

CDS Clearing and Depository Services Inc. (CDS[®])

MATERIAL AMENDMENTS TO CDS PROCEDURES

AMENDMENTS RELATED TO THE CAD and USD RECEIVERS OF CREDIT CATEGORY CREDIT RINGS

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the CDS Participant Procedures (“*Amendments*”) make changes with respect to the Canadian dollar (“*CAD*”) and U.S. dollar (“*USD*”) Receivers of Credit Pool (“*RCP*”) Category Credit Rings (“*CCRs*”). Specifically, the Amendments require Participants in the CAD and USD RCP CCRs, who have current or potential exposures, to fully and simultaneously collateralize the losses that would result from their default with a high degree of confidence.

This Notice describes technical details to be included in the CDS Participant Procedures (“*Procedures*”). Corresponding changes to the CDS Participant Rules (“*Rules*”) are described in “*Material Amendments to CDS Rules. Amendments Related to the CAD and USD Receivers of Credit Category Credit Rings*”, to be published concurrently with this Notice.

CDS’s Recognition Orders require the observance, as soon as possible, of the CPMI¹-IOSCO Principles for Financial Market Infrastructures (“*PFMIs*”). CDS’s self-assessment identified the need to eliminate leverage in the CAD and USD RCP CCRs by reducing the mutualization of exposures in favour of increased collateralization of individual exposures.

Background

Timely observance of the PFMIs by CDS is required by CDS’s regulators under its Recognition Order requirements:

- Autorité des Marchés Financiers: Reconnaissance de Services de dépôt et de compensation CDS inc. à titre de chambre de compensation en vertu de la *Loi sur les valeurs mobilières*, L.R.Q., c. V-1.1 – Part III, paragraph 43.1
- Ontario Securities Commission The Canadian Depository for Securities Limited and CDS Clearing and Depository Service Inc. Order; Section 144 of the Act, the Current Recognition Order – Part II: (Terms and Conditions Applicable to CDS Ltd. and CDS Clearing), Paragraph 9.1
- British Columbia Securities Commission requires CDS to comply with the terms and conditions of the order of the Ontario Securities Commission

Currently, Participants in the CAD and USD RCP CCRs benefit from common use collateral held in their respective pools. Such collateral pledged by all Participants in the CCRs has a leveraged effect on individual contributions. Consequently, Participant exposures are not fully and simultaneously collateralized. This structure does not meet with recognized international standards as described in Principle 4 and Key Considerations 3.4.12 and 3.4.18 of the PFMIs.

¹ The renaming of the Committee on Payment and Settlement Systems (“CPSS”) as CPMI, Committee on Payments and Market Infrastructures became effective as of September 1, 2014.

Amendments – CAD Receivers of Credit Category Credit Ring

The approach endorsed by Participants in the CAD Receivers of Credit CCR entails: (i) using the existing calculation methodology prescribed in the Procedures to derive Participant’s system operating cap (“SOC”); (ii) crediting Participants of the CAD Receivers of Credit CCR with an Initial Aggregate Collateral Value (“Initial ACV”) amount equal to their elected collateral contribution/requirement; and, (iii) in the event of a participant default, allocating settlement service collateral (i.e., “ACV”) to collateralize both the utilization of the cap not collateralized by the Participant’s contribution to the CAD Receivers of Credit CCR and the utilization of the line(s) of credit.

The Initial ACV is the estimated calculated value of the CAD RCP collateral requirement that could be realized if a Participant failed to pay its payment obligation. CDS’s clearing and settlement system, CDSX, maintains a current ACV balance for each Participant at a ledger level. All CDSX functions that affect a Participant’s security and funds balances are subject to an ACV edit. The ACV edit ensures that CDSX is fully collateralized at all times. The amount is calculated in accordance with Rule 5.13 and Chapter 10 of *Participating in CDS Services*.

The CCR members will see each member’s elected collateral contribution and the total amount of collateral in the pool. The corresponding system operating caps will be calculated each quarter and will be locked-in for the quarter as is presently the case. Under this approach the member’s own elected collateral requirement will be its Initial ACV rather than the sum total of all the members’ collateral requirement. The range of elected collateral requirement for the CAD Receivers of Credit CCR is between C\$60 thousand and C\$1 million².

