

**1.1.3 OSC Staff Notice 24-702 – Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies**

**OSC STAFF NOTICE 24-702  
REGULATORY APPROACH TO RECOGNITION  
AND EXEMPTION FROM RECOGNITION OF  
CLEARING AGENCIES**

On February 24, 2010, the Ontario Lieutenant Governor in Council proclaimed in force, effective March 1, 2011, the amendments to sections 21.2 of the *Securities Act* (Ontario) (the Act) that were enacted by section 2 of Schedule 20 to the *Budget Measures Act, 2005 (No. 2)*. New subsection 21.2(0.1) of the Act will prohibit clearing agencies from carrying on business in Ontario unless they are recognized by the Commission as a clearing agency. To assist market participants with this new requirement, OSC Staff are publishing in Chapter 1 of this Bulletin OSC Staff Notice 24-702 – *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*. We encourage all entities operating, or intending to operate, in Ontario as a clearing agency to contact Staff listed in the Notice as soon as possible with any questions regarding the new recognition requirement.

March 19, 2010

**ONTARIO SECURITIES COMMISSION  
STAFF NOTICE 24-702**

**REGULATORY APPROACH TO RECOGNITION  
AND EXEMPTION FROM RECOGNITION OF  
CLEARING AGENCIES**

**I Introduction**

Section 21.2<sup>1</sup> of the *Securities Act* (Ontario) (the Act) prohibits clearing agencies from carrying on business in Ontario unless they are recognized by the Commission as a clearing agency or are exempt from the requirement to be recognized by order of the Commission.<sup>2</sup> Staff of the Ontario Securities Commission (we or Staff) are publishing this notice to set out Staff's regulatory approach to an application for recognition as a clearing agency or exemption from the recognition requirement. We will use this approach when evaluating the requests and making recommendations to the Commission regarding whether to recognize or exempt an applicant and the appropriate regulation for entities desiring to carry on business as a clearing agency in Ontario.

**II The Regulatory Framework for Clearing Agencies**

Subsection 21.2(0.1) of the Act provides that "no person or company shall carry on business in Ontario as a clearing agency unless the person or company is recognized by the Commission under this section as a clearing agency". The term "clearing agency" is defined in subsection 1(1) of the Act as follows:

"clearing agency" means a person or company that,

- (a) acts as an intermediary in paying funds or delivering securities, or both, in connection with trades and other transactions in securities,
- (b) provides centralized facilities for the clearing of trades and other transactions in securities, including facilities for comparing data respecting the terms of settlement of a trade or transaction, or
- (c) provides centralized facilities as a depository of securities,

but does not include,

- (d) the Canadian Payments Association or its successors,
- (e) a stock exchange or a quotation and trade reporting system,
- (f) a registered dealer, or
- (g) a bank, trust company, loan corporation, insurance company, treasury branch, credit union or caisse populaire that, in the normal course of its authorized business in Canada, engages in an activity described in clause (a), but does not also engage in an activity described in clause (b) or (c);<sup>3</sup>

A clearing agency that seeks to operate in Ontario will be required to either apply for recognition under subsection 21.2(0.1) of the Act or apply for an exemption under section 147 of the Act. Generally, we would recommend to the Commission that a clearing agency that performs certain key functions or provides certain facilities, such as central depository, central counterparty, multilateral netting and/or guarantor functions, be recognized and subject to the Commission's full clearing agency regulation and oversight discussed in Part II(a) of this notice (full regulation).

Depending on the circumstances, Staff may recommend to the Commission that a clearing agency be granted an exemption from recognition pursuant to section 147 of the Act. For example, we may consider this approach for an entity that provides limited services or facilities and does not present significant risks to the capital market. We may also consider this approach for a foreign-based clearing agency that intends to operate in Ontario if the clearing agency is subject to an appropriate regulatory

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<sup>1</sup> As amended in 2005 by section 2 of Schedule 20 – *Securities Act* – of the *Budget Measures Act*, 2005 (No. 2), S.O. 2005, c. 31 (Bill 18). The amendments were proclaimed on February 24, 2010 by Order in Council to be in force as of March 1, 2011. See *Ontario Gazette* of Saturday, March 6, 2010, Vol. 143-10, page 435.

<sup>2</sup> In this notice, we refer to this requirement as the "recognition requirement".

