CAPITAL MARKETS
HAYWOOD
SECURITIES INC.

February 20, 2020

Wayne S. M. Ralph
Chief Operating Officer
CDS Clearing and Depository Services Inc.
100 Adelaide Street West
Toronto, Ontario

Wayne
Dear ~~Mr. Ralph~~:

Re: Request for Comment CDS Clearing and Depository Services Inc (CDS); Proposed Significant Change to Eliminate the CDS Fee Rebates, and Proposed Amendments to Eliminate the Network Connectivity Fees

Haywood Securities Inc. (Haywood) appreciates the opportunity to provide CDS and members of the Canadian Securities Administrators (CSA) with our comments on the above-noted proposal.

Founded in 1981, Haywood is an IIROC-regulated investment dealer registered in all Canadian provinces and most territories. Haywood has been a CDS Participant since CDS acquired West Canada Depository Trust Company in 1995. We are an active member of the Canadian investment community. Several of Haywood's management team having chaired or participated in executive level industry committees, including serving as a member of the CDS board from 1999 to 2009.

Our letter discusses the key elements of the proposal, their historical context, and why Haywood opposes the elimination of CDS Fee Rebates in the strongest of terms. Our objections relate mostly to the conceptual arguments of requiring Participants to fund capital projects – especially the instant one - rather than their absolute financial impact on Haywood.

Historical Context

In 2011/2012 CDS management presented its board with a plan to upgrade the existing Entitlements and Corporate Actions system functionality with a new module referred to as BaNCS. The estimated capital cost of BaNCS was $20-$25 million. Management believed there were adequate operational savings to self-fund the BaNCS project. The CDS board deferred its approval of the project because of the ongoing discussions with Maple Group Acquisition Corp. (Maple) regarding its proposed acquisition of the TMX Group (TMX) and CDS.

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Prior to the BaNCS project being proposed, CDS consulted with its Participants to gain an understanding of the improvements they expected. The Strategic Development Review Committee (SDRC) was actively involved in this consultative process. Throughout this review and up to the closing of the Maple transaction, the TMX held a seat on the CDS board. This was therefore a very public and well socialized need during the Maple/TMX discussions.

Following Maple's acquisition of CDS in August 2012, TMX placed the BaNCS project on hold, pending a review of broader CDS technology needs. Following this review, in 2016 CDS management presented Participants with the Mercury and Atlas projects. The Mercury project dealt with the entitlements updates, while the Atlas project focused on replacing CDS's mainframe computing environment with a more TMX consistent server-based technology. The combined cost of these projects was estimated to be approximately $50 million and was to be funded by operational savings.

During this period, CDS submitted for approval to the CSA new fees for Issuer Services. The proposal, which was ultimately approved in December 2016, allowed CDS to charge issuers for entitlement and corporate actions processing. These services were previously provided to the issuers at no additional cost. CDS successfully argued it required the additional service revenues to fund current and future infrastructure and system development, including the overhaul of an end-of-life entitlement and corporate actions system. As noted above, this is the same system which according to CDS management could be funded by operational savings.

It was not until late 2018, after numerous management and consultant changes, CDS installed a new leadership team. By then, the budget for the Mercury and Atlas projects (now known as the Post Trade Modernization (PTM) project) ballooned to $120 - $135 million. No documented scope changes or business plan has been presented to justify the new budget – a 260% cost increase over the prior budget – but Participants are being asked, for the first time, to fund the project through the elimination of the Fee Rebates.

Who does this project benefit?

This section could as aptly be entitled: "Why are we doing this?" or "Who asked for this?". Let's be very clear: Participants did not ask for this project. The SDRC, whose primary mandate is to identify and prioritize system enhancements, has heretofore proposed few meaningful enhancements for clearing, settlement or depository. Most of the historical enhancements have been relatively small modifications to the exiting system. The one exception was the entitlements and corporate actions system referred to above. This has been a top priority for Participants since before 2012. While the PTM project clearly includes an update to this part of the system, every indication is that most of the $120-$135 million budget will be spent in areas of little value or priority to Participants. CDS suggests that system "modernization" is driving much of the PTM initiative. We question this motivation. There has been no Participant push for an updated system, and no discussion about the use of more modern innovations like Blockchain and Distributed Ledger technology which is being pursued by Australia's ASX project. It seems much more likely that the system changes are driven by cost savings for the combined TSX/CDS entity. These savings will not accrue to Participants, even though most of the contemplated system and implementation costs are proposed to be borne by CDS clients.

The CDS Notice provides little detail for the *need* to proceed with the PTM project. It suggests:

- Replacement of the CDSX mainframe... which "while reliable, is expensive and resource-intensive to maintain." Reliability is key for Participants and Capital Markets generally. As CDS states in its Notice, the CDSX mainframe IS reliable. Further, the published annual performance reports suggest CDS always meets or exceeds the stated performance metrics. Similarly, critical infrastructure at DTCC, as well as each of the largest Canadian banks, run on mainframe technology. As for it being "expensive and resource-intensive to maintain", that was in plain site when the TMX acquired CDS. Furthermore, those costs are already built into the existing CDS pricing model.
- "A modern technology platform will enable CDS to make future system changes more efficiently". Changes to infrastructure as central as CDS are complicated, regardless of the technology platform. That is because processing errors can be very expensive and often, changes at CDS can impact upstream and/or downstream Participant systems. Those systems, or the combination of systems, can vary greatly between Participants. As a result, most of the time historically spent on system changes at CDS is spent on business analysis and specifications, and system and user acceptance testing. That effort will not change.
- "The modernized system is also intended to offer a more intuitive user interface to Participants". Many Participants would argue that CDS is too late to this party. Third party vendors who provide a "user friendly" interface already exist and are widely used by Participants.
- "Customize report generation". Much of a Participant's transactional data is available through messaging applications which allow Participants to customize many reports internally. Furthermore, we understand the PTM project includes plans to replace RMS and significantly reduce the current archival function, a function Participants still want.
- "Enable CDS to scale the system more efficiently based on capacity needs." Mainframe technology is exceedingly scalable as is evidenced by DTCC.