This is in contrast to the current approach where a CAD Receiver of Credit receives an Initial ACV leveraged-up to an amount not exceeding the sum total collateral contributions of all the CAD Receivers of Credit³.

The proposed changes to the CAD Receivers of Credit CCR in conjunction with the application of ACV edit in CDSX will ensure that CAD Receivers of Credit credit exposures will be collateralized fully and simultaneously with a high degree of confidence.

In the event of a default, the following defaulter’s resources are added to those already available to collateralize the corresponding cap utilization: ACV collateral allocated to the CAD Receivers of Credit CCR.

As noted above, the suspended participant’s ACV will be allocated to both CDS (on behalf of the members of the CAD Receivers of Credit CCR) and the sureties according to the following ratio:

$$X = \frac{[\text{SOC}_{\text{utilized}} - \text{Defaulter's Collateral Requirement to the CCR}]}{[\text{SOC}_{\text{utilized}} - \text{Defaulter's Collateral Requirement to the CCR} + \text{LOC}_{\text{utilized}}]}$$

Where X defines the proportion of the suspended participant’s settlement service collateral allocated to the exposure associated with the CAD Receiver of Credit’s utilization of its SOC – and allocated to CDS

The settlement service collateral not allocated to the CDS is allocated to the sureties.

² The corresponding range of caps is between C\$1.0 million and C\$16.3 million.

³ Currently the leverage factor for the CAD RCP CCR is approximately 16.3X – i.e., members of the CAD RCP CCR receive C\$16.3 of cap for every C\$1 of collateral pledged.

To obtain the necessary liquidity to make the replacement payment, CDS may use the suspended participant's own collateral pool contributions, eligible settlement service collateral allocated to the CAD Receivers of Credit CCR and any specific collateral that the suspended participant had pledged to the collateral pool. If necessary, the contributions of the survivors in the suspended participant's collateral pool are also used by CDS to obtain liquidity.

The allocation is done at a security level.

Amendments – USD Receivers of Credit Category Credit Ring

Each USD Receiver of Credit will be credited with a USD cap equal to its elected USD Receivers of Credit CCR cap.

Each USD Receiver of Credit may elect a cap up to a maximum amount agreed to by the CDS and the Receivers of Credit Council.

Each USD Receiver of Credit's collateral requirement is equal to its elected cap.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The Amendments align the Procedures with the corresponding changes to the Rules and the CDS Risk Model.

Participating in CDS Services – CAD Receivers of Credit Category Credit Ring

Additions/amendments were made to the following sections of the Procedures to either (i) reflect the removal of the leveraged use of collateral in the CAD Receivers of Credit CCR; or (ii) reflect the allocation of ACV collateral to collateralize a defaulting member of the CAD Receivers of Credit CCR utilization of the CAD cap.

12.4.1 Canadian dollar receivers of credit voluntary adjustments.

14.7.1 Collateral sequence.

14.8.1 Processing a receiver of credit suspension.

17.4 Receivers of credit collateral pool.

17.5.1 Updating Canadian dollar receivers' collateral contributions.

17.5.2 Special margin collateral

17.6 Special margin collateral pools.

The above noted changes were agreed to by both the Receivers of Credit Council and the Extenders of Credit Council.

Participating in CDS Services – USD Receivers of Credit Category Credit Ring

Additions/amendments were made to Sections 17.7.1 "Updating U.S. dollar receivers' collateral contributions" of the Procedures to reflect the removal of the leveraged use of collateral in the USD Receivers of Credit CCR.

CDSX Procedures and User Guide

No amendments

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

- (a) CDS Clearing - The Amendments will ensure CDS's observance of the PFMI and adoption of a recognized international standard for market infrastructures. The Amendments will also enhance risk management by removing leverage from the CAD and USD Receivers of Credit CCRs thereby reducing the likelihood of surviving members of the CCRs being exposed to a loss as a result of the default of another CCR member.
- (b) CDS Participants -The Amendments will benefit Participants by providing them with access to a market infrastructure that meets global standards.
- (c) Other Market Participants and Securities and Financial Markets in General -- The Amendments will help mitigate systemic risk and contribute to the efficiency of Canadian capital markets.

