

**13.3.3 CDS – Notice and Request for Comments – Material Amendments to CDS Rules & Procedures – CDCC Interface – Phase 2 – Partial Settlement**

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

**MATERIAL AMENDMENTS TO CDS RULES & PROCEDURES**

**CDCC INTERFACE – PHASE 2 – PARTIAL SETTLEMENT**

**REQUEST FOR COMMENTS**

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

The proposed Rule amendments address the partial settlement functionality of Phase 2 of the implementation of Canadian Derivatives Clearing Corporation's ("CDCC") fixed income netting service ("SOLA"). CDCC's facility currently receives trade information from CDS and clears the trades prior to their being settled in CDSX between CDCC, as a CDS participant, and another CDS participant. The implementation of partial settlement requires that CDS make changes to its systems and material amendments to its Participant Rules.

At the request of the regulators, the proposed amendments to CDS Participant Rules were split into two phases so that the CDS Participant Rules corresponded with the available functionality.

Phase 1 Rule amendments, submitted for public comment and regulatory review in November, 2010 and approved by the Regulators in February, 2012:

- Created a new mode of settlement indicator enabling participants to instruct CDS to report trades so-identified to a Third Party Clearing System ("TPCS")
- Permitted CDS to report trades to CDCC as a TPCS
- Limited CDS liability in respect of trades or trade information received from a TPCS
- Specified the settlement process by which trades reported to CDS by a TPCS are settled

Phase 2 Proposed Rule amendments, for which Notice and Request for Comment is being given by the present, will:

- Permit partial settlement of trades from CDCC as a TPCS under the CDS Participant Rules.

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

The proposed rule amendments are considered material, as they implement a partial settlement process for trades originating with the CDCC and its fixed income clearing facility.

If a CDCC settlement instruction trade can settle in its entirety, it will. Otherwise, the settlement function will attempt to settle the trade partially. Settlement functions similarly to the FINet partial settlement function. That is, if a trade can settle partially, it will be split into two trades. One trade will be in the amount or quantity that can settle and the other for the remaining net amount or quantity. In this case, the first trade will settle, and the residual trade will be retriggered for settlement. The split trades will carry the same details as the original trade, with the exception of the financial details (quantity and net amount). Only trades delivered to CDS by CDCC (SOLA) and those split by CDSX are eligible for partial settlement. Trades delivered to CDS will always have the CDCC CUID on either side (buyer, seller) of the trade. The trades will also always carry a mode of settlement equal to TFT.

**C. IMPACT OF THE PROPOSED CDS Rule AMENDMENTS**

Under the existing process, confirmed trades that are reported to CDS with a settlement indicator of SNS are reported to CDCC for clearing; CDS acts only as an intermediary that communicates transactional information between participants and CDCC. Novated Trades are then reported back to CDS by CDCC, with a settlement indicator of TFT, as a confirmed trade for settlement in CDSX, via the Trade-for-Trade settlement process, with CDCC and another Participant as the parties to the trade. If CDCC rejects a trade under the current process, CDS advises the submitter of the trade using existing processes and procedures. The submitter is required to modify the transaction as needed in order for it to clear and settle the trade on an appropriate basis (i.e., Trade-for-Trade or through CDS's existing FINet® service on a net basis).

The introduction of partial settlement into the Trade-for-Trade function for trades reported by CDCC will have the effect of reducing the number of failed trades in CDSX.

## C.1 Competition

The Rule amendments are being proposed to support incremental changes to CDSX in response to the industry's requirement for CDCC to develop a central counterparty (CCP) and netting utility for Canada's fixed income securities traded in the cash and repurchase markets. Once implemented, CDS's FINet service will likely be retired.

## C.2 Risks and Compliance Costs

The proposed Rule amendments are not expected to change the risk profile of CDS or its participants. CDCC settles its fixed income central counterparty (CCP) trades as a receiver of credit in CDSX, and the payment obligations of CDCC resulting from fixed income settlement will be supported by an extender of credit providing an adequate line of credit to CDCC.

To settle in CDSX, the corresponding CDCC transactions must pass all of the risk edits. Since CDS does not act as CCP to the corresponding transactions, there is no incremental risk for CDS.

