13.1.3 CDS Notice and Request for Comments – Material Amendments to CDS Procedures Relating to Mark-to-Market Component of Continuous Net Settlement Collateral Requirement

THE CANADIAN DEPOSITORY FOR SECURITIES LIMITED (CDS)

MATERIAL AMENDMENTS TO CDS PROCEDURES

MARK-TO-MARKET COMPONENT OF CONTINUOUS NET SETTLEMENT COLLATERAL REQUIREMENT

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED AMENDMENTS

On April 27th, 2006, the Board of Directors of CDS approved material amendments to CDS Procedures for submission to CDS' regulators. The proposed amendments to the Procedures will affect the calculation of the Mark-to-Market component (the MTM Component) of the Continuous Net Settlement (CNS) Collateral Requirement. CDS proposes to amend a portion of the calculation of collateral requirements in order that the collateral requirement be based on the 'unpaid' Mark rather than the original calculated Mark.

The MTM component of the participant fund will be calculated using the largest unpaid mark by a given participant in the previous fifty (50) days, and is used to address the risk of default prior to delivery of a required mark to a CDS Participant fund. CDS determined that the use of the trailing fifty day period provides approximately ninety-nine percent (99%) confidence that the calculated value of the MTM component will cover the risk of a defaulting Participant failing to pay a Mark.

B. NATURE AND PURPOSE OF THE PROPOSED AMENDMENTS

The proposed amendment to CDS Procedures will add details to the following areas of the Procedures: first, the proposed amendments specify that the MTM (Mark-to-Market) process addresses not only the potential difference between the original trade price and the current price but, in the case of an outstanding position, the potential difference between the most recent mark price and the current price; second, the proposed amendments address the Mark-to-Market pro-rating calculation; and third, the proposed amendments detail the historical period which is surveyed to determine the largest unpaid mark.

The MTM Component of the CNS Collateral Requirements is based on the closing price for a particular security as of the day prior to the value date, and the daily mark-to-market payment exchange is included in CDSX daily processes. A mark-to-market payment can, in a T+3 settlement environment, represent up to three days of price changes to the security being marked.

Once positive and negative marks (as the case may be, depending on whether the price of a security is higher or lower than the original price, when marked) are netted out (a positive mark serves to reduce a negative one and, therefore, the exposure of a participant fund to that risk) and subsequent sales and/or funds credits are taken into account, the residual exposure is the 'unpaid' mark. Since unpaid marks are not specified by service within CDSX, the MTM Component of the mark must be pro-rated from the whole. The calculation for this pro-rating is as follows:

$$\frac{(CNS\ CAD\ net\ mark\ amount)+(Buy-in\ washout\ CAD\ net\ mark\ amount)}{(Total\ net\ mark\ amount^{1})}\ X\ CAD\ unpaid\ mark$$

[1]Total net mark amount = (CNS CAD net mark amount + DetNet CAD net mark amount + buy-in washout CAD net mark amount).

The proposed amendments will allow for increased accuracy and efficiency in the calculation of collateral requirements for the CNS function. In addition, the use of the 'unpaid' mark will reduce the total participant fund requirements for both CNS and DetNet while maintaining the required confidence levels with respect to coverage of possible losses to those funds.

C. IMPACT OF PROPOSED AMENDMENTS

The current calculation is based on the original calculated mark, and not on the portion of that mark that remains unpaid. The latter represents the actual risk to the participant fund, whereas the former overstates the risk to the participant fund and results in the over-collateralization of that risk. The proposed amendments take into account both the nature of the two principal risks and the actual rather than theoretical risk to the participant funds while maintaining a confidence level which exceeds the 99% confidence level with respect to the coverage of potential loss to the participant fund.

There is no cost impact for compliance with the change to the collateral calculation and the decrease in collateral requirement continues to meet the 99% confidence level. The reduction in collateral requirements will not be evenly distributed across CNS participants since the decrease in collateral requirements is based on the risk that each CNS participant poses to the CNS Participant Fund. Although the change to the collateral calculations maintains a 99% confidence level, the proposed amendment increases the potential exposure of the survivors of a default of a CNS participant.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

CDS is recognized as a clearing agency by the Ontario Securities Commission pursuant to Section 21.1 of the Ontario Securities Act and as a self-regulatory organization by the Autorité des marchés financiers pursuant to Section 169 of the Québec Securities Act. In addition, CDS is deemed to be the clearing house for CDSX, a clearing and settlement system designated by the Bank of Canada pursuant to Section 4 of the Payment Clearing and Settlement Act. The Ontario Securities Commission, the Autorité des marchés financiers and the Bank of Canada will hereafter be collectively referred to as the "Recognizing Regulators".

