximum amount that any bidder will be able to hold at the completion of an auction would be that bidder's bidding limit times the amount of the security outstanding when the security auctioned that day is delivered. These changes will make it more difficult for auction participants to acquire a large proportion of the amount outstanding through the auction process and to use a concentration of holdings of the security to affect its availability and price in the market.

#### **4.3 Reporting Requirements and Market Surveillance**

The new reporting rules will require any market participant wishing to bid at auction to submit to the Bank of Canada its position in the when-issued market and in the outstanding securities in order to adjust its bidding limit for these holdings. Additionally, enhanced market and position reporting requirements will be part of the new terms of reference for government securities distributors and primary dealers.

A summary table of proposals is presented in Appendix 2. While the structure described in this paper is very similar to that set out in Discussion Paper 1, some changes have been made in the proposed rules to reflect the input of interested parties (the changes are summarized in Appendix 3). In contrast to the first paper, the rules no longer provide for an increase in bidding limits when the bidder has a short position. Secondly, the proposed requirement for customers to settle directly with the Bank of Canada has been removed; rather, customers will continue to settle through the distributor that bid on their behalf. Limits on bidding by distributors and customers are also set out for the first time in this paper; the bidding limits used in the first paper were purely for illustration.

## 5. Detailed Proposals

### 5.1 Bidder Definition

#### Proposal

- *All bidders must certify that they will not bid in concert with any other bidder.*
- *Entities that do not have a strict arm's length relationship with one another (i.e. affiliates) will be considered one bidder for the purposes of Government of Canada securities auctions. To avoid being considered a single bidder, affiliated entities will have to certify that they do not exchange information about yields, amounts, positions they hold or plan to hold, or their investment strategies with respect to the securities being auctioned.*
- *The new bidder definition covers all government securities distributors and customers, and applies to corporations, partnerships, governments and government-related entities, foreign central banks (as well as governments of foreign states or international organizations), trusts and individuals.*
- *Entities are affiliates of one another if one is controlled by the other or if both are controlled by the same entity. The specific definition of control includes formal voting control along with direct and indirect controlling influence over management and policies.*
- *Affiliated entities who wish to be treated as separate bidders must certify that they will not act in concert in formulating strategy or auction bids.*
- *Any entity that implements the conditions necessary to be considered a separate bidder must direct all of its bids/purchases through a non-affiliate.*

#### Comparison to Proposal in Discussion Paper 1

The proposal outlined above is the same as that in Discussion Paper 1.

#### Comments on the Proposal in Discussion Paper 1

Some parties expressed reservations about the proposed bidder definition because its use, in conjunction with the other auction rules, could constrain the amount that bank-owned government securities distributors could bid at auction. A number of Canadian subsidiaries of foreign-owned distributors supported the proposed bidder definition, with some already operating under similar auction rules in their home country.

#### Rationale for the Proposal

The views of participants have been duly considered, and it is believed that a more precise concept of the bidding entity is an essential component of the new regime and is necessary to prevent manipulation of securities. The proposed definition reflects the increasing integration of bank treasury operations with those of bank-owned government securities distributors. The new bidder definition also limits the ability of related entities to act in concert and manipulate securities by, for example, evading auction limits by holding securities in

areas of the institution that remain under the bidder's realm of effective control or by obtaining knowledge as to who holds the securities, along with their intended investment strategy. Accordingly, under the new auction rules, all affiliated parties within an organizational structure will be treated as a single bidder unless there are clear policies and procedures in place that prevent the transmission of information about investment strategies and holdings (described below). In addition, all bidders must certify that they will not bid in concert with any other bidder.

Some concern was expressed that the new bidder definition would reduce auction access, but an analysis of dealer positions and bidding for the period May to August 1997 indicated that the impact of the new proposals would have been minimal in most cases. One significant reason for this finding is that, under the new auction rules, bids that distributors submit on behalf of customers are subject to separate auction limits, rather than being included under the participant's auction limit as is currently the case.

### **5.1.1 Definition of Affiliated Party**

The type of entity that may bid at auction, either directly or indirectly, is limited to the following legal entities: corporations, partnerships, governments and government-related entities, foreign central banks (as well as governments of foreign states or international organizations), trusts and individuals. Various operational components, departments or divisions within the same legal entity will not be considered separate bidders at auction. Under the new definition of a bidder, only legal entities that are not affiliated with any other bidder may submit a separate auction bid for Government of Canada securities. Entities which are considered under the new rules to be affiliated will be treated collectively as a single bidder unless they can meet, to the satisfaction of the Bank of Canada and the Department of Finance, the criteria set out for treating otherwise affiliated parties as separate bidders.

Two persons are affiliated if one is controlled by the other or if both are controlled by the same person.<sup>1</sup> The specific definition of control is presented in Appendix 4. Briefly, a person controls a corporation if that person beneficially owns securities which are sufficient to enable that person to control the corporation. A person controls a limited partnership if that person is a general partner. In the case of an unincorporated entity other than a limited partnership, a person exercises control if 50 per cent of the ownership interests, however designed, into which the entity is divided, are beneficially owned by the person and that person is able to direct the business and affairs of the unincorporated entity. A person also controls a corporation, a limited partnership or an unincorporated entity if the person controls an entity that in turn controls the corporation, limited partnership or unincorporated entity, respectively. In addition, a person controls any entity if that person has any direct or indirect controlling influence over the management and policies of the entity, whether alone or in combination

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1. For the purposes of this section, "person" means a natural person, an entity within the meaning of Appendix 4 or a personal representative.

with other persons and whether through the beneficial ownership of securities, through one or more other persons or otherwise.

### **5.1.2 Requirements to Establish Non-Affiliated Status Within a Corporate Group**

The new definition of a bidder will permit an otherwise affiliated entity within a corporate group to bid separately if it is prepared to organize itself in such a manner that there is no exchange of information on auction bidding and strategy between itself and other affiliated entities. Specifically, two or more entities that are affiliated may submit separate bids provided that each affiliate has certified to the Bank of Canada that it meets certain specified criteria meant to prevent the exchange of information on auction bidding and strategy, and that it has established written policies and procedures designed to ensure continued compliance. The criteria include: (i) the affiliate does not act jointly or in concert with any of the other affiliates with respect to securities; (ii) no director, officer, partner, employee or agent of the affiliate that purchases Government of Canada securities at auction or advises with respect to, participates in the formulation of, has influence over, or has knowledge of decisions or information relating to holdings, investment or bidding strategies in or for Government of Canada securities by or on behalf of that affiliate, also engages in any of the same activities or has any of the same knowledge in respect of Government of Canada securities for or on behalf of any of the other affiliates<sup>1</sup>; (iii) the affiliate does not exchange information related to bidding at auctions with any of the other affiliates and (iv) its records relating to holdings of and investment and bidding strategies for Government of Canada securities are maintained separate and apart from the records of any of the other affiliates.