Increasing the suite of transactions supported by CDCC's fixed income netting service will benefit participants by reducing their bi-lateral exposure. Also, partial settlement allows greater opportunity to settle settlement instructions delivered to CDSX by CDCC by expediting settlement as soon as any settlement is possible.

The proposed amendments are not expected to result in changes or increases in compliance costs for CDS, its participants, or other market participants.

## 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 proposed amendments are consistent with the CPSS/IOSCO principles for PFMI as described below:

Principle #21 – Efficiency and effectiveness – states that financial market infrastructure such as CDS “should be designed to meet the needs of its participants and the market 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”.

The proposed Rule amendments are intended to support the IIAC mandate to develop a central counterparty (CCP) and netting utility for Canada's fixed income.

The proposed amendments are also within the scope of Recommendation #5 – Securities lending set out in the CPSS/IOSCO report *Recommendations for securities settlement systems* which states that ‘securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed. The process is intended to increase securities repurchase agreement volumes and enhance market liquidity through a more efficient use of such securities.

## D. DESCRIPTION OF THE RULE DRAFTING PROCESS

### D.1 Development Context

Phase 1 of the CDCC Interface was implemented at the Industry's request and was intended to minimize the impact to the current roles, practices, and systems of all affected market participants.

Phase 2 of the Rule Amendments is an incremental addition implementing the partial settlement functionality of the CDCC Interface.

### D.2 Rule & Procedure 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 the CDS 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 proposed rule amendments were reviewed by the LDG on October 22nd, 2010, and approved by the Board of Directors of CDS Ltd. on October 29th, 2010 and published for public comment on November 5th, 2010.

The proposed Rule Amendments were not initially bifurcated into Phases 1 and 2. At the Request of the Bank of Canada, the

Ontario Securities Commission, and the Autorité des marchés financiers, CDS removed reference to partial settlement of trades, as the functionality accommodating that process was not yet implemented. These proposed Rule amendments address the partial settlement functionality of Phase 2 of the implementation.

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

The primary considerations in the development of the rules in response to the industry initiative were twofold: first, development of the process and the legal framework was intended to minimize effects on market participants' processes, practices, and systems; and second, the minimal changes required, and the desire to leave systems as unchanged as possible, were with the goal of meeting the industry-mandated implementation date.

The effect of the proposed rules is to allow partial settlement of trades reported by CDCC to CDS, and the proposed amendments themselves have been minimized to the furthest extent possible; Rule 7.2.7(d), which was removed at the request of the Regulators (see D.2, above), is being re-submitted.

### **D.4 Consultation**

In addition to direct consultation with market participants at the IIAC in respect of the process, and the instructions given in that forum, CDS has, as noted above, sought the views, input, and contributions of those of its participants who participate in CDS's LDG in respect of the proposed rule amendments.

### **D.5 Alternatives Considered**

As the fixed income clearing facility is an industry initiative, alternatives to the new fixed income clearing facility process were considered at the outset of that initiative. In respect of Phase 2, CDS was asked to develop a solution that would implement partial settlement with a minimum of development required by CDS's participants and other affected market participants.

### **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*. CDS is recognized as a clearing agency by the British Columbia Securities Commission pursuant to section 24(d) of the British Columbia *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*, the British Columbia Securities Commission and the Bank of Canada will hereafter be collectively referred to as the "Recognizing Regulators".

The amendments to the participant rules may become effective on or after date of approval of the amendments by the Recognizing Regulators following public notice and comment.

## **E. TECHNOLOGICAL SYSTEMS CHANGES**

### **E.1 CDS**

CDS's systems will be modified to accommodate and include a partial settlement engine for trades sourced from CDCC's CCP.

### **E.2 CDS Participants**

Participant systems will be required to identify trades that have been deleted and the new trades created by CDSX according to the partial settlement process.

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

Where a CDS participant's systems are operated by a third-party vendor, the vendor will be required to make similar modifications to their systems as would be required by the Participant (described in section E.2).

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

Netting and novation of fixed income repo trades in the U.S. market occur through the Fixed Income Clearing Corporation (FICC); a subsidiary of the Depository Trust & Clearing Corporation (DTCC). FICC nets and novates transactions on a near real-time basis and provides counterparties with net outstanding obligations on a current and forward-dated basis. Repo transactions with a "start" or "on" leg of the current day are novated by FICC. The "end" or "off" legs are future dated and are novated and netted, with settlement taking place on the net obligation on the value date. In each case the security obligation settles through

the Federal Reserve and the funds component is settled through Fedwire.

