

**CDS Clearing and Depository Services Inc. (CDS®)**

**MATERIAL AMENDMENTS TO CDS PARTICIPANT RULES**

**NON-LVTS SETTLEMENT AGENTS**

**NOTICE & REQUEST FOR COMMENTS**

**A. BACKGROUND AND DESCRIPTION**

CDS Participant Rule 9 – *Suspension of Participant*, includes provisions which describe the process which CDS follows in the event of a Participant’s suspension. More specifically, Rule 9.3.6 – *Immediate Use of Category Credit Ring Collateral* describes the process by which, amongst others, Settlement Agents’ collateral is delivered to the Bank of Canada (the Bank) via the Large Value Transfer System (LVTS) in return for liquidity. Rule 9.3.6 currently refers to a process by which, in the event that a Settlement Agent is suspended, the Bank of Canada may purchase securities from surviving *non-LVTS* Settlement Agents in exchange for funds (always subject to the Bank of Canada’s discretion under Rule 1.3.17). Pursuant to Rule 8.3.6 – *Type L Securities*, non-LVTS Settlement Agents may not deliver collateral, as Type L, to the Bank in order to immediately monetize such collateral.

The proposed amendments remove reference to the ability of a non-LVTS user to deliver, or to the Bank accepting eligible collateral (“L-type” securities) from CDS Participants who are not LVTS users in exchange for funds.

CDS must also mitigate the risk that the last surviving member of the Settlement Agent Category Credit Ring is a non-LVTS-user Settlement Agent (and is therefore unable to deliver Type L collateral to the Bank). The proposed amendments provide that, in the event of default and/or suspension, a surviving non-LVTS-user Settlement Agent’s replacement payment shall be effected, by that survivor, by means of an instruction to CDS, which instruction shall be to transfer collateral (collateral eligible for the Bank of Canada’s standing liquidity facility) to an account maintained for the benefit of the administrative agent of a credit facility established by CDS on behalf of the non-LVTS-user Settlement Agent. The instruction will provide for the transfer of collateral sufficient to allow CDS to make good on the survivor’s replacement payment. The proposed amendments are the result of continued dialogue between CDS, the Bank and non-LVTS-user Settlement Agents.

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

The proposed amendments ensure that the Participant Rules accurately reflect the operational fact that only Participants who are LVTS users are able to make L-type security pledges to the Bank. Further, since non-LVTS-user Settlement Agents may not make L-type security pledges to the Bank in order to fund their liquidity needs (i.e., in the event of a Settlement Agent default consequent to which the surviving non-LVTS Settlement Agents must pay their portion of the defaulter’s payment obligation), the resulting liquidity gap must be addressed.

In order to mitigate the above-mentioned risk, CDS has considered, and evaluated for timeliness and commercial feasibility, several potential solutions. Each of the foregoing solutions was determined to require clarificatory amendments to the CDS Participant Rules. Concurrent to the solution analysis, CDS was tasked with calculating the size and scope of the largest potential impact to a surviving non-LVTS Settlement Agent would or could be in the event that the Settlement Agent with the largest elected cap, having used their entire system operating cap (SOC), then defaulted on their payment obligations. CDS completed this modelling in order to calculate, a surviving non-LVTS-user Settlement Agent’s potential share of the defaulter’s payment obligation and, consequently, the liquidity required to satisfy that obligation.

CDS concluded that the establishment, by CDS itself, of a credit facility dedicated solely to mitigating the risk of non-payment by a Non-LVTS Settlement Agent was the simplest, least disruptive, and most expeditious means to ensure that a surviving non-LVTS Settlement Agent's share of a suspended Settlement Agent's Category Credit Ring Collateral can immediately be monetized.

The proposed rule amendments address the liquidity gap associated with non-LVTS settlement agents through the establishment of a dedicated credit facility by CDS on behalf of non-LVTS Settlement Agents only.

The proposed rule amendments are captured in Rule 9.3.6 as shown in Appendix A.

### **C. IMPACT OF THE PROPOSED CDS RULE AMENDMENTS**

*(a) CDS Clearing* – The proposed rule amendments have no impact on CDS Clearing in a business-as-usual context. The clarification to Rule 9.3.6 does, however, provide CDS with the appropriate tools, in the event of the default of a Settlement Agent, to fulfil its role as the operator of a designated, systemically important, clearing and settlement system.

*(b) CDS Participants* – In clarifying the process and obligations of Settlement Agents who are, and are not, LVTS-users, the proposed rule amendments provide transparency and important protection to Participants and minimize the risk of unintended disruption to, or access to, CDS systems and services. While CDS does not expect that Settlement Agents, as a Category, will be impacted, CDS notes that, in respect of the process specified in proposed Rule 9.3.6(c), all costs for establishing, and maintaining, the proposed credit facility shall be borne by the non-LVTS Settlement Agent(s) for which the facility was established.

