

CDS Clearing and Depository Services Inc. (CDS[®])

MATERIAL AMENDMENTS TO CDS PROCEDURES

**AMENDMENTS RELATED TO THE EXTENDERS OF CREDIT AND SETTLEMENT AGENTS
CATEGORY CREDIT RINGS**

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the CDS Participant Procedures (“Amendments”) make changes with respect to certain category credit rings (“CCR”). Specifically, the Amendments require Participants in the Settlement Agent and Extenders of Credit CCRs, who have current or potential exposures, to fully cover their own losses with a high degree of confidence.

This Notice describes technical details to be included in the CDS Participant Procedures (“Procedures”). Corresponding changes to the CDS Participant Rules (“Rules”) are described in “Material Amendments to CDS Rules. Amendments Related to the Extenders of Credit and Settlement Agents Category Credit Rings,” to be published concurrently with this Notice.

CDS’s Recognition Orders require the observance, as soon as possible, of the CPSS-IOSCO Principles for Financial Market Infrastructures (“PFMI”). CDS’s self-assessment identified the need to reduce leverage in the Settlement Agent and Extender of Credit CCRs by reducing the mutualization of exposures in favour of increased collateralization of individual exposures.

Background

Timely observance of the PFMI by CDS is required by CDS’s regulators under its Recognition Order requirements:

- Autorité des Marchés Financiers: Reconnaissance de Services de dépôt et de compensation CDS inc. à titre de chambre de compensation en vertu de la *Loi sur les valeurs mobilières*, L.R.Q., c. V-1.1 – Part III, paragraph 43.1
- Ontario Securities Commission The Canadian Depository for Securities Limited and CDS Clearing and Depository Service Inc. Order; Section 144 of the Act, the Current Recognition Order – Part II: (Terms and Conditions Applicable to CDS Ltd. and CDS Clearing), Paragraph 9.1
- British Columbia Securities Commission requires CDS to comply with the terms and conditions of the order of the Ontario Securities Commission

Currently, Participants in the Extender of Credit and Settlement Agent CCRs benefit from common use collateral held in their respective pools. Such collateral pledged by all Participants in the CCRs, has a leveraged effect on individual contributions. Consequently, Participant exposures are not fully covered. This structure does not meet with recognized international standards as described in Principle 4 and Key Considerations 3.4.12 and 3.4.18 of the PFMI.

Amendments – Extenders of Credit CCR

The approach endorsed by Participants in the Extender of Credit CCR uses the existing calculation methodology as prescribed in the Procedures and entails Participants of the ring being credited with an Initial ACV amount equal to their collateral/contribution.

Initial ACV (Aggregate Collateral Value) is the estimated calculated value of the collateral that could be realized if a Participant failed to pay its payment obligation. CDS's clearing and settlement system, CDSX, maintains a current ACV balance for each Participant at a ledger level. All CDSX functions that affect a Participant's security and funds balances are subject to an ACV edit. ACV ensures that CDSX is fully collateralized at all times. The amount is calculated in accordance with Rule 5.13 and Chapter 10 of *Participating in CDS Services*.

The CCR members will see each member's required collateral contribution and the total amount of collateral in the pool. The collateral requirement will be calculated each quarter and will be locked-in for the quarter as is presently the case. Under this approach the member's own collateral requirement will be its initial ACV rather than the sum total of all the members' collateral requirement. The range for the Extenders of Credit is between C\$250 million and C\$670 million.

This is in contrast to the current approach where all Extenders of Credit receive an initial ACV in the amount of the sum total collateral contributions of all the Extenders of Credit (approximately C\$2.8 billion at present).

Amendments – Settlement Agents CCR

Each Settlement Agent will be credited an Initial ACV amount equal to its Extenders of Credit CCR collateral requirement/contribution. Methodology changes are proposed for determining the System Operating Cap ("SOC") and Collateral Requirements.

The changes to the SOC will introduce a maximum SOC for tenured members, a maximum SOC for new members and a maximum US\$ SOC.