Any affiliate that provides the Bank of Canada with the above certification must promptly notify the Bank of Canada, in writing, if any of the circumstances that enable the affiliate to qualify for separate bidder status change, or if the certification is no longer valid, such that the affiliate is no longer entitled to non-affiliated status.

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1. This criterion does not apply in respect to (i) individuals who are either involved in senior management or engaged solely in clerical or administrative activities and who do not in either case make decisions relating to holding, investing and bidding for Government of Canada securities and (ii) knowledge of information that has been generally and publicly disseminated.

## 5.2 Submission of Bids

### Proposal

#### Government Securities Distributors

- *Government securities distributors will be able to bid on their own behalf subject to an auction limit. Government securities distributors will also have a separate limit for the aggregate amount of bids they place on behalf of customers. These bids must be listed separately from the distributor's own bids.*

#### Customers

- *Bidding by individual customers will be subject to an auction limit.*
- *Customers will be required to obtain a unique bidder identification number from the Bank of Canada before they can bid competitively. An application form for a unique bidder identification number will be available by facsimile or from the Bank of Canada web site (<http://www.bank-banque-canada.ca>).*
- *Customers will be able to bid at auction by submitting bids through government securities distributors. Competitive bids must be listed separately from the distributor's own bids and be accompanied by the customer's unique bidder number received from the Bank of Canada.*
- *Customers will not settle directly with the Bank of Canada. Government securities distributors will be responsible for the settlement of customer bids which they have submitted and shall be liable to the Bank of Canada for any losses incurred as a result of those sales failing to settle in the Debt Clearing System (DCS).*

### Comparison to Proposal in Discussion Paper 1

The proposal outlined above is the same as that in Discussion Paper 1, except that the proposal that customers settle directly with the Bank of Canada has been withdrawn.

### Comments on the Proposal in Discussion Paper 1

Reservations were expressed about allowing customers to bid, albeit through government securities distributors, and about the proposal for direct settlement between customers and the Bank of Canada. Some believed that these proposals would enhance the profile and status of customers and would undermine the incentive for distributors to bid at auctions on a consistent basis and to make markets. It was also feared that separate customer bidding would draw information out of the market and away from distributors, thus damaging the liquidity of the when-issued and secondary markets in the period leading up to an auction.

### Rationale for the Proposal

The primary rationale for introducing separate customer bidding limits is to reduce the potential for misuse of the auction process as part of an effort to deliberately corner the market. In the past, customers did not face restrictions on the amount of securities that they

could win at an auction by placing orders through a number of distributors. This unlimited access for customers is inappropriate, and customers will be subject to bidding constraints under the new rules.

However, all customer bids will continue to be submitted through government securities distributors. This system is similar to the present one whereby customers place pre-tender orders with dealers. Thus, distributors will continue to see customer bids, and the liquidity of the when-issued and cash markets should not be impeded. In addition, there will still be incentives for distributors to bid on behalf of customers because such bids will be taken into account in the determination of future bidding limits for distributors.

The proposal to have customers settle directly with the Bank of Canada has been eliminated. Instead the current practice will continue; that is, customers will settle through government securities distributors. This procedure means that distributors will continue to play a significant role with respect to customer bids.

### **5.3 Competitive Auction Limits**

#### **Proposal**

- *The amount that any distributor or customer can bid on a competitive basis at an auction (its auction limit) will equal its bidding limit less its net long position in excess of the product of its percentage bidding limit and the par value of any outstanding stock of the security being auctioned. Examples are provided in Appendix 5.*
- *All bidders, both government securities distributors and customers, must report their net positions prior to an auction (see the section on reporting requirements for details). For the purposes of computing the auction limit, the bidder's net position will include the par amount of (1) cash holdings of a security with the same International Securities Identification Number (ISIN), (2) when-issued positions, (3) futures contracts that require delivery of the specific security being auctioned but not futures contracts for which the security being auctioned is one of several securities that may be delivered, and not futures contracts that are cash-settled, (4) forward contracts, (5) holdings of the residual component of a stripped bond of the security being auctioned, and (6) any position in the security not covered by the above types of contracts, including "guaranteed" trades. For repurchase agreements or securities lending, the entity that owns the security, not the one that has borrowed it, must report the repoed or lent security as part of its position. All positions are based on trade date rather than delivery date.*
- *Customer bids will not be netted against the limits of government securities distributors.*
- *Bidding limits for bond and treasury bill auctions are discussed below.*

#### **Comparison to Proposal in Discussion Paper 1**

The proposal outlined above is the same as that in Discussion Paper 1 with two exceptions. The proposal that a participant's bidding limit would be increased by the amount of its short

position (up to a maximum of 10 per cent of the par value of the securities being auctioned) has been withdrawn. Also, there have been some changes concerning the requirements for customers to notify the Bank of Canada of net positions. The proposals for customers are more consistent with those for distributors, and there are no exceptions to such reporting requirements. These are reviewed in the section on reporting.

### **Comments on the Proposal in Discussion Paper 1**

Market participants noted that many bidders have legitimate reasons for holding large amounts of individual Government of Canada securities. They were concerned that the provisions limiting the total amount of the long position and bidding would constrain auction participation and the investment strategies of both distributors and large customers. This concern was heightened by the related-party provision, which meant that they would have to take into account the positions not only of trading desks but also of numerous other desks and related companies. There was concern that this constraint on investment and auction activity would be exacerbated if the size of individual issues outstanding fell as the overall government debt declined. It was also argued that the provision to adjust bidding limits to take into account long positions could lead to some distortions in the market if, for example, participants sought to minimize their holdings just before a reopening of an issue.

