13.3.2 Notice and Request for Comments – Material Amendments to CDS Procedures – Enhancements to the CNS Allotment and Conversion Process

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

MATERIAL AMENDMENTS TO CDS PROCEDURES

ENHANCEMENTS TO THE CNS ALLOTMENT AND CONVERSION PROCESS

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

On September 7, 2012 CDS submitted a Notice and Request for Comments – Material Amendments to CDS Procedures relating to Enhancements to the CNS Allotment Process, for regulatory review, that described proposed changes to the processing of voluntary events. The Notice and the proposed amendments to the procedures were published on September 20, 2012 by the Ontario Securities Commission (OSC Bulletin (2012) 35 OSCB 8708) and on September 13, 2012 by the Autorité des marchés financiers (AMF Bulletin 13 septembre 2012 - Vol. 9, n° 37).

This document proposes amendments to the CDS Participant Procedures that will amend functionality of the allotment process in the Continuous Net Settlement Service (CNS) for mandatory events, thereby aligning the allotment processing of both mandatory and voluntary corporate actions. This change is made at the request of the Debt and Equity Subcommittee of the Strategic Development Review Committee (SDRC). The CNS allotment process refers to (i) the creation of non-exchange trades with a settlement mode of trade-for-trade (TFT) from outstanding CNS positions by assigning or allotting buyers to sellers against outstanding CNS positions, and (ii) trade conversion activities whereby exchange and non-exchange trades with a settlement mode of CNS are changed to settle TFT. This process is initiated in the case of mandatory corporate actions that would result in a participant receiving (i) a non-CNS eligible security, (ii) cash or (iii) a combination of security and cash.

Background

CNS is a central counterparty service designed to clear and settle primarily equity trades initiated on a Canadian exchange, a quotation and trade reporting system or an alternative trading system. Transactions targeted to CNS may also originate as non-exchange trades with a settlement mode of CNS, manually setup in CDSX® by participants.

Novation and netting of CNS trades

When an exchange or non-exchange trade with a settlement mode of CNS reaches value date, the original buyer and seller obligations (to receive securities and deliver payment, and vice versa) are extinguished and replaced with settlement obligations between each party and CDS (i.e., novation). Each time another trade for the same security reaches value date, the new novated obligations are netted with the existing settlement obligations for that security. These netted obligations are the “to receive” and “to deliver” positions that are settled in the overnight batch net settlement process, and continuously settled in CDSX in the real-time CNS settlement process that runs from system start-up through to the start of payment exchange.

Allotment of CNS positions and trade conversion activities for mandatory corporate actions

Outstanding positions and trades directed to settle in CNS, involving a security subject to a mandatory corporate action, are treated differently depending upon whether the action results in exchanging that security with another CNS eligible security, a CNS ineligible security, or a cash payment (the “receive” item). If the only receive item is a CNS eligible security, the outstanding CNS position, and all exchange and non-exchange trades, are converted to the new security at the conversion rate stipulated by the corporate action. These actions occur on the payable date of the corporate action.

If one of the receive items is a security ineligible for the CNS service or is a cash payment, the outstanding CNS position is allotted and then converted. The allotment process removes CDS as the central counterparty by assigning buyers and sellers to the outstanding CNS obligations and replacing those obligations with non-exchange trades targeted to settle TFT. In addition to allotting the outstanding CNS position, CNS exchange and non-exchange trades are retargeted to settle TFT. The TFT trades are then converted to the new receive item at the conversion rate stipulated by the corporate action. These actions also occur on the payable date of the corporate action.

The current process contains inherent inefficiencies. Changing the mode of settlement from CNS to TFT results in a large number of trades over which participants have no control. This is because participants cannot modify exchange trades and therefore they cannot effectively prioritize their settlement activity. Moreover, the process of converting existing trades to the new CNS eligible security results in multiple trades undergoing conversion activity, one at a time. This results in multiple fractional differences that cannot be credited to the participant. For example; if the specified conversion rate was 1.333, a trade for 100 shares of security A would result in a trade for only 133 shares of security B. In this case, .3 shares would be truncated or dropped from the converted trade.

Proposed Amendments

The SDRC Debt and Equity Subcommittee requested that CDS review the current process related to mandatory conversions and propose an approach whereby participants would be (i) afforded greater flexibility to manage their settlement activities, (ii) mitigate the effects of the trade conversion process, and, (iii) be consistent with the process in place for voluntary corporate actions. The proposal approved by the SDRC Debt and Equity Subcommittee amends the process as described below.

If the receive item specified in a mandatory corporate action results in the exchange of the affected security with another CNS eligible security, all existing trades targeted to settle CNS will now be netted on value date with any existing outstanding CNS positions. Once netting has occurred, the outstanding CNS position will then be converted to the new security. This process will reduce fractional differences arising from the conversion of individual trades.

