

13.3.2 CDS – Notice and Request for Comments – Material Amendments to CDS Procedures – CDCC Interface – Caps and Lines of Credit Updates

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

NOTICE AND REQUEST FOR COMMENT

MATERIAL AMENDMENTS TO CDS PROCEDURES

CDCC INTERFACE – CAPS AND LINES OF CREDIT UPDATES

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

In December 2009, the Investment Industry Association of Canada (IIAC) received a mandate to develop a central counterparty (CCP) and netting utility for Canada's fixed income securities traded in the cash and repurchase markets. Following a request-for-proposal process, the Canadian Derivatives Clearing Corporation (CDCC) was requested by IIAC to develop this facility. CDS was asked by the IIAC Fixed Income CCP Steering Committee to modify CDS's systems and procedures to accommodate the facility.

The phased implementation of the facility is as follows:

- Phase 1 was implemented effective February 21, 2012. This phase addressed repurchase agreements.
- Phase 1.1 was implemented effective June 25, 2012. This change gives participants the option to have their settlement control indicator updated from 'Yes' to 'No' for trades with a mode of settlement SNS ('SOLA Netting System') and a value date of the current business day which have been received in CDS's system CDSX® after the CDCC cutoff time.
- Phase 2 is scheduled to be implemented effective December 10, 2012 and will include enhancements to CDSX functionality to support cash trades as well as blind trades negotiated by Inter-dealer Brokers. (For further details, refer to the Notice and Request for Comment – Material Amendments to CDS Procedures, CDCC Interface - Phase 2)

In addition to the functionality introduced in each of the phases, CDS was asked by the IIAC Fixed Income CCP Steering Committee to provide participants eligible for fixed income clearing at CDCC with a facility to designate a portion of their system operating cap and/or lines of credit exclusively for CDCC settlements. Available system operating cap and lines of credit are currently allocated across participants' ledgers. The portion of ledger cap and/or lines of credit designated for CDCC settlements will be used specifically for settling trades between the eligible participants and CDCC. The CDSX settlement process will look to exhaust the CDCC designated ledger cap and/or lines of credit prior to drawing on existing CDSX caps and lines of credit to settle net settlement positions delivered to CDSX by CDCC using the CDCC CUID.

The changes to CDSX for a CDCC designated ledger cap and lines of credit are to support CDCC's Morning Net DVP (Delivery versus Payment) settlement period, also known as the Point-in-Time (PIT) settlement obligation. Pursuant to CDCC Rules, CDS Participants eligible for novation/netting at CDCC '*available funds in its cash account at the Central Securities Depository to settle the lesser of (i) its Morning Net Payment Against Delivery Requirement, and (ii) the amount of CDCC Daylight Credit Facility*'.¹

The changes to CDSX to support the CDCC designated ledger cap and lines of credit are scheduled for implementation concurrently with phase 2 and, are intended to be effective December 10, 2012.

Background

Caps in CDSX

Company caps are used by CDSX to enforce a limit on the amount participants are eligible to use for settlements and credit extension. The size of the company cap is determined as prescribed in the CDS rules and procedures. Company caps can be allocated in both Canadian and US dollars; however, US dollar company caps can only be allocated to the ledger cap (for settlement).

Once the company cap is allocated by CDS, the elective cap is set and must be less than or equal to the allocated company cap.

Participants may allocate their elective cap to their ledger cap and/or credit extension cap. The ledger cap is used to settle transactions in a given ledger. Settlements cannot exceed the amount of the ledger cap. The credit extension cap is applicable

¹ TMX-CDCC Rules can be found at http://www.cdcc.ca/f_rules_en/cdcc_rules_en.pdf

to extenders of credit and federated Participants only. This cap controls the total value of lines of credit a Participant can authorize each day.

CDSX draws down on the participant's ledger cap if the participant does not have sufficient positive funds account balance to settle a transaction for the specific ledger.

Lines of Credit (LOC) in CDSX

Lines of credit provide participants with intraday financing in Canadian dollars in CDSX. The terms of the lines of credit are negotiated between participants outside of CDSX. Lines of credit are extended by participants that are extenders of credit in CDSX. Receivers of credit may use lines of credit to increase their available funds for settlements in CDSX. Any participant in CDSX may be granted a line of credit.

If the participant does not have a sufficient positive funds account balance or available ledger cap to settle a transaction for the specific ledger, CDSX draws down on the participant's line of credit.

