

**13.3.2 CDS – Request for Comments – Material Amendments to CDS Rules – Requirement for Uncertificated Withdrawal of Securities**

**CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)**

**MATERIAL AMENDMENTS TO CDS RULES**

**REQUIREMENT FOR UNCERTIFICATED WITHDRAWAL OF SECURITIES**

**REQUEST FOR COMMENTS**

**A. DESCRIPTION OF THE PROPOSED CDS RULE AMENDMENTS**

The proposed amendments to the CDS Rules will require participants to withdraw securities from the CDSX® system in uncertificated format where the issuer offers a direct registration system.

**B. NATURE AND PURPOSE OF THE PROPOSED CDS RULE AMENDMENTS**

**B.1 Proposed Amendment**

The proposed Rule amendments are a further step toward the objective of paperless processing of securities transactions and holdings. The Rule amendments promote a reduction in the use of certificates evidencing securities. Progress towards the dematerialization of securities will require changes to market practices made by individual issuers and transfer agents.

**B.2 Paperless Processing of Securities Transactions**

Certificates require manual handling, which increases costs and reduces efficiency. Costs associated with certificates include vaults, special custody procedures, audits, surety bonds, specialized transportation and handling, and clerical processing. Certificates also give rise to the risk of theft or loss, with the resulting costs to replace certificates. DTC has estimated that the annual cost to the American securities industry in handling paper security certificates approaches \$250 million; no definitive studies have been done in Canada, but it can be assumed that the Canadian costs are proportionate. CDS has supported many initiatives by the financial services sector to reduce the number of security certificates. Recent CDS dematerialization efforts include destruction of NTI certificates, development of trust indentures for book-entry only security issuance, electronic closings, TRAX to facilitate the electronic processing of stock options and buy backs, warrant subscriptions in uncertificated form, and a fee structure that provides incentives for issuers to avoid certificate issuance.

Certain Canadian transfer agents are promoting the use of a direct registration system (DRS) and encouraging issuers to make the change to such systems, to reduce the number of share certificates issued and the resulting costs in handling and transfers. In such a system, when a security is issued or transferred, the security holder receives a statement showing the security holding, in place of a certificate evidencing the security. The system does not impinge on the rights of shareholders, who may continue to request a certificate. Transfers of DRS securities are accomplished by submitting the usual form of stock power of attorney signed by the registered holder, together with the direct registration system statement.

CDS proposes changes to its Rules to support these initiatives by the transfer agent sector. Under the amended Rules, when a participant withdraws a security from CDSX and the issuer uses DRS, CDSX will default the withdrawal request to DRS format instead of a physical certificate; the participant will not have the option to choose certificated format for the withdrawn securities. The transfer agent will not deliver a physical certificate evidencing the withdrawn security. Instead, the transfer agent will issue a statement to the new registered holder of the withdrawn security confirming that the security has been transferred and is now registered in the name of the new holder (generally the participant's customer).

**B.3 New International Standards**

The Canadian financial services industry is subject to developing international standards. In March of 2011, the Bank for International Settlements, through its committees the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), issued a draft report for public consultation. The report, *Principles for Financial Market Infrastructures*, proposes new international standards for payment, clearing and settlement systems.<sup>1</sup> After a consultation period, CPSS and IOSCO will review all comments received and publish a final report in early 2012. It is proposed that the new principles will be implemented in legal and regulatory frameworks by the end of 2012. The report states that the new principles "are designed to ensure that the essential infrastructure supporting global financial markets is even more robust and thus even better placed to withstand financial shocks than at present". Financial market infrastructures or "FMIs", including central securities depositories and securities settlement systems such as CDS, will be

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<sup>1</sup> The report can be found at <http://www.bis.org/pub/cpss94.htm>

expected to take “appropriate and swift action” to comply with the new standards. CDS is following these developments closely, and will take the necessary steps to ensure that it complies with the new standards when they are implemented. Principle #10 - Physical Deliveries states: “An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.” Principle #11 - Central Securities Depositories (CSD) states: “A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.” The detailed explanation of this principle states that a CSD “should strive to support securities immobilisation or dematerialisation to the greatest extent possible, such as through the use of incentives” if legal considerations prevent the full implementation of a dematerialization strategy. The Board of Directors, in considering the proposed Rule amendments, directed that participants should be advised that CDS will continue its efforts to achieve the objective of paperless processing of securities transactions. Further Rule amendments to support the elimination of the use of security certificates will be brought forward at a later date. CDS anticipates that any necessary further amendments will be put forward in the timeframes established by CPSS/IOSCO when the new international standards are implemented. CDS will continue to work with the financial services industry, including issuers and their agents, to achieve compliance with the new international standards.