It was also noted that the Bank of Canada would have to receive accurate and timely reporting of net positions. Otherwise, there was a concern that some bids would be disallowed retroactively. It was also felt that the reporting of long positions would impose an administrative burden, which might inhibit bidding. Finally, there was criticism of the proposal to allow a bidder to increase its bidding limit by its short position because such a system might provide an incentive to create when-issued short positions to increase auction participation, and could result in a distributor and its customer ultimately controlling a large proportion of the securities being auctioned.

### **Rationale for the Proposal**

It is important to take the bidder's long position into account in the calculation of the auction limit in order to make it more difficult for bidders to use the auction process to accumulate a controlling position. While there may be some additional administrative burden involved in submitting data on net positions, this burden is relatively small compared with the potential benefit. It is good business practice for companies to have such information, and the task of reporting the information to the Bank of Canada would not represent much additional work.

The data collected from dealers in recent months indicate that taking long positions into account in calculating auction limits would not, in general, have had a significant impact on actual bidding or winnings in treasury bill and bond auctions (especially taking into account the other proposals, including the separate bidding limit for customers and the increase in the maximum bidding limit for bonds). This provision would have interfered only rarely with actual



bidding in auctions that were reopenings (over two-thirds of auctions for Government of Canada securities are reopenings). There would tend to be some impact in the first auction of a security, when any long position of a bidder would have a direct impact on auction limits. However, in general, long positions of distributors in when-issued securities tend to be relatively small at the time of the first auction of a security. Moreover, it is desirable in the cases in which a bidder has a substantial long position (either in an initial auction or in a reopening) to reduce its access to tender.

The competitive bids of any participant that does not submit its net position before the auction will be disallowed. The Government of Canada and the Bank of Canada would view very seriously any case in which a bidder knowingly understated its net long position.

#### **5.4 Bidding Limits for Bonds**

##### **Proposal**

##### **Government Securities Distributors**

- *Primary dealers will have bidding limits tiered from 10 to 25 per cent of the auctioned amount for bids on their own account for Government of Canada bonds. Other government securities distributors will have limits tiered from 1 to 9 per cent. All distributors will also have an additional bidding limit which will cover bids on behalf of customers. The aggregate limit for bidding by a distributor on behalf of customers will equal the limit set on bidding for its own account.*
- *Bidding limits for distributors will be tiered in line with their performance in auctions of Government of Canada bonds and in secondary markets for such securities over the preceding year. For the purpose of determining these bidding limits, winning bids submitted on behalf of customers will be taken into account in the assessment of the government securities distributor's performance at auction.*

##### **Customers**

- *A customer will be able to bid through government securities distributors for up to 25 per cent of the amount auctioned. A customer can use as many government securities distributors as it chooses to submit its bids as long as the total amount of its bids does not exceed its auction limit.*
- *It is the responsibility of each customer to ensure that the total of its bids through all government securities distributors does not exceed its auction limit.*

#### **Comparison to Proposal in Discussion Paper 1**

There was no discussion of the appropriate levels of bond auction bidding limits for dealers and customers in the first discussion paper. The current limit of up to 20 per cent for dealers was used for illustrative purposes.

## **Comments on the Proposal in Discussion Paper 1**

A number of interested parties suggested that bidding limits for distributors should be higher than those for customers to provide an incentive for distributors to participate at auction and in the secondary market. It was also thought that lower limits for customers would increase the use of the when-issued market and secondary markets by customers. Concern was expressed that, with tiered limits for distributors, some distributors would have lower bidding limits than customers despite their responsibilities for bidding at auction and for market making.

### **Rationale for the Proposal**

The proposal to increase maximum bidding limits from 20 per cent to 25 per cent reflects the view that a 20 per cent limit may be too restrictive, particularly in combination with the decision to take into account the long positions of the bidder and its related parties when calculating the limit for any particular auction. If long positions are taken into account in the calculation of bidding limits for any specific auction, it becomes more difficult for any individual bidder to come out of an auction with more than 25 per cent of the issue. This is in contrast to the current situation, where long positions are not taken into account and therefore there is no limit on a bidder's holdings coming out of an auction. Bidding limits of up to 25 per cent of the amount being auctioned mean that at least four bidders would win some of the bonds being auctioned.

Winning bids submitted by distributors on behalf of customers will be taken into account in determining future bidding limits for distributors. This provision recognizes the role that distributors play in the distribution of Government of Canada securities by soliciting and facilitating customer bids, and provides an incentive for distributors to continue this role.

The proposed limit for customers will be set at 25 per cent rather than at a lower level. The main reason is that customers are the end buyers of Government of Canada securities and bidding limits for customers should be sufficiently large to permit them to meet most portfolio requirements and not hinder their activity in the when-issued and secondary markets. It should be noted that distributor access to auctions under the new rules will still be larger than under the current system because distributors will submit bids on their own behalf and have a separate limit for customers. Under the present system, dealer bids for customers are included in the dealer limit. In addition, distributors will continue to benefit from the reputational value of being the only category of bidders able to submit bids directly to the Bank of Canada.

## 5.5 Bidding Limits for Treasury Bills

### Proposal

#### Government Securities Distributors

- *Primary dealers will have a bidding limit of 25 per cent of the auctioned amount for bidding on their own behalf. Other government securities distributors, who are less active in the treasury bill auctions and in the secondary market, will have a limit of 10 per cent of the auctioned amount.*
- *Distributors will have an additional bidding limit for the total amount of bids they submit on behalf of customers. This limit will equal the limit set on bidding for their own account.*

#### Customers

- *The bidding limit for a customer will be 25 per cent of the amount auctioned. A customer may use as many distributors as it chooses to submit bids, as long as the total amount of its bids does not exceed its auction limit.*
- *It is the responsibility of each customer to ensure that the total of its bids through all government securities distributors does not exceed its auction limit.*

### Comparison to Proposal in Discussion Paper 1

The first discussion paper asked for comments on the possibility of setting the limit for bills below the current 33 1/3 per cent, but a 25 per cent limit was not specifically proposed.

### Comments on the Proposal in Discussion Paper 1

There were few comments on appropriate access to treasury bill auctions. One participant thought that the current limit of 33 1/3 per cent was too high given the declining supply of treasury bills and the relatively small number of participants. It was suggested that the limit be reduced to 20 or 25 per cent to reduce the risk of squeezes, to create a more level playing field in a market with only a limited number of distributors, and to encourage more when-issued and secondary market trading. Another commentator did not want to see any reduction in the limit because of a concern that its investment strategy might be impeded.

