13.1.3 Material Amendments to CDS Rules Relating to Delivery Services – Summary of Comments

CDS RESPONSES TO COMMENTS RECEIVED ON
MATERIAL AMENDMENTS TO CDS RULES – DELIVERY SERVICES

On July 21st, 2006 a proposed amendment CDS Participant Rules relating to Delivery Services was published for comment.

CDS received one comment letter from State Street Trust Company of Canada and one comment via electronic mail from Canaccord Capital Inc.

SUMMARY OF WRITTEN COMMENTS RECEIVED ON THE PROPOSED AMENDMENT

The commentator's stated position was that it sought Rules that fairly allocated the risk with respect to shipments to or from CDS and noted several concerns with respect to the scope, applicability, and specificity included in the proposed amendments.

Comment 1 - State Street Trust Company of Canada

The commentator noted that there is no specific definition of "Delivery Services" included in section 1.2.1 of the Participant Rules and postulated as to whether the term is to refer the reader to Rule 13.

CDS Response

CDS proposes to amend the proposed amendment to include a definition of Delivery Services.

Comment 2 - State Street Trust Company of Canada

a) Commentator proposes that CDS be responsible for the risk of loss once a shipment made through the Delivery Services is received by CDS because CDS has control of said shipment upon receipt.

b) Commentator raises the matter of negligence or fraud on the part of a CDS employee.

c) Commentator suggests that shipment contents could be reviewed and inventoried upon receipt and that CDS could accept or refuse shipment based on such contents.

CDS Response

a) CDS has no knowledge of the contents of such shipments until opened. Assigning responsibility to CDS earlier in the Delivery Services process would make CDS liable for an unquantifiable loss. The Participant shipping such contents is fully knowledgeable of the potential loss and thus is in a better position to insure such potential loss. Requiring CDS to obtain insurance coverage for shipments of which CDS does not know the contents or value thereof makes such insurance problematic and costly. Additionally, Participants elect to use the Delivery Services, aside from CDSX deposits and withdrawals, and assume the responsibilities and liabilities associated with such. As stated in the aforementioned Request for Comments, "Participants are free to make shipments by using their own messengers or by contracting with commercial carriers and are under no obligation to use the CDS delivery services."

b) CDS is currently in the process of completing a review of its whole internal control structure. This review includes the Delivery Services. As the internal control review has the highest priority at the CDS Board of Directors level, CDS Participants effectively control the direction as to the degree of risk mitigation employed by CDS management regarding potential negligence or fraud on the part of a CDS employee in the Delivery Services. Also, while never a perfect prognostication tool, it is noted there has never been an instance of fraud on the part of a CDS employee in the Delivery Services nor has there been an instance of negligence determined.

c) From an operational efficiency perspective, this is not feasible. The Delivery Service is provided using a low-cost operational model. The additional resources required to create and maintain an inventorying system would cause the low-cost operational model to fail. Increased costs on CDS's behalf (that would be passed onto Participant users of the Delivery Services) would render the Delivery Services an unappealing Service for Participants – Participants would elect to use alternatives to CDS' Delivery Services. This would be undesirable especially after the investment of resources by CDS to create such an inventorying system.

Comment 3 - State Street Trust Company of Canada

Commentator raised concerns with regards to risk associated with withdrawals from CDS. Specifically, that:

> "[w]e are particularly troubled by the scenario in which CDS has effected the withdrawal of the Securities on its system and has possession of the Securities Certificate, but, due to the negligence of an employee of CDS, fails to timely send the certificates evidencing those Securities for delivery to the Participant."

CDS Response

When CDS receives a withdrawal request, it may be for a certificated issue or a non-certificated issue.

<u>Certificated Issue Withdrawal</u>

For a certificated issue withdrawal, CDS delivers a certificate (in CDS' nominee name) to the transfer agent which splits the certificate into two certificates (for example) and makes the certificates (one in CDS & Co.; the other in the Participant's nominee or client name) available for pick-up by CDS messenger in a sealed envelope. The envelope is brought to CDS' offices, the details are confirmed and the Withdrawal Account is debited, the Participant's certificate is available for pick-up by a duly authorized individual on the Participant's behalf and CDS' certificate is returned to the CDS vault. At this point the risk of loss for the Participant's certificate shifts to the Participant.

<u>Non-Certificated Issue Withdrawal</u>

For a non-certificated issue withdrawal request, the Participant makes an unconfirmed entry for the Participant's Withdrawal Account for the amount of the withdrawal. The transfer agent produces a certificate in a Participant's nominee name and then electronically confirms the entry to the Participant's Withdrawal Account. At this point the withdrawal has been effected and the Withdrawal Account debited. Liability from that point in time rests with the Participant. A CDS messenger picks up the sealed envelope containing the certificate in Participant's nominee name and returns it to CDS' offices where the certificate is then available for pick-up by a duly authorized individual on the Participant's behalf.

Comment 4 - State Street Trust Company of Canada

Commentator raised concerns in respect of acquiring insurance sufficient to mitigate the risk of loss inherent in the proposed Rule and resulting from CDS' disclaimer of liability.

CDS Response

CDS is of the view that it makes most sense that Participants that use the Delivery Services should obtain appropriate insurance coverage for their shipments, especially since CDS can never determine the contents of a particular shipment. Proposed Rule 13.6 makes it clear that since CDS is not responsible for loss, disclaimer of liability for those enumerated situations should apply. As provided in the Request for Comments:

> *Participants are already required as part of the standards of participation to maintain a policy of insurance (such as a financial institution bond). The Central Handling of Securities Rider forming part of such policies provides that the Participant's insurance coverage is enacted when loss exceeds CDS coverage (which under the proposed Rule amendments is nil). CDS is sympathetic to its Participant's business requirements, and anticipates that the application of a strong control environment for the Delivery Services would make it easier for a Participant to negotiate any additional insurance coverage that a Participant would need based on its level of usage and value of shipments.*

Comment 5 - Canaccord Capital Inc.

The commentator requested clarification with respect to its required insurance in regards to the armoured courier service. The commentator also asked how many times in a year has a CDS messenger lost a certificate on the way to the transfer agent?

CDS Response

CDS replied that under the Delivery Services that do not use armoured courier, CDS would not be responsible regardless of the shipped value and under the armoured courier option, the courier provides $15 million in aggregate insurance (excess amount over such being the responsibility of the Participant). CDS also advised that in the past year no certificates had been lost by a CDS messenger on the way to a transfer agent.