Participants may have both a cap and a line of credit. In this case, the effective limit on the participant's negative funds balance is the sum of the cap and the line of credit. The system will always use a participant's cap before drawing on a line of credit. The limit on each participant's negative funds balance meets CDS's risk management principle of limiting the potential exposure created by a participant. The funds edit ensures that negative funds balances in a participant's funds account do not exceed the participant's limit as calculated by the sum of cap and line of credit.

A more detailed description of the CDSX system operating cap and line of credit functions is available in the procedure guide entitled Participating in CDS Services, posted on www.cds.ca.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments change current CDSX functionality such that participants will have the ability to designate a portion of their ledger cap and/or lines of credit exclusively to settle trades involving CDCC. The CDCC designated ledger cap and/or line(s) of credit will be available for use in CDSX by the participant starting at 10:10 a.m. ET each morning. The 10:10 a.m. ET startup time is consistent with CDCC's Morning DVP settlement period that runs between 10:15 a.m. and 10:30 a.m. ET. The facility will be the first source of funding for trades involving the CDCC CUID throughout that period. The CDCC designated ledger cap and line(s) of credit will not be available for use during the overnight online processing period and batch net settlement process (BNS) in CDSX. The CDSX designated ledger cap and lines of credit will be available to settle trades with CDCC prior to 10:10 a.m. and if the CDCC designated ledger cap and lines of credit are fully drawn.

Designating a settlement facility

A new data element, settlement facility, has been introduced in CDSX that allows participants to designate ledger cap and lines of credit for specific settlement purposes. This implementation introduces the ability to designate ledger cap and lines of credit to one of two settlement facilities - the CDSX settlement facility and the CDCC settlement facility. The CDSX trade settlement function has also been changed to recognize from which ledger cap and/or lines of credit to draw in order to fund a Participant's settlement activity.

The participant will have the ability to designate their ledger cap and/or line(s) of credit to one of two settlement facilities:

- CDCC settlement facility: the CDSX settlement process will only draw on caps and lines of credit designated for CDCC trade settlement activity related to those net settlement positions (trades) reported to CDSX by CDCC's fixed income netting service (SOLA).
 - The facility will only consider trades reported to CDSX by CDCC for settlement.
 - The facility becomes effective at 10:10 a.m. ET.
 - The CDCC designated caps and lines are drawn first to fund settlement activity involving trades reported for settlement by CDCC.
 - Available funds are increased in the following sequence – CDSX LOC, CDSX CAP, CDCC LOC, CDCC CAP and positive funds.

- CDSX settlement facility; the CDSX settlement process will be available to draw on caps and lines of credit designated for all trade settlement activity including trades involving CDCC. The CDSX settlement process will use the CDSX designated ledger cap and/or line(s) of credit for settlement to settle CDCC trades if:
 - The participant has not designated any portion of their ledger cap and/or line(s) of credit to the CDCC settlement facility;
 - The CDCC designated ledger cap and/or line(s) of credit are not yet available for use (prior to 10:10 a.m. ET);

- The portion designated for the CDCC settlement facility is insufficient to cover the participant's CDCC settlement requirement.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

C.1 Competition

The proposed procedure amendments are in support of an industry request to allow participants the ability to manage their available funds in CDSX to insure that they are adequately funded to meet the PIT settlement obligation period. This facility is not expected to have any adverse effect on any other CDSX settlement activity. Participants have indicated that they would allocate ledger cap and or lines to the CDCC facility only to the extent that "assured" funding for fixed income settlement is required only during the PIT settlement obligation period.

C.2 Risks and Compliance Costs

Given the systemic importance and potential liquidity impacts of failed CDCC fixed income transactions, the proposed designation of caps and LOCs assigns a higher priority to corresponding transactions. Thus the proposed allocation of caps and LOCs can be viewed as a positive risk mitigant. However, the designation of caps and LOCs to the CDCC settlement facility could adversely impact the settlement of non-CDCC transactions for all CDS participants.

However, there is a potential increase to the risk exposure in CDSX due to the potential decrease in available funds for the participants designating a portion of their cap and LOC. As portions of the caps and LOC are designated to exclusively serve for CDCC settlements, there are fewer funds available for non-CDCC settlements. As settlements do not occur in CDSX unless the risk edits are passed, a decrease in available funds could cause an increase in participant's failing the funds edit. This would result in an increase in failed trades or outstanding positions in CNS. This risk can be further compounded by the fact that available CDSX funding remains accessible to CDCC fixed income transactions should the designation not cover the transactions processed through CDSX.