### Rationale for the Proposal

The proposal is to reduce the maximum bidding limit for treasury bill auctions to 25 per cent. This lower limit will mean that at least four bidders will win newly auctioned bills, reducing the potential for one or two participants to hold a controlling share of the newly auctioned bills. The proposal might also increase use of the when-issued and secondary markets.

Bidding limits at treasury bill auctions for government securities distributors will not be tiered in the same way as for bonds because the current system for treasury bill auctions appears to be working well. Nevertheless, some differentiation will be introduced between primary

dealers and other government securities distributors. This recognizes the additional responsibilities of primary dealers, while still providing some auction access to smaller distributors.

A summary of competitive bidding limits for both treasury bills and bonds is shown below. Note that the actual auction limits for both distributors and customers will be adjusted downward to reflect net long positions.

<b>Bidder</b>	<b>Competitive Bidding</b>
Distributor Submission - for own account	Up to 25 percent as determined by a formula based on primary and secondary market participation.
- for customers	The sum of customer bids cannot exceed the distributor's own bidding limit.
Customer Bidding Limit	25 per cent

## **5.6 Noncompetitive Bidding**

### **Proposal**

- *Each government securities distributor will be able to make one noncompetitive bid, in addition to any competitive bids, in auctions of Government of Canada bonds and each tranche of treasury bills.*
- *The ceiling on noncompetitive bids for each participant will be \$3 million for Government of Canada bonds and for each tranche of treasury bills.*
- *All government securities distributors will also be able to bid noncompetitively on behalf of customers. The total amount of customer noncompetitive bids that each government securities distributor can submit will be limited to \$3 million.*

### **Comparison to Proposal in Discussion Paper 1**

The issue of noncompetitive bidding was not raised in the first discussion paper.

### **Comments on the Proposal in Discussion Paper 1**

Although the subject was not raised in the first paper, one commentator argued for allowing customers to purchase securities at auction noncompetitively.

## Rationale for the Proposal

Noncompetitive bidding for treasury bills will be introduced because it provides a way for distributors and customers who are less familiar with the market and who may not have the knowledge required to make a successful competitive bid to acquire small amounts of securities.

A summary of noncompetitive bidding limits for treasury bills and bonds is shown below.

<b>Bidder</b>	<b>Noncompetitive Bidding</b>
Distributor Submission - for own account	\$3 million
- for customers	The sum of customer bids cannot exceed \$3 million.
Customer Bidding Limit	\$3 million

## 5.7 Reporting Requirements

### Proposal

#### Reporting of Net Positions

- *Government securities distributors must report their aggregate net positions in the auctioned security to the Bank of Canada when submitting their bids. The net position must be reported regardless of whether it is a long or short position. This position must be updated with each resubmission of bids.*
- *Government securities distributors are responsible for ensuring that their customers are informed that they must report their net position either indirectly through the distributor or directly to the Bank of Canada before their competitive bids will be included in an auction.*
- *Customers bidding competitively at auction must report their net position in the auctioned security. If no net position is reported, the bid will be rejected automatically.*
- *Customers can submit that report either directly to the Bank of Canada or through a government securities distributor that is submitting a bid on their behalf. A customer reporting its net position directly to the Bank of Canada may do so up to 30 minutes before the bidding deadline on the day of the auction.*
- *All bidders are required to re-submit their position, by the bidding deadline, if it changes by more than \$25 million. Customer position changes must be reported directly to the Bank of Canada.*
- *Customers can make noncompetitive bids without submitting a net position report.*

#### Bid Certification and Verification

- *Government securities distributors must ensure that bidding customers are aware of the reporting requirements and that, upon completion of the auction, customers are informed of any auction allotments. The Bank of Canada will rely on a process of spot checks of customer bids to ensure their validity.*
- *As part of the proposed certification and confirmation process, all government securities distributors and customers must provide annual certificates of compliance from their internal audit departments.*

#### Market Information

- *The Bank of Canada requires complete disclosure of government securities distributor activities related to Government of Canada debt, including on request the activities and names of customers with whom the distributor has traded.*
- *The Bank of Canada maintains the discretion to (1) investigate whether activity outside the auction rules has occurred, (2) notify the appropriate regulatory authorities if other questionable activities are found, (3) refer incidents of questionable secondary market activity to the Investment Dealers Association for investigation of possible violations of their proposed Policy No. 5, and (4) sell securities from its own portfolio. The Department of Finance maintains the discretion to reopen an issue outside the timetable provided by the Quarterly Bond Schedule and the usual treasury bill issuance cycle.*

## **Comparison to Proposal in Discussion Paper 1**

Government securities distributors and customers must report their aggregate net position in the auctioned security regardless of the size of their competitive bid at auction or their existing position. This differs from the requirement outlined in the first discussion paper, whereby customers were required to report their net position only when the total of their bids plus the absolute value of their net long position exceeded \$100 million.

The customer reporting requirements that have been eliminated include the furnishing of written trade confirmation to the Bank of Canada by 10 a.m. of the day following the auction (net long or short positions will now be reported before the auction) and the confirmation by telephone by the Bank of Canada of customer awards equal to or greater than \$200 million. Those confirmation methods have been eliminated as the same objectives can be achieved through spot checks by the Bank of Canada.

Measures for bid certification remain unchanged from those outlined in the first discussion paper.

## **Comments on the Proposal in Discussion Paper 1**

Comments received in response to the first discussion paper concerned the perceived administrative burden that the proposals would place on distributors and customers. It was argued that the additional burden would discourage auction participation, thereby reducing the efficiency of the primary debt market.

A number of dealers indicated that customer reporting obligations (and notification thereof) should rest strictly with the Bank of Canada, and should not be the responsibility of government securities distributors. Customers voiced concern over client confidentiality, specifically that reporting through government securities distributors would give the distributors an informational advantage when bidding at auction. There were also some comments regarding the threshold amount used in determining customer reporting requirements, with some suggesting that it was too low or that it should be set as a percentage of the auctioned amount instead of a fixed dollar amount.