## **C. IMPACT OF THE PROPOSED CDS RULE AMENDMENTS**

### **C.1 Competition**

All CDS participants will be subject to the same requirement, so there will be no competitive disadvantage among them. Several Canadian transfer agents offer DRS processing to their issuers, and a number are considering this option. Nothing in the Rule amendments will require any issuer or transfer agent to use DRS processing.

### **C.2 Risks and Compliance Costs**

The reduced costs and increased efficiencies in DRS processing will benefit all users.

### **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**

Dematerialization in the securities industry is an objective supported by all international regulatory and advisory groups. As noted below (see section F), many other jurisdictions have advanced to a completely dematerialized system, and others are moving towards that objective. CDS is closely following the development of new international standards for payment, clearing and settlement systems set out in the CPSS/IOSCO report *Principles for Financial Market Infrastructures*, and will continue to work with the financial services industry, including issuers and their agents, to achieve compliance with the new international standards to limit the use of certificated securities.

## **D. DESCRIPTION OF THE RULE DRAFTING PROCESS**

### **D.1 Development Context**

CDS consulted with transfer agents to understand their DRS systems, and how best to integrate these with the CDSX system in securities withdrawal processing. CDS also consulted with participants on their requirements for records of withdrawals, and ability to communicate with customers.

### **D.2 Rule Drafting Process**

Each amendment to the CDS Participant Rules is reviewed by CDS’s Legal Drafting Group (“LDG”). The LDG is a committee that includes members of Participants’ legal and business groups. The LDG’s mandate is to advise CDS management and its Board of Directors on rule amendments and other legal matters relating to centralized securities depository and clearing services in order to ensure that they meet the needs of CDS, its participants and the securities industry. The LDG had no comment on the proposed Rule amendments.

These Rule amendments were reviewed and approved by the Board of Directors of CDS Ltd. on April 20, 2011.

### **D.3 Issues Considered**

CDS reviewed the increasing use of DRS processing in the Canadian securities industry, and considered how best to integrate this processing with the CDSX system. It was determined that the primary point of contact between DRS issuer systems and CDSX was the point at which participants withdraw securities from DRS, and that this was the only point at which a change in CDSX processes would be required.

#### D.4 Consultation

CDS has consulted widely with the financial services sector on its dematerialization objectives. CDS gave a presentation to the March 31, 2011 annual general meeting of STAC (the Stock Transfer Association of Canada). CDS has also had detailed discussions with a number of transfer agents, in order to understand their direct registration system initiatives. Computershare has reported that a large number (over 1200) of its issuers are now using, or in the process of switching to, DRS. Other transfer agents have indicated that they are beginning to implement DRS as an option for their issuers.

CDS has also discussed the proposal with its participants. A presentation was made to the FAS Operations Committee (the Financial Administrators Section of IIROC), which represents the Canadian broker community. The initiative has also been reported to CDS participants at the Debt and Equity Subcommittee of the SDRC (CDS's Strategic Development Review Committee).

Many Canadian transfer agents are not participants of CDS; as such transfer agents are not bound by the CDSX Rules, they do not routinely receive notice of changes to the CDSX Rules. CDS will provide a copy of this Notice to all transfer agents for CDSX eligible securities, to ensure that they are fully informed of the CDS policy with respect to the uncertificated withdrawal of DRS securities, and the anticipated implementation of the new CPSS/IOSCO standards.

#### D.5 Alternatives Considered

CDS considered the alternative of giving participants the option to have a physical certificate delivered, even where the issuer and its transfer agent offer DRS processing. It was determined that it would be most efficient for transfer agents and participants to have a single automatic withdrawal process. Participants and their customers retain the ability to have securities evidenced by a certificate, once the withdrawal from CDSX is complete.

#### D.6 Implementation Plan

CDS is recognized as a clearing agency by the Ontario Securities Commission pursuant to section 21.2 of the Ontario *Securities Act*. The Autorité des marchés financiers has authorized CDS to carry on clearing activities in Québec pursuant to sections 169 and 170 of the Québec *Securities Act*. In addition CDS is deemed to be the clearing house for CDSX<sup>®</sup>, 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".