The Settlement Agent CCR agreed to the following changes to the methodology for determining the System Operating Cap and Collateral Requirements as follows:

(i) System Operating Cap (SOC)

- **MAXIMUM SOC – TENURED MEMBERS:** The Settlement Agent CCR agrees to set a C\$1 Billion maximum SOC.
 - **TENURE CRITERIA:** Must have been a member of the Settlement Agent CCR for a period of at least 1 year.
- **MAXIMUM SOC – NEW MEMBERS:** New members of the Settlement Agent CCR can elect a SOC not exceeding 50% of the maximum cap.
- **MAXIMUM US\$ SOC:** Settlement Agents may elect to convert up to 3% of their elected C\$ cap to a US\$ cap.

(ii) Contribution to Settlement Agents CCR

- **POOL COLLATERAL REQUIREMENT:** Settlement Agent CCR collateral contribution at an agreed percentage of the maximum cap 25% of maximum SOC.
- **PARTICIPANT COLLATERAL REQUIREMENT:** Participants contribute to the Settlement Agents CCR collateral equivalent to their pro-rata share of the total elected SOC.

(iii) Determination of "Available System Operating Cap" and "Initial ACV"

- **RATING DISCOUNT:** The settlement agent category credit ring retains the use of a Ratings Discount to adjust the initial ACV allotted to each settlement agent.
 - The Ratings Discount will be applied to Participants' Collateral Requirement to Determine Initial ACV.

- A reduction in the Ratings Discount will result in a decrease in the members' Initial ACV available for the given collateral requirement the magnitude of which depends on the number of notches to the downgrade.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The Amendments align the Procedures with the corresponding changes to the Rules and the CDS Risk Model.

Participating in CDS Services – Extenders of Credit CCR

No amendments related to the Extenders of Credit CCR

Participating in CDS Services – Settlement Agents

Section 12.2 – Settlement Agent Cap Adjustments: These additions/amendments to the Procedures describe the approach agreed to by the Settlement Agents for determining the SOC and Collateral Requirements.

Section 17.2 – Settlement Agents Collateral Pool: These additions/amendments to the Procedures describe the approach for determining the ratings discounts used to determine the members' Initial ACV.

CDSX Procedures and User Guide – Extenders of Credit CCR and Settlement Agents CCR

No amendments

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

- (a) CDS Clearing - The Amendments will ensure CDS's observance of the PFMI and adoption of a recognized international standard for market infrastructures. The Amendments will also enhance risk management by removing leverage from the CCRs.
- (b) CDS Participants -The Amendments will benefit Participants by providing them with access to a market infrastructure that meets global standards.
- (c) & (d) Other Market Participants and Securities and Financial Markets in General -- The Amendments will help mitigate systemic risk and contribute to the efficiency of Canadian capital markets.

C.1 Competition

The Amendments will apply to all CDS Participants who currently are, or may choose to become Participants in the Settlement Agent or Extender of Credit CCRs. From a fair access perspective, no CDS Participant will be disadvantaged or otherwise prejudiced with the introduction of these changes.

C.2 Risks and Compliance Costs

The Amendments to the collateralization of the Extenders of Credit and Settlement Agents CCRs will result in changes to the CDS Risk Model, Rules and Procedures. CDS does not foresee other risks or compliance costs accruing to Participants or other stakeholders.

C.3 Comparison to International Standards – (a) Committee on Payment and Settlement Systems of the Bank for International Settlements, (b) Technical Committee of the International Organization of Securities Commissions, and (c) the Group of Thirty

The PFMI are minimum international standards for enhancing the safety and efficiency of clearing, settlement and recording arrangements, which aim to limit systemic risk and foster transparency and financial stability. The PFMI apply to CCPs, central securities depositories (“CSDs”) and security settlement systems (“SSS”). CDS engages in all three of these market infrastructure activities. According to the terms of CDS’s recognition order requirements, CDS is required to observe PFMI as soon as possible.