CDS Procedure Amendments originate from a number of sources, both internal and external, and may be standalone or consequential amendments. Standalone amendments are most often necessitated by internal systems changes or service enhancements, while consequential amendments stem from amendments to CDS Participant Rules and/or other regulatory requirements. All CDS Procedure Amendments are reviewed and approved by CDS' Strategic Development Review Committee prior to submission for regulatory approval.

E. IMPACT OF PROPOSED AMENDMENTS ON TECHNOLOGICAL SYSTEMS

An analysis has determined that the only material impact of the implementation of the proposed amendments will be a revision of calculation referred to above within CDSX. No other impacts are foreseen.

F. COMPARISON TO OTHER CLEARING AGENCIES

The specifics of the calculation of the CNS Participant Fund collateral requirements are unique to CDS and, as such, cannot readily be compared to the operations of other clearing agencies.

G. PUBLIC INTEREST ASSESSMENT

An analysis of the impact of the proposed amendments on the Participant Procedures and CDS technological systems has determined that the implementation of these amendments would not be contrary to the public interest.

H. COMMENTS

Comments on the proposed amendments should be in writing and delivered by July 10, 2006 and delivered to:

Tony Hoffmann
Legal Counsel
The Canadian Depository for Securities Limited
85 Richmond Street West
Toronto, Ontario M5H 2C9

Fax: 416-365-1984
e-mail: attention@cds.ca

A copy should also be provided to the Ontario Securities Commission by forwarding a copy to:

Cindy Petlock
Manager, Market Regulation
Capital Markets Branch
Ontario Securities Commission
Suite 1903, Box 55,
20 Queen Street West
Toronto, Ontario, M5H 3S8

Fax: 416-595-8940
e-mail: cpetlock@osc.gov.on.ca

CDS will make available to the public, upon request, copies of comments received during the comment period.

I. PROPOSED PROCEDURE AMENDMENTS

Appendix "A" contains text of current CDS Participant Procedure marked to reflect proposed amendments as well as text of these procedures reflecting the adoption of the proposed amendments.

J. QUESTIONS

Questions regarding this notice may be directed to:

Tony Hoffmann
Legal Counsel
The Canadian Depository for Securities Limited
85 Richmond Street West
Toronto, Ontario M5H 2C9

Fax: 416-365-1984
e-mail: attention@cds.ca

JAMIE ANDERSON
Senior Legal Counsel

APPENDIX "A"