The amendments to Participant Rules may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment.

### E. TECHNOLOGICAL SYSTEMS CHANGES

#### E.1 CDS

Implementation of the restriction on certificated withdrawal will require limited system development to CDSX. The CDSX Security Master File will identify which issuers offer DRS, and will default withdrawal requests for securities of those issuers to DRS format. In addition, CDSX will be enhanced, so that an additional confirmation notification is delivered to each participant when a withdrawal is completed in uncertificated DRS format. Without such confirmation, the participant would not otherwise have a separate record of the completion of the withdrawal. The confirmation provides a separate record of the completion of the withdrawal. Participants may use a copy of the confirmation to report to their customers, as described in the next section.

#### E.2 CDS Participants

It is not anticipated that participants will have to make significant system changes to comply with the amended Rule. Certain changes in back office processing and customer communication will be required to reflect the delivery of direct registration statements in place of certificates. When securities are withdrawn in certificated format under the current, non-DRS processing, the certificate (even if registered in the name of the participant's customer) is delivered to the participant; the participant then delivers the certificate to its customer. In the new DRS processing of withdrawals, the transfer agent delivers the DRS security registration statement directly to the registered holder, usually the participant's customer. It is for this reason that CDS proposes to enhance CDSX, as noted above, to generate a separate confirmation of a withdrawal in DRS format. Participant back office systems will receive, and must be able to appropriately process, the CDSX system-generated confirmation of a withdrawal in uncertificated DRS format. This confirmation provides the participant with a separate record of the completion of the withdrawal; it is anticipated that participants will wish to enhance their systems in order to use the confirmation to report to their customer on the withdrawal. Participants will benefit from the increased efficiency and reduced costs arising from the reduction in the handling of security certificates. While there will be some initial costs to participants in making these system enhancements, it is anticipated that there will be a net benefit to participants, particularly as more issuers and transfer agents adopt a DRS system.

A DRS position can be deposited back into CDSX at a later date without difficulty. The participant will use its customer's DRS security registration statement to provide the information necessary to complete the deposit instructions (DRS identification number); the statement, together with the standard stock power of attorney holder (guaranteed and/or medallion stamped), will be delivered to the transfer agent. The transfer agent will then transfer the securities into CDS Nominee name, and confirm the deposit.

### **E.3 Other Market Participants**

A number of Canadian transfer agents now offer a DRS system to issuers, and others are in the process of introducing this option for issuers using their services. Transfer agents must make system changes in order to offer a DRS option. The CDS Rules do not in any way compel an issuer or a transfer agent to adopt a DRS system; that remains a business decision entirely outside of the scope of the CDS Rules. The proposed Rule amendments do support those issuers and their transfer agents who have independently chosen the DRS option, enabling them to interact more efficiently with the financial institutions that are CDS participants.

The position of customers of participants (the beneficial owners of securities) is not directly affected by the Rules. The DRS system is being implemented by many Canadian issuers; the Rule amendments and system enhancements provide an efficient interface between these DRS systems and CDSX, for the benefit of the financial institutions that are participants. However, it is not anticipated that the customers who are the beneficial owners of securities will be negatively affected. They will benefit from the reduced risk in receiving regular DRS statements, rather than having to provide safekeeping for a potentially negotiable security certificate. Issuers will continue to comply with legislative or regulatory requirements to supply a security certificate when requested by the registered holder. As noted above, customers can provide their financial institutions with the DRS registration statement and a stock power of attorney when the customer wishes to transfer the securities.

### **F. COMPARISON TO OTHER CLEARING AGENCIES**

The Securities and Exchange Commission approved a rule change by The Depository Trust Company (DTC) to eliminate issuing physical certificates for withdrawals beginning January 1, 2009. The rule applies to all issues that participate in DTC's direct registration system. In 2008, all the major and regional exchanges in the United States mandated that direct registration system become a listing requirement for all issues. Eliminating withdrawals in physical certificate format is part of DTC's overall dematerialization efforts aimed at eliminating all paper certificates in the securities industry. DTC states: "Both the industry and the U.S. government continue to encourage dematerialization, knowing that paper certificates are inefficient and increase the risk of lost or stolen certificates."<sup>2</sup>

Markets in many countries around the world no longer issue paper securities at all. New Zealand, for example, won't permit a company to list its stock on the exchange if it insists on issuing paper certificates. Many countries in Europe, Asia, and South America are using paperless electronic securities either exclusively or predominately.