When the PTM project is completed, two-plus years down the road with a spend of some $135 million, Participants have been promised a replacement system which is substantially equivalent to the existing system. Only then will CDS turn its attention to Participant enhancements specifically focused on the entitlements and corporate actions system.

The Numbers Don't Make Sense

The CDS proposal to eliminate the Fee Rebates, carefully ignores ongoing contributions by its clients through existing fees. At the outset, the existing Participant pricing model includes $3million per year that was supposed to be directed towards system enhancements. There is a separate budget for system maintenance. This was the annual budget allocated to the SDRC prior to the Maple transaction and was institutionalized in the Recognition Order by virtue of adopting the pre-existing pricing model. Since 2012, CDS has delivered little in the way of enhancements, arguing that the "new system" would deliver most of the requested changes and it would not be prudent to develop the enhancements twice. We assume that most of these funds have been re-directed to consultants and staff focused on the various incarnations of the PTM project or have simply accrued to the TMX's bottom line. We do know that these funds have not been used to deliver the system enhancements Participants have prioritized. In addition, new revenue generated from Issuer Services was justified, in part, by suggesting it would go towards improved systems. In other words, CDS's community of users are already directly contributing to system upgrades. While those contributions may not fully fund the new $135 million PTM project, they are more than adequate to satisfy the development efforts Participants and issuer clients are looking for.

CDS has tried to position the PTM project as a response to client priorities. It is not. The 2012 BaNCS project is what Participants asked for. The mainframe transition is solely a TMX initiative. With project costs ballooning to $135million, CDS is seemingly unable to justify the spend based on system savings alone. We see no value in a wholesale system replacement. The existing system is very reliable, efficient (especially in the clearing and settlement areas), and generally meets the needs of Participants. There are few areas the existing system fails to provide comparable functionality to DTCC. We support the previously defined enhancements to the entitlements and corporate actions functionality; and based on previous CDS cost estimates, we believe the current funding model by Participants and issuers is adequate to meet those needs.

The $135 million PTM project budget also ignores the additional costs that will be borne by CDS's client community. This project requires active participation in defining and reviewing specifications and will necessitate expending major effort for testing and implementation. These are real costs, not simply notional allocations. Staffing needs at all participants are being affected by this project. In many cases, existing staff will be seconded to the project and backfilled with new resources. Third party vendors like Broadridge, IBM and Paramax will have to dedicate significant resources to test the new interfaces and make modifications to their systems. These costs will be passed along, directly or indirectly, to Participants. Internally developed Participant systems used to augment CDS processing will also need to be tested and will require some yet to be defined amount of re-development. These additional costs to the industry will be in the tens of millions of dollars.

Conclusion

The CDS proposal states that this change "will allow for both stable and effective provision of our services and for ongoing capital investment while simultaneously meeting TMX's minimum expected IRR for the CDS business." We have no view into CDS's financial results, or the economic model associated with the PTM project. What we do know is that in the pre-TMX era, fee rebates reflected excess annual working capital. The TMX era rebate formula is based on revenue growth and a projected static earnings ratio. Based on 2018 rebates, CDS's 50% was $10.2million. It seems reasonable to assume that the TMX has improved on the static earnings ratio and therefore profitability. We base this assumption on the fact that the CDS purchase was justified by anticipated cost savings from synergies through the integration of CDS to its existing business, and since 2012 CDS has evidenced these synergies with noticeable staff reductions. As a result, we assume the CDS earnings ratio has improved. On the surface, these economic variables along with the added revenue from Issuer Services, suggest plenty of opportunity for CDS to reinvest profits in capital projects unless its expectations are to earn monopoly returns.

The TMX (and therefore Maple) were fully aware during their purchase negotiations that system improvements and capital investment were required. The TMX's Board participation in 2012 provided the TMX (and therefore Maple) with ample knowledge of required system upgrades. As a significant technology provider to the industry, it would be incredulous for the TMX to suggest replacing its depreciating technology assets comes as a surprise. If the TMX (or Maple) felt the economic model they were negotiating could not sustain the capital required for technology upgrades, they should have included provisions in the Recognition Order. They didn't. To raise it now seems opportunistic.

We did not ask for this project and have not been shown how or if we will benefit from it. We have no transparency as to the revised budget and have no visibility into the business plan that purports to justify it. We are told this budget is mostly for a "like for like" system application, and CDS will focus on functional improvements after project implementation. We have no means of holding CDS accountable for the delivery, cost, or timing, and yet Participants and issuers are expected to fund it by giving CDS a $10-plus million annuity in fee rebates, plus a comparable sum from a combination of existing fees and Issuer Services.

In our view, there is no justification for Participants to fund the PTM project. We urge the CSA to make it clear to CDS that capital projects for core systems are a CDS/TMX responsibility to be funded from retained earnings, just like any other for-profit organization.

We appreciate the opportunity to comment on these proposed reforms. If you have any questions or further inquiry, please feel free to contact us.

Respectfully submitted,

HAYWOOD SECURITIES INC.

Peter Virvilis
Chief Financial Officer

cc: Philippe Lebel, Autorite des Marches Financiers
Manager, Market Regulation, Ontario Securities Commission
Doug MacKay, BC Securities Commission
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