## **Rationale for the Proposal**

The Bank of Canada and the Department of Finance are conscious of the potential administrative burden that any new reporting requirement would impose on auction participants, and thus are reluctant to impose additional responsibilities unless the resulting benefits clearly outweigh any potential costs. After due consideration, the Bank of Canada and the Department of Finance believe that position reporting is essential in preventing undue

concentration. The burden of reporting should not be particularly onerous as prudent risk management practices would suggest that auction participants should already have systems in place to monitor their securities positions. Given the potential damage that squeezes can have on the efficiency of the Government of Canada securities market, it is believed that the benefits of the new position reporting requirements more than offset the administrative inconvenience.

Other components of the proposed reporting regime have been reviewed by the Bank of Canada and the Department of Finance in light of the feedback from the first discussion paper. The annual certification requirement proposed in the first discussion paper will be retained since it provides an important assurance, from a source not directly involved in the trading and distribution of Government of Canada securities, that the auction rules are being respected by participants. The additional administrative burden in complying with this requirement is minimal, as the process of certification should easily fall out of the normal annual internal audits of government securities distributors and other auction bidders.

Comments regarding the potential complexity of the customer reporting requirements and concerns expressed about client confidentiality have resulted in a number of proposed changes. These will simplify the reporting process and provide customer bidders with the option of reporting net positions directly to the Bank of Canada. Under the new reporting rules, all customers bidding competitively at auction must report their net positions, regardless of the amount of their bids and existing holdings of the auctioned securities. This change will eliminate any confusion over when a customer should or should not report. Although government securities distributors will still be responsible for notifying their customers of their responsibilities, the burden of that activity is reduced by virtue of the standardization of customer responsibilities and because customers will already be aware of their reporting requirements through the application process for a unique identification number.

Principal indicators as to whether the level of surveillance for a particular Government of Canada security should be intensified include repo rates (the degree of "specialness"), the amount of the outstanding stock controlled by one or more participants, the turnover of the security, and the extent to which the security trades away from the yield curve. The Bank of Canada maintains the discretion to (1) investigate whether activity outside the auction rules has occurred, (2) notify the appropriate regulatory authorities if other questionable activities are found, (3) refer incidents of questionable secondary market activity to the Investment Dealers Association for investigation of possible violations of their proposed Policy No. 5, and (4) sell securities from its own portfolio. The Department of Finance maintains the discretion to re-open an issue outside the timetable provided by the Quarterly Bond Schedule and the usual treasury bill issuance cycle.

In its discussions with government securities distributors, the Bank of Canada requires complete disclosure of distributor activities related to Government of Canada issues,



including on request the activities and names of customers with whom the distributor has traded.

## **6. Conclusions**

Auctions should be free of, and perceived to be free of, manipulation since it is very important that the confidence of direct participants and end investors in the auction process be sustained. The measures discussed in this paper seek to reinforce the integrity of the auction process. Taken together, the initiatives presented in this discussion paper represent a significant change in the way the Government of Canada auctions its marketable debt and are expected to have a significant impact in reducing the occurrence of manipulative behaviour in the primary market.

These proposals are also intended to maintain broad-based involvement in auctions by ensuring that participants have confidence in the process. Anticipated benefits include a more open and level playing field for market intermediaries, a more efficient primary market for investors, a well-functioning capital market for the economy and a reduced cost of borrowing for the government.



## **Appendix 1**

### **Definitions**

*Government securities distributor* means an entity that has been given notice of its status as such by the Bank of Canada and has access to bid at Government of Canada auctions.

*Primary dealer* means a subset of government securities distributors whose participation in the primary and secondary markets for Government of Canada securities is above a threshold level. A distributor may be a primary dealer for bonds, for treasury bills or for both.

*Bid* means an offer to purchase a stated par amount of securities at an auction, either on a competitive or noncompetitive basis. An offer to purchase a stated par amount of securities submitted by a government securities distributor to fulfil a guarantee to sell a specified amount of securities at an agreed-upon price or a price fixed in terms of an agreed-upon standard is a bid of the government securities distributor and not a bid of a customer.

*Bidder* means a person or an entity that bids either directly or through an entity authorized to submit bids for customers in an auction. In some cases, two or more persons or entities are considered to be one bidder, based on their relationship.

*Submitter* means the entity that is permitted to submit bids, either on its own behalf or on behalf of customers, to the Bank of Canada for the auction of Government of Canada securities. Only government securities distributors and the Bank of Canada may be submitters.

*Customer* means a bidder on whose behalf a government securities distributor has been directed to submit a competitive or noncompetitive bid for a specified amount of securities at a specific price.

*Bidding limit* means the distributor's or customer's limit prior to adjusting for long positions. If a distributor or a customer does not have a long position, its auction limit would equal its bidding limit.

*Auction limit* means the maximum amount for which a distributor or customer is allowed to bid at a specific auction. The auction limit is equal to the bidding limit adjusted for long positions in the securities being auctioned. An auction limit is equal to or smaller than the bidding limit.

## **Appendix 2**

### **Summary of Proposals**

#### **Bidder Definition**

- All bidders must certify that they will not bid in concert with any other bidder.
- Entities that do not have a strict arm's length relationship with one another (i.e. affiliates) will be considered one bidder for the purposes of Government of Canada securities auctions. To avoid being considered a single bidder, affiliated entities will have to certify that they do not exchange information about yields, amounts, positions they hold or plan to hold, or their investment strategies with respect to the securities being auctioned.
- The new bidder definition covers all government securities distributors and customers, and applies to corporations, partnerships, governments and government-related entities, foreign central banks (as well as governments of foreign states or international organizations), trusts and individuals.
- Entities are affiliates of one another if one is controlled by the other or if both are controlled by the same entity. The specific definition of control includes formal voting control along with direct and indirect controlling influence over management and policies.
- Affiliated entities who wish to be treated as separate bidders must certify that they will not act in concert in formulating strategy or auction bids.
- Any entity that implements the conditions necessary to be considered a separate bidder must direct all of its bids/purchases through a non-affiliate.

#### **Submission of Bids**

##### *Government Securities Distributors*

- Government securities distributors will be able to bid on their own behalf subject to an auction limit. Government securities distributors will also have a separate limit for the aggregate amount of bids they place on behalf of customers. These bids must be listed separately from the distributor's own bids.