### **G. PUBLIC INTEREST ASSESSMENT**

CDS has determined that the proposed amendments are not contrary to the public interest. The Rule amendments support dematerialization, which reduces costs and risk in the financial services industry as a whole.

### **H. COMMENTS**

Comments on the proposed 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 to:

Legal Department  
CDS Clearing and Depository Services Inc.  
85 Richmond Street West  
Toronto, Ontario M5H 2C9

Fax: 416-365-1984  
e-mail: [attention@cds.ca](mailto:attention@cds.ca)

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<sup>2</sup> DTCC Thought Leadership: Industry Issues release "SEC Approves Eliminating Paper Certificates for Withdrawals-by-Transfer", available at <http://www.dtcc.com/leadership/issues/nomorepaper/about/announcements.php>

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

M<sup>e</sup> Anne-Marie Beaudoin  
Secrétaire del'Autorité  
Autorité des marchés financiers  
800, square Victoria, 22<sup>e</sup> étage  
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Manager, Market Regulation  
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Télécopieur: (514) 864-6381

Courrier électronique: [consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)

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

#### **I. PROPOSED CDS RULE AMENDMENTS**

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

## APPENDIX "A"

## PROPOSED CDS RULE AMENDMENTS

[NOTE – for marked text of rules, additions are underlined; deletions are strikethrough text]

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
<p><b>Rule 6 Depository Service</b>  <b>6.3.3 Withdrawal of Securities</b>  <b>6.3.3.1 Withdrawal of Securities</b></p> <p>A Participant withdraws eligible Securities from the Depository Service by requesting a withdrawal from its Ledger and taking the steps set out in the Procedures and User Guides for that class of Security. Withdrawal of Securities prior to completion of Payment Exchange must satisfy the ACV edit. Securities in respect of which a withdrawal request has been made are debited from the Participant's Securities Account and credited to the Participant's Withdrawal Account. Securities credited to a Withdrawal Account are held for the Participant, but the Participant cannot effect any Transactions affecting such Securities. If a withdrawal request is rejected, the Securities shall be transferred back to the Participant's Securities Account. A withdrawal is effected only when the withdrawal request is confirmed by the Person with the appropriate withdrawal facility for that Security (Bank of Canada, the Issuer, the Transfer Agent, the Security Validator or the Custodian, as appropriate). Upon withdrawal, CDS debits the Securities from the Withdrawal Account of the Participant. <del>The withdrawn Securities shall be made available in accordance with the instructions of the withdrawing Participant, including delivery of a Security Certificate evidencing the withdrawn Securities or confirmation by the Transfer Agent or Custodian that the withdrawn Securities are held for or registered in accordance with such instructions. The Transfer Agent or Custodian for the withdrawn Securities will either (i) deliver a Security Certificate evidencing the withdrawn Securities, registered in accordance with the instructions of the withdrawing Participant, or (ii) for Securities in a direct registration system described in Rule 6.3.3.3, provide a statement confirming that the withdrawn Securities are registered in accordance with such instructions.</del></p> <p><b><u>6.3.3.3 Uncertificated Withdrawal in Issuer's Direct Registration System</u></b></p> <p><u>Where the Issuer of a Security offers a direct registration system, a Participant making a withdrawal may not request a Security Certificate evidencing the withdrawn Securities; the Transfer Agent or Custodian will provide a statement confirming that the withdrawn Securities are registered in accordance with the instructions of the withdrawing Participant. Nothing in this Rule restricts the rights of a Participant or other holder of the withdrawn Security to request a certificate when the Security is no longer held in CDSX after completion of the withdrawal process. A direct registration system for a particular Security means that the Issuer offers holders of that Security the option of holding the Security by registration in the name of the holder without</u></p>	<p><b>Rule 6 Depository Service</b>  <b>6.3.3 Withdrawal of Securities</b>  <b>6.3.3.1 Withdrawal of Securities</b></p> <p>A Participant withdraws eligible Securities from the Depository Service by requesting a withdrawal from its Ledger and taking the steps set out in the Procedures and User Guides for that class of Security. Withdrawal of Securities prior to completion of Payment Exchange must satisfy the ACV edit. Securities in respect of which a withdrawal request has been made are debited from the Participant's Securities Account and credited to the Participant's Withdrawal Account. Securities credited to a Withdrawal Account are held for the Participant, but the Participant cannot effect any Transactions affecting such Securities. If a withdrawal request is rejected, the Securities shall be transferred back to the Participant's Securities Account. A withdrawal is effected only when the withdrawal request is confirmed by the Person with the appropriate withdrawal facility for that Security (Bank of Canada, the Issuer, the Transfer Agent, the Security Validator or the Custodian, as appropriate). Upon withdrawal, CDS debits the Securities from the Withdrawal Account of the Participant. The Transfer Agent or Custodian for the withdrawn Securities will either (i) deliver a Security Certificate evidencing the withdrawn Securities, registered in accordance with the instructions of the withdrawing Participant, or (ii) for Securities in a direct registration system described in Rule 6.3.3.3, provide a statement confirming that the withdrawn Securities are registered in accordance with such instructions.</p> <p><b>6.3.3.3 Uncertificated Withdrawal in Issuer's Direct Registration System</b></p> <p>Where the Issuer of a Security offers a direct registration system, a Participant making a withdrawal may not request a Security Certificate evidencing the withdrawn Securities; the Transfer Agent or Custodian will provide a statement confirming that the withdrawn Securities are registered in accordance with the instructions of the withdrawing Participant. Nothing in this Rule restricts the rights of a Participant or other holder of the withdrawn Security to request a certificate when the Security is no longer held in CDSX after completion of the withdrawal process. A direct registration system for a particular Security means that the Issuer offers holders of that Security the option of holding the Security by registration in the name of the holder without</p>