<sup>3</sup> The definition "clearing agency" in subsection 1(1) of the Act was amended in 2006 by section 144 of the *Securities Transfer Act*, 2006, S.O. 2006, c. 8 (Bill 41), which came into force on January 1, 2006.

and oversight regime in a foreign jurisdiction. A clearing agency that is granted an exemption would generally be subject to certain terms and conditions discussed in more detail in Part II(b) of this notice.<sup>4</sup>

**(a) Recognition of Clearing Agency**

An application for recognition should include a detailed description of the business operations of the clearing agency and how the clearing agency meets specified criteria that deal with the following:

- Governance
- Fees
- Access
- Rules and rulemaking
- Due process
- Risk management
- Systems and technology
- Financial viability and reporting
- Operational reliability
- Protection of assets
- Outsourcing
- Information sharing and regulatory cooperation

The detailed criteria are attached to this notice as Appendix A. Staff consider the criteria to be characteristics that a clearing agency must have in order to carry on business in Ontario.

A recognition order issued by the Commission under section 21.2 will be subject to terms and conditions that are determined based on the criteria, the operations of the clearing agency, and other relevant factors. Generally, if a clearing agency is recognized it will be required to:

- file rules, procedures and other similar instruments for approval by the Commission
- file financial statements
- file annual reports containing information relating to its participants, risk controls and risk management, and other items
- comply with Staff's Automation Review Program<sup>5</sup>
- be subject to oversight reviews conducted by Staff
- comply with the terms and conditions.

**(b) Exemption from Recognition**

A clearing agency may request an exemption from the recognition requirement pursuant to section 147 of the Act in certain circumstances. For example, an entity may perform limited activities which do not present significant risk to the Ontario capital markets, such that full regulation may not be warranted. Depending on the nature of the functions performed by the clearing agency and the risks arising from such functions, we may recommend that the exemption be subject to certain terms and conditions. The specific terms and conditions may vary depending on the operations of the clearing agency, its risk controls, the

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<sup>4</sup> A Commission order, including any terms and conditions contained in the order, forms part of Ontario securities law. See definition "Ontario securities law" in subsection 1(1) of the Act.

<sup>5</sup> The Automation Review Program (ARP) provides a mechanism for any specified market infrastructure entity to follow a formal methodology in identifying and managing information technology risk. For a copy of the ARP, please see (2002) 25 OSCB 6789.

methods of access for its participants, and any regulatory regime to which it is already subject. Whether a clearing agency is recognized or is exempted from recognition, there will be terms and conditions to enable the Commission to have access to information on its operations and the trading and clearing activity of Ontario participants.

We discuss below two circumstances in which we may be prepared to recommend an exemption from recognition: foreign-based clearing agencies and matching service utilities. An application for an exemption should include a detailed description of the operations of the clearing agency and how the clearing agency meets the specified criteria in Appendix A.

(i) *Foreign-based clearing agencies*

A foreign-based clearing agency that is carrying on business or intends to carry on business in Ontario would be required to apply either for recognition or for an exemption from recognition. A foreign-based clearing agency that offers to provide its services or facilities to a person or company resident in Ontario would be considered to be carrying on business in Ontario.<sup>6</sup> Depending on the circumstances, Staff may recommend to the Commission that a foreign-based clearing agency be granted an exemption from recognition pursuant to section 147 of the Act if the clearing agency does not pose significant risk to the Ontario capital markets and is subject to an appropriate regulatory and oversight regime in a foreign jurisdiction. We recognize that some foreign-based clearing agencies are already subject to a regulatory regime in their country of origin (home jurisdiction). Full regulation, similar to that applied to domestic clearing agencies, may be duplicative and inefficient when imposed in addition to the regulation of the home jurisdiction. However, where the regulatory regime of the home jurisdiction is not comparable to that of Ontario, the Commission may consider it necessary to impose additional requirements.

The foreign-based clearing agency should establish at the time of application that it meets the criteria in Appendix A. The application should explain how the clearing agency meets each criterion and provide a detailed description of the regulatory regime of the home jurisdiction and the regulatory requirements imposed on the clearing agency in its home jurisdiction.

The following terms and conditions may be considered:

- ongoing compliance with home jurisdiction regulation and oversight
- prior notice of material changes to the application
- periodic reporting of information relating to operational activities
- access restrictions
- financial reporting
- information sharing arrangements
- home jurisdiction's adherence to CPSS-IOSCO standards for securities settlement systems and/or central counter-parties<sup>7</sup>
- submission to non-exclusive jurisdiction

(ii) *Matching service utilities*

One type of entity that may be considered by Staff to have limited activities is a "matching service utility" (MSU) governed by National Instrument 24-101—*Institutional Trade Matching and Settlement* (NI 24-101). An MSU is a provider of centralized automated services and facilities for the institutional trade matching process, i.e., it facilitates the clearing of trades executed by or on behalf of institutional investors, where multiple parties such as a dealer, investment manager and custodian are required to provide information to confirm and agree to the terms and settlement instructions of a trade. An MSU is subject to certain reporting and other requirements under NI 24-101. Depending on the circumstances, Staff may be prepared to recommend an exemption subject to terms and conditions.