##### *Customers*

- Bidding by individual customers will be subject to an auction limit.
- Customers will be required to obtain a unique bidder identification number from the Bank of Canada before they can bid competitively. An application form for a unique bidder identification number will be available by facsimile or from the Bank of Canada web site (<http://www.bank-banque-canada.ca>).
- Customers will be able to bid at auction by submitting bids through government securities distributors. Competitive bids must be listed separately from the distributor's own bids and be accompanied by the customer's unique bidder number received from the Bank of Canada.
- Customers will not settle directly with the Bank of Canada. Government securities distributors will be responsible for the settlement of customer bids which they have submitted and shall be liable to the Bank of Canada for any losses incurred as a result of those sales failing to settle in the Debt Clearing System (DCS).

## **Competitive Auction Limits**

- The amount that any distributor or customer can bid on a competitive basis at an auction (its auction limit) will equal its bidding limit less its net long position in excess of the product of its percentage bidding limit and the par value of any outstanding stock of the security being auctioned. Examples are provided in Appendix 5.
- All bidders, both government securities distributors and customers, must report their net positions prior to an auction (see the section on reporting requirements for details). For the purposes of computing the auction limit, the bidder's net position will include the par amount of (1) cash holdings of a security with the same International Securities Identification Number (ISIN), (2) when-issued positions, (3) futures contracts that require delivery of the specific security being auctioned but not futures contracts for which the security being auctioned is one of several securities that may be delivered, and not futures contracts that are cash-settled, (4) forward contracts, (5) holdings of the residual component of a stripped bond of the security being auctioned, and (6) any position in the security not covered by the above types of contracts, including "guaranteed" trades. For repurchase agreements or securities lending, the entity that owns the security, not the one that has borrowed it, must report the repoed or lent security as part of its position. All positions are based on trade date rather than delivery date.
- Customer bids will not be netted against the limits of government securities distributors.
- Bidding limits for bond and treasury bill auctions are discussed below.

## **Bidding Limits for Bonds**

### *Government Securities Distributors*

- Primary dealers will have bidding limits tiered from 10 to 25 per cent of the auctioned amount for bids on their own account for Government of Canada bonds. Other government securities distributors will have limits tiered from 1 to 9 per cent. All distributors will also have an additional bidding limit which will cover bids on behalf of customers. The aggregate limit for bidding by a distributor on behalf of customers will equal the limit set on bidding for its own account.
- Bidding limits for distributors will be tiered in line with their performance in auctions of Government of Canada bonds and in secondary markets for such securities over the preceding year. For the purpose of determining these bidding limits, winning bids submitted on behalf of customers will be taken into account in the assessment of the government securities distributor's performance at auction.

### *Customers*

- A customer will be able to bid through government securities distributors for up to 25 per cent of the amount auctioned. A customer can use as many government securities distributors as it chooses to submit its bids as long as the total amount of its bids does not exceed its auction limit.
- It is the responsibility of each customer to ensure that the total of its bids through all government securities distributors does not exceed its auction limit.

## **Bidding Limits for Treasury Bills**

### *Government Securities Distributors*

- Primary dealers will have a bidding limit of 25 per cent of the auctioned amount for bidding on their own behalf. Other government securities distributors, who are less active in treasury bill auctions and in the secondary market, will have a limit of 10 per cent of the auctioned amount.
- Distributors will have an additional bidding limit for the total amount of bids they submit on behalf of customers. This limit will equal the limit set on bidding for their own account.

### *Customers*

- The bidding limit for a customer will be 25 per cent of the amount auctioned. A customer may use as many distributors as it chooses to submit bids, as long as the total amount of its bids does not exceed its auction limit.
- It is the responsibility of each customer to ensure that the total of its bids through all government securities distributors does not exceed its auction limit.

## **Noncompetitive Bidding**

- Each government securities distributor will be able to make one noncompetitive bid, in addition to any competitive bids, in auctions of Government of Canada bonds and each tranche of treasury bills.
- The ceiling on noncompetitive bids for each participant will be \$3 million for Government of Canada bonds and for each tranche of treasury bills.
- All government securities distributors will also be able to bid noncompetitively on behalf of customers. The total amount of customer noncompetitive bids that each government securities distributor can submit will be limited to \$3 million.

## **Reporting Requirements**

### *Reporting of Net Positions*

- Government securities distributors must report their aggregate net positions in the auctioned security to the Bank of Canada when submitting their bids. The net position must be reported regardless of whether it is a long or short position. This position must be updated with each resubmission of bids.
- Government securities distributors are responsible for ensuring that their customers are informed that they must report their net position either indirectly through the distributor or directly to the Bank of Canada before their competitive bids will be included in an auction.
- Customers bidding competitively at auction must report their net position in the auctioned security. If no net position is reported, the bid will be rejected automatically.
- Customers can submit that report either directly to the Bank of Canada or through a government securities distributor that is submitting a bid on their behalf. A customer reporting its net position directly to the Bank of Canada may do so up to 30 minutes before the bidding deadline on the day of the auction.
- All bidders are required to re-submit their position, by the bidding deadline, if it changes by more than \$25 million. Customer position changes must be reported directly to the Bank of Canada.
- Customers can make noncompetitive bids without submitting a net position report.

### *Bid Certification and Verification*

- Government securities distributors must ensure that bidding customers are aware of the reporting requirements and that, upon completion of the auction, customers are informed of any auction allotments. The Bank of Canada will rely on a process of spot checks of customer bids to ensure their validity.
- As part of the proposed certification and confirmation process, all government securities distributors and customers must provide annual certificates of compliance from their internal audit departments.

### *Market Information*

- The Bank of Canada requires complete disclosure of government securities distributor activities related to Government of Canada debt, including on request the activities and names of accounts with whom the distributor has traded.
- The Bank of Canada maintains the discretion to (1) investigate whether activity outside the auction rules has occurred, (2) notify the appropriate regulatory authorities if other questionable activities are found, (3) refer incidents of questionable secondary market activity to the Investment Dealers Association for investigation of possible violations of their proposed Policy No. 5, and (4) sell securities from its own portfolio. The Department of Finance maintains the discretion to re-open an issue outside the timetable provided by the Quarterly Bond Schedule and the usual treasury bill issuance cycle.