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
<p>the issuance of a physical certificate evidencing the <u>Security</u>.</p> <p><b>Rule 11 TA Participants</b>  <b>11.4.7 Withdrawal of Securities</b></p> <p>Regardless of the identity of the Participant who requests the Withdrawal of a Security, such Person shall be deemed to be acting on behalf of CDS in presenting the Security for registration of transfer out of CDS Name. Withdrawal instructions shall constitute delivery by CDS (and its Nominee, if applicable) of a valid assignment of the Securities to the transferee specified in the instructions, and an endorsement by CDS and its Nominee of any certificate or statement evidencing the Securities to be Withdrawn. The TA Participant will confirm to CDS when the Withdrawal has been effected. CDS will then debit the Withdrawn Securities from the account of the Withdrawing Participant. <del>The TA Participant will deliver a certificate or statement evidencing the Withdrawn Securities, registered in the name of the transferee specified in the instructions.</del> <u>The TA Participant will either (i) deliver a Security Certificate evidencing the withdrawn Securities, registered in accordance with the withdrawal instructions, or (ii) for Securities in a direct registration system described in Rule 6.3.3.3, provide a statement confirming that the withdrawn Securities are registered in accordance with such instructions.</u> Nothing in this Rule shall require CDS or any TA Participant to deliver any Security in contravention of any constraint in the conditions or attributes of the Security, or of any adverse claim, execution, writ, seizure or similar action, or any order or judgment of a governmental or regulatory agency or court or officer thereof, having jurisdiction over CDS, the TA Participant or the Security, which on its face affects such Security.</p>	<p>the issuance of a physical certificate evidencing the Security.</p> <p><b>Rule 11 TA Participants</b>  <b>11.4.7 Withdrawal of Securities</b></p> <p>Regardless of the identity of the Participant who requests the Withdrawal of a Security, such Person shall be deemed to be acting on behalf of CDS in presenting the Security for registration of transfer out of CDS Name. Withdrawal instructions shall constitute delivery by CDS (and its Nominee, if applicable) of a valid assignment of the Securities to the transferee specified in the instructions, and an endorsement by CDS and its Nominee of any certificate or statement evidencing the Securities to be Withdrawn. The TA Participant will confirm to CDS when the Withdrawal has been effected. CDS will then debit the Withdrawn Securities from the account of the Withdrawing Participant. The TA Participant will either (i) deliver a Security Certificate evidencing the withdrawn Securities, registered in accordance with the withdrawal instructions, or (ii) for Securities in a direct registration system described in Rule 6.3.3.3, provide a statement confirming that the withdrawn Securities are registered in accordance with such instructions. Nothing in this Rule shall require CDS or any TA Participant to deliver any Security in contravention of any constraint in the conditions or attributes of the Security, or of any adverse claim, execution, writ, seizure or similar action, or any order or judgment of a governmental or regulatory agency or court or officer thereof, having jurisdiction over CDS, the TA Participant or the Security, which on its face affects such Security.</p>