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<sup>6</sup> We note that electronic access in Ontario to a clearing agency's systems and facilities will generally indicate that it is "carrying on business" in Ontario, even if the clearing agency has no physical presence in Ontario. This is similar to the approach used by Staff for foreign-based stock exchanges. See OSC Staff Notice 21-702 *Regulatory Approach for Foreign-Based Stock Exchanges*, dated October 31, 2003.

<sup>7</sup> See *Recommendations for securities settlement systems - Report of the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions*, dated November 2001; and *Recommendations for Central Counterparties - Report of the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions*, dated November 2004.

#### **IV Application Process**

The application process for both recognition and exemption from recognition as a clearing agency is similar. The clearing agency must file an application, detailing, for example, its history, business and regulatory structure (if any), and addressing how it meets the specific criteria as outlined in Appendix A. Where specific criteria in Appendix A may not be relevant to an applicant because of the nature or scope of its clearing agency activities, its specific structure, the products it clears or settles, or its regulatory environment, the application should explain in reasonable detail why the criteria are not relevant.

After discussing the application with the applicant, Staff will seek the Commission's approval to publish the application, together with a draft order, for a 30 day comment period. Publication will occur in the OSC Bulletin and on the OSC website. Once all issues raised during the comment process are resolved, Staff will submit the order for approval to the Commission in the form of the published order, as amended in response to the comment process.

#### **V OSC Staff Contact**

The following Staff may be contacted to discuss this notice or the application process:

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## Appendix A

### Criteria for Recognition and Exemption from Recognition as a Clearing Agency

Responses to the criteria in this Appendix A must address, where applicable, the following:

- (i) Describe how the clearing agency meets each criterion. Where a specific criterion may not be relevant because of the nature or scope of the clearing agency's activities, please explain in reasonable detail why it is not relevant.
- (ii) Where an application for an exemption is being made by a foreign clearing agency, describe the requirements, if any, that are imposed by the applicable regulator in the clearing agency's jurisdiction (the foreign regulator) in each area.
- (iii) Describe how the oversight of the foreign clearing agency by the foreign regulator ensures ongoing compliance with the criteria.

#### **PART 1 GOVERNANCE**

- 1.1 The governance structure and governance arrangements of the clearing agency ensures:
- (a) effective oversight of the clearing agency;
  - (b) the clearing agency's activities are in keeping with its public interest mandate;
  - (c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors;
  - (d) a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency;
  - (e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;
  - (f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and
  - (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.

#### **PART 2 FEES**

- 2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.
- 2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.

#### **PART 3 ACCESS**

- 3.1 The clearing agency has appropriate written standards for access to its services.
- 3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of
- (a) each grant of access including, for each participant, the reasons for granting such access, and
  - (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.

#### **PART 4 RULES AND RULEMAKING**

- 4.1 The clearing agency's rules are designed to govern all aspects of the settlement services offered by the clearing agency, and
- (a) are not inconsistent with securities legislation,

- (b) do not permit unreasonable discrimination among participants, and
- (c) do not impose any burden on competition that is not necessary or appropriate.

4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.

4.3 The clearing agency monitors participant activities to ensure compliance with the rules.

4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.

#### **PART 5 DUE PROCESS**

5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:

- (a) an applicant or a participant is given an opportunity to be heard or make representations; and
- (b) the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.

#### **PART 6 RISK MANAGEMENT**

6.1 The clearing agency's settlement services are designed to minimize systemic risk.

6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.

6.3 Without limiting the generality of the foregoing, the clearing agency's services or functions are designed to achieve the following objectives:

1. Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.
2. The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.
3. Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.
4. Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.
5. Assets used to settle the ultimate payment obligations arising from securities transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in settlement services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
6. If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.

6.4 The clearing agency engaging in activities not related to settlement services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the settlement service.

#### **PART 7 SYSTEMS AND TECHNOLOGY**

7.1 For its settlement services systems, the clearing agency:

- (a) develops and maintains,
  - (i) reasonable business continuity and disaster recovery plans,
  - (ii) an adequate system of internal control,

- (iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;
- (b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,
  - (i) makes reasonable current and future capacity estimates,
  - (ii) conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,
  - (iii) tests its business continuity and disaster recovery plans; and
- (c) promptly notifies the regulator of any material systems failures.

7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).

#### **PART 8 FINANCIAL VIABILITY AND REPORTING**

8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.

#### **PART 9 OPERATIONAL RELIABILITY**

9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.

#### **PART 10 PROTECTION OF ASSETS**

10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.

#### **PART 11 OUTSOURCING**

11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.

#### **PART 12 INFORMATION SHARING AND REGULATORY COOPERATION**

12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.