**Appendix 3**  
**Summary Tables of Discussion Paper 1 Proposals and Subsequent Revisions**

	<b>ORIGINAL PROPOSAL</b>	<b>MODIFICATIONS</b>
<b>Bidder Definition</b>	<ul style="list-style-type: none"> <li>• Entities that do not have a strict arm's length relationship (definition left largely undefined) with each other will be considered one bidder.</li> <li>• In order to be considered as a separate bidder, an entity within the same organization must certify that it does not exchange any information about the yields, amounts, positions they hold or plan to hold, or their investment strategies with respect to the securities being auctioned.</li> </ul>	<ul style="list-style-type: none"> <li>• No modification in the bidder definition, but greater clarification is provided in this proposal.</li> <li>• The type of entity that may submit auction bids is limited to legal entities.</li> <li>• Entities that are affiliated with each other will be considered one bidder. Entities are affiliates if one is controlled by the other or if both are controlled by the same person. The specific definition of control includes formal voting control along with direct and indirect controlling influence over management and policies.</li> <li>• In order to be considered as a separate bidder, an entity within the same organization must certify that it does not exchange any information about the yields, amounts, positions they hold or plan to hold, or their investment strategies with respect to the securities being auctioned.</li> <li>• Any entity that implements the conditions necessary to be considered a separate bidder must direct all of its bids/purchases through a non-affiliate.</li> </ul>

	ORIGINAL PROPOSAL	MODIFICATIONS
<p><b>Submission of Bids</b></p>	<p><i>Government Securities Distributors</i></p> <ul style="list-style-type: none"> <li>Only government securities distributors are permitted to submit bids directly to the Bank of Canada.</li> <li>Government securities distributors submit separate bids for their own account and for the account of customers.</li> <li>There are separate bidding limits for government securities distributors and customers.</li> </ul> <p><i>Customers</i></p> <ul style="list-style-type: none"> <li>Customers bid at auction by submitting their bids through government securities distributors.</li> <li>Sales of securities are directly from the Bank of Canada to each bidder (government securities distributor or customer) and are settled by a transfer of securities from the Bank of Canada to the Debt Clearing Service.</li> <li>Each bidder has to file settlement instructions with the Bank of Canada prior to an auction, and bidders other than government securities distributors may be required to have a line of credit with their settlement agent.</li> </ul>	<ul style="list-style-type: none"> <li>Government securities distributors are responsible for making payment for securities won by customers on whose behalf they are bidding. As a result, the Bank of Canada will not require customer bidders to file settlement instructions with the Bank of Canada nor will customer bidders be required to have a line of credit with their settlement agent. Such arrangements will now be a matter between the customer and the government securities distributor through which the order was submitted.</li> </ul>
<p><b>Bidding Limits &amp; Net Positions</b></p> <p><b>Government Securities Distributors</b></p>	<ul style="list-style-type: none"> <li>The auction limit for a government securities distributor in respect of its own account is equal to its specific bidding limit less any net long position in excess of the product of its specific percentage bidding limit and the dollar value of any outstanding stock of the security being auctioned. Conversely, a net short position of up to 10 per cent of the dollar value being auctioned is added to the bidding limit.</li> <li>Individual firm bidding limits may be set below the maximum at the discretion of the Bank of Canada.</li> <li>Customer bids are not netted against the bidding limits of government securities distributors.</li> <li>The limit for bidding by a government securities distributor on behalf of customers is equal to the distributor's own bidding limit.</li> </ul>	<ul style="list-style-type: none"> <li>The option of adding a net short position of up to 10 per cent of the dollar value of the securities being auctioned to an auction limit has been eliminated. Only adjustments for net long positions will be made.</li> <li>Maximum bond auction bidding limits for primary dealers will be tiered from 10 to 25 per cent based on each dealer's previous auction winnings (both proprietary and for clients) and secondary market activity. Other government securities distributors will have maximum bidding limits tiered from 1 per cent to 9 per cent.</li> <li>Maximum treasury bill auction bidding limits for primary dealers will be 25 per cent. Other government securities distributors will have a maximum bidding limit of 10 per cent of the auctioned amount.</li> </ul>



	ORIGINAL PROPOSAL	MODIFICATIONS
<p><b>Bidding Limits &amp; Net Positions</b></p> <p><b>Customers</b></p>	<ul style="list-style-type: none"> <li>The auction limit for a customer is equal to its bidding limit less its net long position in excess of the product of its percentage bidding limit and the dollar value of any outstanding stock of the auctioned security. Conversely a net short position of up to 10 per cent of the dollar value being auctioned is added to the bidding limit.</li> <li>It is the responsibility of each customer to ensure that the total of its bids through all government securities distributors does not exceed its auction limit.</li> </ul>	<ul style="list-style-type: none"> <li>The option of adding a net short position of up to 10 per cent of the dollar value of the securities being auctioned to a bidding limit has been eliminated. Only adjustments for net long positions will be made to bidding limits.</li> <li>The maximum customer bidding limit for a bond auction is 25 per cent.</li> <li>The maximum customer bidding limit for a treasury bill auction is 25 per cent.</li> </ul>
<p><b>Non-Competitive Bidding</b></p>	<ul style="list-style-type: none"> <li>Not specifically addressed.</li> </ul>	<ul style="list-style-type: none"> <li>Each government securities distributor and each customer is permitted to bid non-competitively, in addition to any competitive bids they make in auctions.</li> <li>The maximum non-competitive bid for a government securities distributor or customer is \$3 million in respect to each Government of Canada bond auction and each tranche of a treasury bill auction.</li> <li>All government securities distributors will be able to bid noncompetitively on behalf of customers. The total amount of customer noncompetitive bids that each government securities distributor can submit is \$3 million.</li> </ul>