Currently there are seven participants in the CDCC service, six are extenders of credit. The extenders of credit have large caps so that this should not pose a significant risk. However, as participants migrate from FINet to CDCC's fixed income netting service (SOLA), the methodology can result in situations where scarce caps and LOCs are being allocated, resulting in an increase of failed trades in CDS's CCP services. To date none of the participants have indicated how they plan to allocate their caps and LOCs between the CDCC and CDSX settlement facilities; as such it is not possible to model the impact of designating a specific portion of the caps and LOCs to CDCC.

The risks outlined above are not new to the CDSX services. As such, monitoring of the impact of the effect of the proposed cap and LOC designation will look to identify situations where there is increased risks to the CDS services, whereupon Risk Management may request the corresponding participants increase their LOC. Therefore, Risk Management will monitor the risk profile of the participants in question to see whether there is a material increase in their risk profile.

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:

The proposed amendments are within the scope of Principle #21 – Efficiency and effectiveness – which states that a 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".

This proposed system change and procedure amendment is intended to support the participants' request that they are able to designate a portion of their cap and/or line(s) of credit for settling trades resulting from CDCC's novation/netting process during CDCC's Morning Net DVP settlement period.

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*² 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.

² The report can be found at <http://www.bis.org/publ/cps46.htm>

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

The industry's desire for an alternative, additional fixed income clearing facility, currently being developed by the CDCC on behalf of the IIAC, is the impetus for the proposed procedure amendments and the systems changes which the proposed amendments will implement. The systems changes and procedure amendments are intended to minimize the impact to the current roles, practices, and systems of all affected market participants.

D.2 Procedure Drafting Process

CDS procedure amendments are reviewed and approved by CDS's Strategic Development Review Committee ("SDRC"). The SDRC determines or reviews, prioritizes and oversees CDS-related systems development and other changes proposed by participants and CDS. The SDRC membership includes representatives from the CDS participant community and the committee meets on a monthly basis.

The proposed procedure amendments were reviewed and approved by the SDRC on August 30, 2012.

Prior to review by the SDRC, the proposed functionality was reviewed and approved by the IIAC Fixed Income CCP Steering committee on November 3, 2011.

D.3 Issues Considered

The primary consideration was to minimize impacts on market participants' processes, practices, and systems. In respect of the business requirements, the most important issue was to agree on the sequence in which available funds were drawn and increased in the event of a purchase or sale of securities. The approach taken is consistent with the underlying requirement to insure that adequate ledger cap and or line(s) of credit are available to fund deliveries from CDCC's SOLA facility during the CDCC PIT settlement obligation period. That is, a CDCC specific ledger cap and or line of credit are available to purchase all deliveries alleged from CDCC.

D.4 Consultation

The processes, and the procedures, were developed with direct consultation with market participants at the IIAC.

D.5 Alternatives Considered

The fixed income clearing facility is an industry initiative. Alternatives to the new fixed income clearing facility process were considered at the outset of the initiative. In respect of the proposed amendments, CDS was asked to develop a solution that would support the implementation of the CDCC fixed income clearing facility with minimal development effort required by CDS's participants and other affected market participants. Participants are familiar with the CDSX system operating cap and line of credit functions. Consequently, this change will have minimal impact on their internal procedures and processes.

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* and by the British Columbia Securities Commission pursuant to Section 24(d) of the British Columbia *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 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 to the participant procedures 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

CDSX functionality will be impacted by the following changes:

- a) Introduction of a new data element – 'settlement facility' – into the CDSX system operation cap and line of credit data model.

- b) Modification of the ledger cap function to permit participants to designate their ledger cap(s) to the CDSX settlement facility and/or the CDCC settlement facility.
- c) Modification of the line of credit function to permit receivers of credit to designate their line(s) of credit to the CDSX settlement facility or the CDCC settlement facility.
- d) Modification of the funds inquiry function to display ledger cap and credit allocated and used for each of the CDSX settlement facility and the CDCC settlement facility.
- e) Modification of the trade settlement function such that it draws on available funds and replenishes available funds designated for CDSX or CDCC settlements based upon the trade source (e.g. CDCC).

E.2 CDS Participants

The system changes are applicable to CDSX functionality only. There are no changes required to participant systems.

E.3 Other Market Participants

There are no changes required to third party vendor systems.

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 procedures 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 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

The proposed procedure amendments are available for review and download on the www.cds.ca/cdsclearinghome.NSF/Pages/-EN-UserDocumentation?Open page on the CDS website.