If one of the receive items is an ineligible CNS security or is a cash payment, all existing exchange and non-exchange trades targeted to settle CNS will be netted on value date with any existing outstanding CNS position. Once netted, the outstanding CNS position will then be allotted and non-exchange TFT trades will be created. These TFT trades will be subsequently converted to the new security. This process is consistent with the recently proposed enhancements for voluntary corporate actions and will allow for the prioritization of settlement of the non-exchange TFT trades by the participant.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments describe changes to the CNS allotment process, the timing of when trades targeted to CNS are retargeted to TFT, and the timing of when trade conversion from one security to another is applied.

These changes will address the inefficiencies noted above, specifically netting will (i) eliminate the exchange and non-exchange trades that are currently retargeted to settle TFT, (ii) reduce the number of TFT trades requiring conversion and settlement and (iii) reduce the number of fractional shares that could result from a corporate action.

CDS participants will benefit from the proposed enhancements in the following ways:

- The number of transactions that require monitoring and settlement management activities by the participant will be reduced, thereby reducing operational risk

- The novation and netting process will reduce the quantity to be settled; and

- The number of trades undergoing conversion will be reduced, thereby minimizing the number of fractional shares that are not credited to the participant.

Currently, when a CNS settlement restriction exists on a security requiring allotment, all trades with a settlement mode of CNS, received from an exchange or entered by participants, are prevented from being picked up in the CNS novation and netting processes. The settlement mode of the trades is automatically changed to TFT and these trades are subsequently converted to the receive item of the corporate action. Participants must manage these transactions manually. However, participants are restricted from placing the trades that originated at an exchange on hold, which prevents settlement until such time as they are ready for the movement of securities or cash to be completed from their CDSX ledgers. This results in trades which participants have no ability to manage, and which may have used funds or securities for small value trades that participants would have preferred to first target toward larger value trades. In addition, conversion of these trades can produce fractional differences depending on the rate applied to the receive item. These fractional differences cannot be allocated to a participant.

In cases where a security is undergoing a corporate action and the receive item is a CNS eligible security, a CNS settlement restriction is not placed on the security. The exchange and non-exchange trades with a mode of settlement of TFT and CNS, as well as the outstanding CNS position, are directly converted to the receive item on the payable date of the corporate action. In these cases fractional differences may result from the conversion of these trades to the new security

A change will be made so that the CNS novation and netting process will disregard the CNS settlement restriction if it has been automatically created by a mandatory corporate action. This will allow all CNS trades reaching value date to be netted each day during the corporate action period. Settlement of outstanding obligations will still be restricted, and these settlement obligations will then be allotted out and converted to the new receive item each day. In cases where a restriction has not been placed on a security (i.e. the receive item is a CNS eligible security), future dated trades will not be converted on payable date. This will allow all CNS trades reaching value date to be novated and netted, and then converted to the new receive item. This will result in fewer numbers of non-exchange trades over which settlement can be managed. This will also reduce the number of trades converted to the receive item, thereby reducing the fractional differences that are created at the time of conversion to a new security.

CNS settlement restrictions that have been placed on a security manually or automatically for reasons other than a corporate action will continue to be processed as they are today. That is, the mode of settlement on exchange and non-exchange trades will be converted from CNS to TFT.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments will provide processing efficiencies and trade settlement management flexibility. The impact of these changes will be limited to those CDS participants that utilize the CNS function within CDSX.

C.1 Competition

The proposed procedure amendments apply to all CDS participants who currently use, or may choose to use, the CNS service. Consequently, no CDS participant will be disadvantaged with the introduction of these enhancements.

C.2 Risks and Compliance Costs

CDS Risk Management has determined that the proposed amendments will improve the risk profile of its participants due to the novation and netting process. It will not change the risk profile of CDS.

The introduction of the proposed enhancement to the CNS allotment process will not result in any changes to the existing CDSX settlement process. The method of (i) applying non-entitlement related CNS settlement restrictions to securities, (ii) placing holds on non-exchange transactions, and (iii) the settlement of exchange and non-exchange trades remain unchanged. The prioritization of settlements is also not impacted by this initiative.

There are no compliance costs to the participants associated with the proposed enhancements to the CNS allotment process.

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

As stated in Principle #21 – Efficiency and effectiveness – of the new international standards for payment, clearing and settlement systems set out in the CPSS/IOSCO report *Principles for Financial Market Infrastructures*[4], a financial market infrastructure such as CDS "should be designed to meet the needs of its participants and the markets it serves, in particular, with regard to choice of a clearing and settlement arrangement; operating structure; scope of products cleared, settled, or recorded; and use of technology and procedures".

This development, requested by some of CDS's participants, supports greater flexibility for managing the settlement of transactions.