	ORIGINAL PROPOSAL	MODIFICATIONS
<p><b>Reporting Requirements</b></p>	<p><i>Reporting of Net Positions</i></p> <ul style="list-style-type: none"> <li>Government securities distributors must report their aggregate net position in the auctioned security to the Bank of Canada at the time they submit their bids.</li> <li>Customers must report their aggregate net positions in the auctioned security either directly to the Bank of Canada or to a government securities distributor who is submitting a bid on behalf of the customer, whenever the total of all the customer's bids and their net position in the auctioned security equals or exceeds \$100 million.</li> </ul> <p><i>Certification/Confirmation Process</i></p> <ul style="list-style-type: none"> <li>All bidders are required to provide annual certification that the information they provide to the Bank of Canada is correct.</li> <li>Government securities distributors are responsible for notifying their customers of their allotment following an auction.</li> <li>Any customer with a winning bid is required to furnish a written trade confirmation to the Bank of Canada. Customer awards greater than or equal to \$200 million must be confirmed by the Bank of Canada by telephone prior to settlement.</li> <li>The Bank of Canada, at its discretion, will spot check customer bids submitted by government securities distributors.</li> </ul> <p><i>Market Information</i></p> <ul style="list-style-type: none"> <li>Government securities distributors may be asked to provide, from time to time, detailed issue-specific trading reports to the Bank of Canada so that reasons why specific securities are trading at prices above their underlying value may be understood more clearly.</li> </ul>	<p><i>Reporting of Net Positions</i></p> <ul style="list-style-type: none"> <li>Government securities distributors must report their aggregate net position in the auctioned security to the Bank of Canada at the time they submit their bids.</li> <li>Customers must report their aggregate net positions in the auctioned security either directly to the Bank of Canada or to the government securities distributor who will be submitting a competitive bid on behalf of the customer, regardless of the total of size of the customer's bid or net position.</li> <li>The position reporting requirements, if submitted directly to the Bank of Canada, must be satisfied by 30 minutes before the auction deadline in order for the customer to bid competitively. If submitted through a distributor, the report must accompany the bid.</li> <li>Any revisions in excess of \$25 million must be reported directly to the Bank of Canada prior to the auction deadline.</li> </ul> <p><i>Certification/Confirmation Process</i></p> <ul style="list-style-type: none"> <li>Customers will no longer be required to furnish a written trade confirmation to the Bank of Canada.</li> <li>The Bank of Canada will not confirm client awards by telephone prior to settlement.</li> </ul> <p><i>Market Information</i></p> <ul style="list-style-type: none"> <li>The Bank of Canada requires complete disclosure of government securities distributor activities related to Government of Canada debt, including on request the activities and names of accounts with whom the distributor has placed securities, or from whom it has purchased securities.</li> </ul>

## **Appendix 4**

### **Specific Definition of Control**

#### ***Combination of Affiliates Under a Single Bid***

“*Entity*” includes the following:

- corporations;
- partnerships;
- trusts;
- funds;
- unincorporated associations or organizations;
- Her Majesty in Right of Canada or of provincial governments;
- agencies of Her Majesty in either of such rights;
- governments of foreign countries or any political subdivision thereof and any agency thereof;
- foreign central banks and
- international organizations.

“*Person*” means a natural person, an entity or a personal representative.

Bids may be submitted by the following persons:

- corporations;
- partnerships;
- trusts;
- the Government of Canada;
- provincial governments;
- federal and provincial crown corporations and agencies;
- local governments (including, without limitation, municipalities, regional municipalities, counties and townships);
- individuals;
- foreign central banks;
- foreign governments and
- international organizations.

Only persons who are not affiliated with any other bidder may submit a separate bid. Persons who are affiliated must combine their bids in a single bid unless they can meet the criteria and provide the certification required in the following section for submitting separate bids.

Two persons are affiliated if one is controlled by the other or if both are controlled by the same person.

A person controls a corporation if:

- (a) securities of the corporation to which are attached more than 50 per cent of the votes that may be cast to elect directors of the corporation are beneficially owned by that person and the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the corporation;

- (b) the aggregate of (i) any securities of the corporation which are beneficially owned by that person and (ii) any securities of the corporation which are beneficially owned by any entity controlled by that person is such that, if that person and all of the entities controlled by it which beneficially own securities of the corporation were one person, that person would control the corporation; or
- (c) that person controls an entity which controls the corporation.

A person controls a limited partnership if:

- (a) that person is a general partner of the limited partnership; or
- (b) that person controls an entity which controls the limited partnership.

A person controls an unincorporated entity, other than a limited partnership, if:

- (a) more than 50 per cent of the ownership interests, however designated, into which the entity is divided are beneficially owned by that person and that person is able to direct the business and affairs of the entity; or
- (b) that person controls an entity which controls the unincorporated entity.

A person controls any entity if that person has any direct or indirect controlling influence over the management and policies of the entity whether alone or in combination with one or more other persons and whether through the beneficial ownership of securities, through one or more other persons or otherwise.

In order to be able to submit a separate bid, a person must certify to the Bank that it will not intentionally act together with any other person with respect to bidding in an auction.

## **Appendix 5**

### **Illustration of Auction Limits**

This appendix provides illustrations of the implications of the proposed rules for auction limits.

Assume that the outstanding stock of a bond is \$5 billion and that the government is offering a further \$2 billion at auction. In addition, the individual bidding limit is 25 per cent.

Example 1: Assume the bidder has a net long position of \$1.0 billion.

	a)	0.25 x \$2.0 billion	= \$0.5 billion	
less	b)	\$1.0 billion - (0.25 x \$5.0 billion)	<u>= \$0 billion</u>	(only if positive)
equals	c)		= <b>\$0.5 billion</b>	

Example 2: Assume the bidder has a net long position of \$1.25 billion.

	a)	0.25 x \$2.0 billion	= \$0.5 billion	
less	b)	\$1.25 billion - (0.25 x \$5.0 billion)	<u>= \$0 billion</u>	
equals	c)		= <b>\$0.5 billion</b>	

Any long position less than \$1.25 billion would therefore not affect the auction limit.

Example 3: Assume the bidder has a net long position of \$1.5 billion.

	a)	0.25 x \$2.0 billion	= \$0.5 billion	
less	b)	\$1.5 billion - (0.25 x \$5.0 billion)	<u>= \$0.25 billion</u>	
equals	c)		= <b>\$0.25 billion</b>	

Example 4: Assume the bidder has a net long position of \$1.75 billion.

	a)	0.25 x \$2.0 billion	= \$0.5 billion	
less	b)	\$1.75 billion - (0.25 x \$5.0 billion)	<u>= \$0.5 billion</u>	
equals	c)		= <b>\$0 billion</b>	

Any long position larger than \$1.75 billion would therefore imply a auction limit of \$0.

Example 5: Assume the bidder has a net short position of \$0.5 billion.

	a)	0.25 x \$2.0 billion	= <b>\$0.5 billion</b>	
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Short positions do not increase the auction limit.