PROPOSED RULE AMENDMENT

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
15.5 Mark-to-market component	**15.5 Mark-to-market component**
CDS applies a mark-to-market to all trades and outstanding positions for the central counterparty services. This mark-to-market process addresses the potential loss from the original trade price to the current price<u>, or from the last mark price to the current price for outstanding positions</u>. CDS marks trades for the first time at netting and novation (e.g., the evening of T+2 for equities in CNS) and continues to mark daily until the position is settled or the outstanding position is cleared.	CDS applies a mark-to-market to all trades and outstanding positions for the central counterparty services. This mark-to-market process addresses the potential loss from the original trade price to the current price, or from the last mark price to the current price for outstanding positions. CDS marks trades for the first time at netting and novation (e.g., the evening of T+2 for equities in CNS) and continues to mark daily until the position is settled or the outstanding position is cleared.
~~CDS applies a mark~~<u>Mark</u>-to-~~market~~ <u>markets are applied</u> to all CNS ~~and ACCESS~~ trades and outstanding positions in each security based on the closing price available for that security as of the day prior to value date (typically the closing price on T+2). The daily mark-to-market payment exchange is included in the daily processes of CDSX. In a T+3 environment where CDS nets and novates CNS trades on the evening of T+2, the mark-to-market payment can represent as much as three days of price movement.	Mark-to-markets are applied to all CNS -trades and outstanding positions in each security based on the closing price available for that security as of the day prior to value date (typically the closing price on T+2). The daily mark-to-market payment exchange is included in the daily processes of CDSX. In a T+3 environment where CDS nets and novates CNS trades on the evening of T+2, the mark-to-market payment can represent as much as three days of price movement.
Since a participant's CNS mark is calculated and applied to the participant's funds accounts during the early morning batch settlement process in CDSX (i.e., at around 5:00 a.m. ET, 3:00 a.m. MT, 2:00 a.m. PT), the entry to a participant's funds account occurs prior to CDS having an opportunity to receive additional collateral from the participant.	Since a participant's CNS mark is calculated and applied to the participant's funds accounts during the early morning batch settlement process in CDSX (i.e., at around 5:00 a.m. ET, 3:00 a.m. MT, 2:00 a.m. PT), the entry to a participant's funds account occurs prior to CDS having an opportunity to receive additional collateral from the participant.
<u>**Mark-to-market pro-rating**</u>	**Mark-to-market pro-rating**
<u>Both positive and negative marks from CNS and DetNet are applied to a participant's funds account. In CDSX, a participant may have a negative mark applied to their funds account, however, subsequent sales or funds credits reduce the mark owing to CDS. Repayment of the negative mark reduces the exposure of the participant funds to the negative mark obligation of the participant.</u>	Both positive and negative marks from CNS and DetNet are applied to a participant's funds account. In CDSX, a participant may have a negative mark applied to their funds account, however, subsequent sales or funds credits reduce the mark owing to CDS. Repayment of the negative mark reduces the exposure of the participant funds to the negative mark obligation of the participant.
<u>The residual exposure is called the unpaid mark. In CDSX, unpaid marks are not specified by the service (e.g., CNS, DetNet) and as a result, must be prorated. The unpaid mark provides the mark-to-market component of the collateral requirements.</u>	The residual exposure is called the unpaid mark. In CDSX, unpaid marks are not specified by the service (e.g., CNS, DetNet) and as a result, must be prorated. The unpaid mark provides the mark-to-market component of the collateral requirements.
<u>The unpaid mark is pro-rated using the following calculation:</u>	The unpaid mark is pro-rated using the following calculation:
$\dfrac{\text{CNS CAD net mark amount} + \text{Buy-in washout CAD net mark amount}}{\text{Total net mark amount}^{1}} \times \text{CAD unpaid mark}$	$\dfrac{\text{CNS CAD net mark amount} + \text{Buy-in washout CAD net mark amount}}{\text{Total net mark amount}^{1}} \times \text{CAD unpaid mark}$
[1] Total net mark amount = CNS CAD net mark amount + DetNet CAD net mark amount + buy-in washout CAD net mark amount.	[1] Total net mark amount = CNS CAD net mark amount + DetNet CAD net mark amount + buy-in washout

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
For more information on buy-in washouts, refer to *Trade and Settlement Procedures.* **Mark-to-market in collateral requirements** The mark-to-market component of the participant fund is calculated using the largest unpaid mark paid by the participant in the last 50 days. The calculation is used to address the risk that a default may occur prior to the participant delivering their required contribution to CDS. The ~~mark-to-market component is the largest of the participant's mark-to-market payments paid to or received from CDS in the last 50 business days, including the current day for which the calculation is being made. The calculation is used to address the risk that a default may occur prior to the participant delivering their required contribution to CDS. Since the marks are based on the participant's CNS outstanding positions and the movements in market prices, a participant is just as likely, on a given day, to owe CDS a mark as to be owed a mark. The~~ use of 50 business days as the historical look-back period provides approximately 99 per cent confidence that the mark-to-market component will cover the risk of a defaulter failing to pay a mark. This is consistent with the coverage provided by the outstanding positions component of the fund.	CAD net mark amount. For more information on buy-in washouts, refer to *Trade and Settlement Procedures.* **Mark-to-market in collateral requirements** The mark-to-market component of the participant fund is calculated using the largest unpaid mark paid by the participant in the last 50 days. The calculation is used to address the risk that a default may occur prior to the participant delivering their required contribution to CDS. The use of 50 business days as the historical look-back period provides approximately 99 per cent confidence that the mark-to-market component will cover the risk of a defaulter failing to pay a mark. This is consistent with the coverage provided by the outstanding positions component of the fund.