No other comparisons to international standards were identified.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

The development request was tabled at the SDRC Debt and Equity Subcommittee as an opportunity to increase efficiencies in the settlement of trades systematically allotted from the CNS service and converted to the receive item. Once approved by the SDRC for further analysis, CDS developed a requirements document that was reviewed with the SDRC Debt and Equity Subcommittee. Their input was incorporated into the final design which was subsequently approved by the SDRC.

D.2 Procedure Drafting Process

The CDS procedure amendments were drafted by CDS's Business Systems Development and Support group, and subsequently reviewed and approved by the SDRC. The SDRC determines or reviews, prioritizes and oversees CDS-related systems development and other changes proposed by participants and CDS. The SDRC's membership includes representatives from a cross-section of the CDS participant community, and it meets on a monthly basis.

These amendments were reviewed and approved by the SDRC on October 25, 2012.

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4 The report can be found at http://www.bis.org/publ/cpss101.htm

D.3 Issues Considered

During the processing of a corporate action where the receive item is a new security, the quantity amounts of any existing trades in the original security are converted to the corresponding equivalent amount of the new security. When the rate of the receive item includes a fractional amount (e.g. receive 1.333 shares of a new security for each 1 share of the original security), the resulting quantity amounts on the converted trades may contain a fractional quantity. CDSX only handles settlement of whole shares; consequently, the conversion process truncates any fractions. This systematic truncation of fractional amounts can result in dropping a significant number of shares when applied to large volumes of trades. These fractional shares are accumulated by CDS and may be reclaimed by the participant. The proposal increases the potential for netting, thus reducing the negative impact of the conversion process.

D.4 Consultation

This development was requested by the SDRC Debt and Equity Subcommittee. CDS reviewed the requirements document with that group and received their final approval for the development of the described enhancement.

CDS's Customer Service account managers provide continuous communication and status updates of all proposed changes to their clients, as well as soliciting input on those changes.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings which provide a forum for detailed requirement review, and monthly meetings with service bureaus to discuss development impacts to them. All development initiatives are also presented to the Investment Industry Regulatory Organization of Canada's (IIROC) Financial Administrators Section (FAS) working group.

D.5 Alternatives Considered

Initially, the SDRC Debt and Equity Subcommittee requested that CDS enable participants to manage the settlement control indicator on exchange trades changed from CNS to TFT. During the review and analysis phase, it was determined that this approach would be insufficient to achieve maximum efficiencies in the management of these trades because large volumes of trades would continue to exist. Consequently, the SDRC Debt and Equity Subcommittee and the SDRC agreed that CDS's proposal to net CNS trades prior to allotment and conversion was a more complete solution.

D.6 Implementation Plan

The proposed procedure amendments and the scheduled date of implementation have been communicated regularly to CDS participants through the SDRC and its subcommittees, as well as through Customer Service relationship meetings. The Customer Service account managers will provide their clients with details of the upcoming changes, and provide customer-related training during the months of December 2012 and January 2013. CDS will distribute a bulletin to all CDS 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*. 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®, 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 Procedures may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment. Implementation of this initiative is planned for February 9, 2013.

E. TECHNOLOGICAL SYSTEMS CHANGES

E.1 CDS

CDSX functionality will be impacted by these changes as follows:

a) Eliminate the change to the settlement mode of existing trades from CNS to TFT during the allotment process. Trades will remain as CNS and be available for novation and netting.

b) Newly entered exchange and non-exchange CNS trades will be populated with a mode of settlement as CNS when a CNS settlement restriction exists. Trades will remain as CNS and be available for novation and netting.

c) Allow for novation and netting of CNS trades (exchange and non-exchange) when a CNS settlement restriction exists on a security. CNS positions will not be settled when this restriction is applied, as per the current process.

d) Automate additional allotments of CNS positions. Existing CNS trades will remain intact. New process to be triggered upon completion of CNS netting where an allotment has previously taken place on the event.

e) Automate additional conversions of (i) trades created through the allotment process or (ii) outstanding CNS positions when a CNS eligible security is received.

E.2 CDS Participants

There are no technological system changes required by CDS Participants.

E.3 Other Market Participants

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

F. COMPARISON TO OTHER CLEARING AGENCIES

A similar CNS trade allotment and conversion process is provided by the National Securities Clearing Corporation (NSCC) as outlined in the NSCC Rules and Procedures dated June 28, 2012. Reference to conversion and allocation as it pertains to corporate actions is made, however CDS is not aware of any impending rule changes in this regard.

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 proposed amendments are not contrary to the public interest.

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, 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 proposed amendments to the CDS Procedures on the User documentation revisions web page (http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-blacklined?Open) and to the CDS Forms (if applicable) on Forms online (Click View by Form Category and in the Select a Form Category list, click External review) on the CDS Services web page (www.cdsservices.ca).