C.1 Competition

The Amendments will apply to all CDS Participants who currently are, or may choose to become Participants in the CAD and USD Receivers of Credit CCRs. From a fair access perspective, no CDS Participant will be disadvantaged or otherwise prejudiced with the introduction of these changes.

C.2 Risks and Compliance Costs

The Amendments to the collateralization of the CAD and USD Receivers of Credit CCRs will result in changes to the CDS Risk Model, Rules and Procedures. CDS does not foresee other risks or compliance costs accruing to Participants or other stakeholders.

C.3 Comparison to International Standards – (a) Committee on Payments and Market Infrastructures of the Bank for International Settlements, (b) Technical Committee of the International Organization of Securities Commissions, and (c) the Group of Thirty

The PFMI are minimum international standards for enhancing the safety and efficiency of clearing, settlement and recording arrangements, which aim to limit systemic risk and foster transparency and financial stability. The PFMI apply to CCPs, central securities depositories (“CSDs”) and security settlement systems (“SSS”). CDS engages in all three of these market infrastructure activities. According to the terms of CDS’s recognition order requirements, CDS is required to observe PFMI as soon as possible.

The Amendments aim to mitigate credit risk exposure by reducing CDS’s reliance on the mutualization of risk resources. The Amendments align with Principle 4 (Credit Risk) and Key Considerations 3.4.12 and 3.4.18 of the PFMI which call for collateral pools to be collateralized such that current and potential future exposures to each Participant are covered fully with a high degree of confidence (i.e. single-tailed confidence level of at least 99 percent of the estimated distribution of future exposures).

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

CDS actively engaged internal and external discussion to explore its options. It established separate workgroups with Participants from the Extenders of Credit, and Receivers of Credit CCRs. The workgroups agreed upon a preferred approach which was socialized by the Participants in the workgroup back to their respective organizations where they were endorsed as required. CDS also prepared documents describing the Amendments which were tabled at the Risk Advisory Committee (“*RAC*”), a Participant committee that meets monthly.

D.2 Procedure Drafting Process

CDS procedure amendments were reviewed and approved by CDS’s Strategic Development and Review Committee (“*SDRC*”) on July 30, 2015. 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 the CDS participant community and it meets on a monthly basis.

D.3 Issues Considered

Consideration was given to the operational impacts that the enhancements might create for CDS Participants as outlined in section C of this Notice.

D.4 Consultation

This Amendment was initiated by CDS. CDS received input and endorsement from the respective Receivers of Credit and Extenders of Credit CCR Councils, the RAC on the concept and methodology underlying this Amendment. The SDRC reviewed and approved the operational aspects of this Amendment by July 30, 2015.

CDS Customer Service account managers will provide ongoing communication and status updates of proposed changes to clients and will solicit input on those changes.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings and monthly meetings with service bureaus to discuss potential development impacts to them. As a courtesy, development initiatives are presented to the Investment Industry Regulatory Organization of Canada’s (“*IIROC*”) Financial Administrators Section (“*FAS*”) working group.

D.5 Alternatives Considered

Alternatives, essentially minor variations of the preferred option, were considered. The proposed methodology is the result of input received from the members of the RAC.

D.6 Implementation Plan

The Amendments and the proposed implementation schedule will be communicated to CDS Participants through the SDRC and the RAC. CDS Relationship Managers and the Customer Service department will provide Participants with the details of the upcoming changes. Subject to regulatory approval, CDS will distribute a bulletin to all 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*, and by the British Columbia Securities Commission pursuant to section 24(d) of the British Columbia *Securities Act*, and as a clearing house by the *Autorité des*

marchés financiers pursuant to Section 169 of the Quebec *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 may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment. Subject to regulatory approval, CDS intends to implement the Amendments on **November 2, 2015**.

E. TECHNOLOGICAL SYSTEM CHANGES

E.1 CDS

There are no technological system changes required by CDS.

E.2 CDS Participants

There are no technological system changes required by Participants.

E.3 Other Market Participants

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

F. COMPARISON TO OTHER CLEARING AGENCIES

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 Amendments are not contrary to the public interest.

H. COMMENTS

Comments on the 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 Amendments to the CDS Procedures on the User documentation revisions web page (<http://www.cds.ca/cds-services/user-resources/user-documentation>).