*(c) & (d) Other Market Participants and Securities and Financial Markets in General* – The proposed rule amendments will have no impact on other market participants or on securities and financial markets in general; the proposed amendments provide CDS management with the flexibility to respond to Participant and CDS needs without causing additional stress to CDS, Participants and Canadian capital markets.

#### **C.1 Competition**

The proposed rule amendments will have a net positive impact on the competitive landscape of Canadian capital markets and CDS Participants by addressing any immediate liquidity gaps.

#### **C.2 Risks and Compliance Costs**

The proposed rule amendments are not expected to result in any 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**

Observance of PFMI standards is a requirement under CDS's recognition orders as well as under National Instrument 24-102 (Clearing Agency Requirements) and related Companion Policy 24-102CP.

The proposed rule amendments, unique to non-LVTS Settlement Agents in CDSX, will help CDS respond to CPMI-IOSCO PFMI requirements, specifically Key Consideration 3 of Principle 7 (Liquidity Risk) and Principle 13 (Participant Default Rules and Procedures).

## **D. DESCRIPTION OF THE RULE DRAFTING PROCESS**

### **D.1 Development Context**

Throughout their development, the proposed rule amendments were discussed with management, participant committees, CDS regulators, and other stakeholders.

### **D.2 Rule Drafting Process**

The proposed rule amendments were reviewed by CDS's Legal Drafting Group ("LDG"). The LDG is an ad hoc advisory committee composed of legal and business representatives of participating CDS Participants.

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

CDS's principal concern, and therefore, principal consideration, was the liquidity gap created in the event of the suspension of a Settlement Agent from CDSX where the surviving Settlement Agent(s) is/are non-LVTS users. In the event of a Settlement Agent suspension, pursuant to the existing Rules, a non-LVTS Settlement Agent would be unable immediately to monetize their share of a suspended Settlement Agent's category credit ring collateral in order to pay their proportionate share of the defaulter's payment obligation. The proposed amendments take account of the foregoing eventuality, and CDS considered CPMI-IOSCO PFMI requirements, specifically Key Consideration 3 of Principle 7 (Liquidity Risk) and Principle 13 (Participant Default Rules and Procedures) in developing the proposed amendments.

### **D.4 Consultation**

CDS consulted directly with members of the CDS Board and CDS management during the development of the proposed rule amendments. The legal drafting of the rule amendments was presented to the Legal Drafting Group (LDG) on January 31, 2018 with no contrary views. The principle underpinning the proposed rule amendments was presented to the CDS Risk Advisory Committee on January 30, 2018 with no contrary views expressed.

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

CDS considered several options, in principle, to mitigate the risk that a non-LVTS user Settlement Agent becomes a Survivor in its Category Credit Ring. More specifically, and in addition to the proposed amendments and the associated credit facility, CDS considered: a) requiring all Settlement Agents to be LVTS users, and b) allowing non-LVTS Settlement Agents to obtain their own credit facility for purposes of supporting their Settlement Agent role in CDSX. While CDS intends that the former requirement will be the solution in the long term, CDS determined that, for risk-mitigation and PFMI compliance purposes, the immediate obtention of a credit facility in respect of the potential obligations of current non-LVTS Settlement Agents was preferable to allowing the foregoing entities to obtain their own, individual credit facilities on terms to which CDS would not be privy.

### **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*, by the British Columbia Securities Commission pursuant to Section 24(d) of the British Columbia *Securities Act* and by the *Autorité des marchés financiers* ("AMF") pursuant to section 169 of the Québec *Securities Act*. In addition CDS is deemed to be the clearing house for CDSX<sup>®</sup>, 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**".

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The amendments to CDS Participant Rules are expected to become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment.

**E. TECHNOLOGICAL SYSTEMS CHANGES (E.1, E.2, E.3)**

The proposed rule amendments are not expected to have an impact on technological systems, or require changes to such systems for CDS, CDS Participants, or other market participants.

**F. COMPARISON TO OTHER CLEARING AGENCIES**

The proposed rule amendments are unique to non-LVTS Settlement Agents in CDSX, which necessitates a credit facility established by CDS on behalf of the non-LVTS Settlement Agents - in the short term - until the current non-LVTS Settlement Agents become LVTS users.

**G. PUBLIC INTEREST ASSESSMENT**

CDS believes that the proposed rule amendments are not contrary to the public interest.

**H. COMMENTS**

Comments on the proposed rule amendments must be made in writing and submitted within 30 calendar days following the date of publication of this notice in the Ontario Securities Commission Bulletin [•Autorité des marchés financiers Bulletin if this is the translated version•] to:

CDS Clearing and Depository Services Inc.  
Attn: Marco Carcasole  
100 Adelaide Street West  
Toronto, Ontario M5H 1S3  
Email: [marco.carcasole@tmx.com](mailto:marco.carcasole@tmx.com)

Copies should also be provided to the Autorité des marchés financiers, 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  
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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 the proposed rule amendments as well as text of these rules reflecting the adoption of the proposed amendments.