The Amendments aim to mitigate credit risk exposure by reducing CDS’s reliance on the mutualization of risk resources. The Amendments align with Principle 4 (Credit Risk) and Key Considerations 3.4.12 and 3.4.18 of the PFMI which call for collateral pools to be collateralized such that current and potential future exposures to each Participant are covered fully with a high degree of confidence (i.e. single-tailed confidence level of at least 99 percent of the estimated distribution of future exposures).

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

CDS actively engaged internal and external discussion to explore its options. It established separate workgroups with Participants from the Extenders of Credit and Settlement Agent CCRs. The workgroups agreed upon a preferred approach which was socialized by the Participants in the workgroup back to their respective organizations where they were endorsed. CDS also prepared documents describing the Amendments which were tabled at the Risk Advisory Committee (“RAC”), a Participant committee that meets monthly.

D.2 Procedure Drafting Process

The Amendments will be presented to the Strategic Development Review Committee (“SDRC”). The SDRC reviews proposed Procedure changes that may have operating or systems development implications to Participants. and the SDRC may propose additional or alternative system or operating changes to CDS. The SDRC’s membership includes representatives from a cross-section of the CDS Participant community which meets monthly.

D.3 Issues Considered

Consideration was given to the operational impacts that the enhancements might create for CDS Participants as outlined in section C of this Notice.

D.4 Consultation

This Amendment was initiated by CDS. CDS received input from the RAC on the concept and methodology underlying this Amendment. The SDRC is expected to comment on the operational aspects of this Amendment by October 30.

CDS Customer Service account managers will provide ongoing communication and status updates of proposed changes to clients and will solicit input on those changes.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings and monthly meetings with service bureaus to discuss potential development impacts to them. As a courtesy, development initiatives are presented to the Investment Industry Regulatory Organization of Canada's ("IIROC") Financial Administrators Section ("FAS") working group.

D.5 Alternatives Considered

Alternatives, essentially minor variations of the preferred option, were considered. The proposed methodology is the result of input received from the members of the RAC.

D.6 Implementation Plan

The Amendments and the proposed implementation schedule will be communicated to CDS Participants through the SDRC and the RAC. CDS Relationship Managers and the Customer Service department will provide Participants with also provide details of the upcoming changes. Subject to regulatory approval, CDS will distribute a bulletin to all Participants the week before implementation reminding them of the upcoming changes and confirming the effective date of those changes.

CDS is recognized as a clearing agency by the Ontario Securities Commission pursuant to section 21.2 of the Ontario *Securities Act*, and by the British Columbia Securities Commission pursuant to section 24(d) of the British Columbia *Securities Act*, and as a clearing house by the *Autorité des marchés financiers* pursuant to Section 169 of the Quebec *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 British Columbia Securities Commission, the *Autorité des marchés financiers* and the Bank of Canada will hereafter be collectively referred to as the "Recognizing Regulators".

The Amendments may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment. Subject to regulatory approval, CDS intends to implement the Amendments on **December 31, 2014**.

E. TECHNOLOGICAL SYSTEM CHANGES

E.1 CDS

There are no technological system changes required by CDS.

E.2 CDS Participants

There are no technological system changes required by Participants.

E.3 Other Market Participants

There are no technological system changes required by Participant service bureaus.

F. COMPARISON TO OTHER CLEARING AGENCIES

No comparable or similar procedures were available for other clearing agencies in order to conduct an analysis.

G. PUBLIC INTEREST ASSESSMENT

CDS has determined that the Amendments are not contrary to the public interest.

H. COMMENTS

Comments on the Amendments should be in writing and submitted within 30 calendar days following the date of publication of this notice in the Ontario Securities Commission Bulletin, the British Columbia Securities Commission Bulletin or the Autorité des marchés financiers Bulletin to:

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Copies should also be provided to the Autorité des marchés financiers, the British Columbia Securities Commission and the Ontario Securities Commission by forwarding a copy to each of the following individuals:

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

I. PROPOSED CDS PROCEDURE AMENDMENTS

Access the Amendments to the CDS Procedures on the User documentation revisions web page (<http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-UserDocumentation?Open>).