The model being developed by CDCC follows roughly that of LCH.Clearnet, an independent clearing house that is based in London, U.K. LCH.Clearnet operates RepoClear, a market utility that nets and novates bond and repo transactions between industry participants in 13 European markets. Settlement of these net obligations that have reached their value date is done at the depository in each market.

**G. PUBLIC INTEREST ASSESSMENT**

CDS has determined that the proposed amendments to the CDS rules 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 by the Recognizing Regulators, 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)

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:

M<sup>e</sup> Anne-Marie Beaudoin  
Secrétaire générale  
Autorité des marchés financiers  
800, square Victoria, 22e étage  
C.P. 246, tour de la Bourse  
Montréal (Québec) H4Z 1G3

Manager, Market Regulation  
Market Regulation Branch  
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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**

Text of CDS Participant Rules marked to reflect proposed amendments	Text of CDS Participant Rules reflecting the adoption of proposed amendments
<p>[marked text of rules – additions are underlined; deletions are strikethrough text]</p> <p>7.2.7 <u>(d) Partial Delivery by Third Party Clearing System</u></p> <p><u>When an outstanding TPCS Obligation is considered for TFT Settlement and the Settlement of the entire TPCS Obligation would not pass the pre-Settlement edit, but a partial Settlement of the TPCS Obligation would pass the pre-Settlement edits, then CDS may modify the original Trade in order to partially Settle that portion of the Trade which would otherwise be eligible for TFT Settlement but for the restriction of Rule 7.5.2(d). Partial Settlement of a TPCS obligation results in the deletion of the original Trade and the creation of two new Trades, one for the amount of the available Securities or Funds, and one for the outstanding remainder. The former Trade will Settle by the delivery of only some of the Securities required and the making of a corresponding partial payment; the latter Trade will remain outstanding, to be reconsidered for Settlement. A pending Trade that constitutes the remainder of a partial Settlement may itself be partially Settled by the same process as defined herein.</u></p> <p><b>7.5.2 Real Time TFT Process</b></p> <p>The Real Time TFT Settlement Process:</p> <p>(a) is run throughout the time the system is operating;</p> <p>(b) processes Settlement of pending Trades that have a Trade-for-Trade mode of settlement indicator (including Pledges.);</p> <p>(c) does not novate or net newly reported Trades to create new Central Counterparty Obligations; and</p> <p>(d) Settles a Trade only if the entire Trade can be Settled: <u>except when such Trade is reported by a Third Party Clearing System as described in Rule 7.2.7.</u></p>	<p>7.2.7 (d) Partial Delivery by Third Party Clearing System</p> <p>When an outstanding TPCS Obligation is considered for TFT Settlement and the Settlement of the entire TPCS Obligation would not pass the pre-Settlement edit, but a partial Settlement of the TPCS Obligation would pass the pre-Settlement edits, then CDS may modify the original Trade in order to partially Settle that portion of the Trade which would otherwise be eligible for TFT Settlement but for the restriction of Rule 7.5.2(d). Partial Settlement of a TPCS obligation results in the deletion of the original Trade and the creation of two new Trades, one for the amount of the available Securities or Funds, and one for the outstanding remainder. The former Trade will Settle by the delivery of only some of the Securities required and the making of a corresponding partial payment; the latter Trade will remain outstanding, to be reconsidered for Settlement. A pending Trade that constitutes the remainder of a partial Settlement may itself be partially Settled by the same process as defined herein.</p> <p><b>7.5.2 Real Time TFT Process</b></p> <p>The Real Time TFT Settlement Process:</p> <p>(a) is run throughout the time the system is operating;</p> <p>(b) processes Settlement of pending Trades that have a Trade-for-Trade mode of settlement indicator (including Pledges.);</p> <p>(c) does not novate or net newly reported Trades to create new Central Counterparty Obligations; and</p> <p>(d) Settles a Trade only if the entire Trade can be Settled except when such Trade is reported by a Third Party Clearing System as described in Rule 7.2.7.</p>