**APPENDIX “A”  
PROPOSED CDS RULE AMENDMENTS**

Red – deletion  
Blue - addition

Text of CDS Participant Rules marked to reflect proposed amendments	Text of CDS Participant Rules reflecting the adoption of proposed amendments
<p><b>9.3.6 Immediate Use of Category Credit Ring Collateral</b></p> <p>Prior to making payment in full to CDS of its proportionate share of the suspended Participant’s obligation, a Survivor of a Category Credit Ring may use its share of the suspended Participant’s Category Credit Ring Collateral only in order to make the replacement payment to CDS. A Survivor of a Category Credit Ring may do so:</p> <ul style="list-style-type: none"> <li>(a) if the Survivor is an Extender, by directing the Lead Extender to transfer such collateral, so that the Survivor can deliver such collateral to Bank of Canada as Type L Securities; or</li> <li>(b) if the Survivor is the Replacement Active Federated Participant or a Settlement Agent <u>that is an LVTS user</u>, by directing CDS to transfer such collateral so that the Survivor can deliver such collateral to Bank of Canada <del>either (i) if the Survivor is an LVTS User, as Type L Securities; or (ii) if the Survivor is not an LVTS User, in settlement of a purchase by Bank of Canada of the Securities that comprise the collateral, in which event Bank of Canada shall pay to CDS the lesser of the purchase price and the amount of the replacement payment owed by the Survivor and such payment to CDS shall discharge Bank of Canada’s payment obligation to the Survivor in the amount of the payment.</del></li> <li>(c) <u>if the Survivor is a Settlement Agent that is not an LVTS user, by directing CDS to transfer, pledge, or otherwise convey, at CDS’s sole discretion pursuant to Rule 5.1.3(f), collateral of the type described in Rule 5.3.1(a) equivalent in value to the Survivor’s replacement payment to a Financial Institution or Institutions, or to a Collateral Administration Ledger in the name or names of the aforementioned, in return for an advance of funds to CDS for the proportionate share of the suspended participant’s payment obligation. Such direction shall under no circumstances relieve the Survivor of its obligation as a Survivor of a Category Credit Ring, and the</u></li> </ul>	<p><b>9.3.6 Immediate Use of Category Credit Ring Collateral</b></p> <p>Prior to making payment in full to CDS of its proportionate share of the suspended Participant’s obligation, a Survivor of a Category Credit Ring may use its share of the suspended Participant’s Category Credit Ring Collateral only in order to make the replacement payment to CDS. A Survivor of a Category Credit Ring may do so:</p> <ul style="list-style-type: none"> <li>(a) if the Survivor is an Extender, by directing the Lead Extender to transfer such collateral, so that the Survivor can deliver such collateral to Bank of Canada as Type L Securities; or</li> <li>(b) if the Survivor is the Replacement Active Federated Participant or a Settlement Agent <u>that is an LVTS user</u>, by directing CDS to transfer such collateral so that the Survivor can deliver such collateral to Bank of Canada as Type L Securities.</li> <li>(c) if the Survivor is a Settlement Agent that is not an LVTS user, by directing CDS to transfer, pledge, or otherwise convey, at CDS’s sole discretion pursuant to Rule 5.1.3(f), collateral of the type described in Rule 5.3.1(a) equivalent in value to the Survivor’s replacement payment to a Financial Institution or Institutions, or to a Collateral Administration Ledger in the name or names of the aforementioned, in return for an advance of funds to CDS for the proportionate share of the suspended participant’s payment obligation. Such direction shall under no circumstances relieve the Survivor of its obligation as a Survivor of a Category Credit Ring, and the</li> </ul>

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<p><a href="#">Survivor shall, in all events, make good its payment obligation to CDS for the foregoing, by Acceptable Payment for such share, no later than the deadline for the fulfilment of the Survivor's initial Collateral contribution as specified in the Procedures on the Business Day immediately following the foregoing direction. Upon receipt of such Acceptable payment, CDS shall deliver the Collateral pledged to secure the replacement payment described in this Rule 9.3.6(c), and the Survivor's share of the</a> suspended Participant's Category Credit Ring Collateral, to the Survivor.</p> <p>If the suspended Participant is a Receiver, its Category Credit Ring Collateral shall not be transferred to the Survivors of the suspended Participant's Category Credit Ring but shall be dealt with in accordance with Rule 9.3.1.</p>	<p>Survivor shall, in all events, make good its payment obligation to CDS for the foregoing, by Acceptable Payment for such share, no later than the deadline for the fulfilment of the Survivor's initial Collateral contribution as specified in the Procedures on the Business Day immediately following the foregoing direction. Upon receipt of such Acceptable payment, CDS shall deliver the Collateral pledged to secure the replacement payment described in this Rule 9.3.6(c), and the Survivor's share of the suspended Participant's Category Credit Ring Collateral, to the Survivor.</p> <p>If the suspended Participant is a Receiver, its Category Credit Ring Collateral shall not be transferred to the Survivors of the suspended Participant's Category Credit Ring but shall be dealt with in accordance with Rule 9.3.1.</p>
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