

Secretary of Commission
Ontario Securities Commission
20 Queen Street West,
Toronto, Ontario
M5H 3S8

June 4, 2012

Subject: Maple Group Recognition Order; Request for Comments

Thank you for the opportunity to comment on the draft Ontario Securities Commission's (OSC) draft Recognition Order for the Maple Group Acquisition Corporation (May 3, 2012). I commend the OSC for the extent and depth of the work they've done on this important initiative.

My comments are limited to a few of the clearing/settlement items within the Proposed Recognition Order, specifically:

- Competition in Clearing: the ability of broker/dealers to choose where their exchange trades are cleared/settled
- Pricing of CDS' services
- Maple undertakings on Fixed Income Clearing
- Cross Margin Benefits

Competition in clearing services:

The draft recognition order should be amended to make it clear that recognized exchanges must provide the ability for broker/dealers to choose where their trades are sent for clearing.

At present, it is impossible for anyone to compete with The Canadian Depository for Securities (CDS) in the "clearing" of exchange-traded equities. That is because the TMX, and the other recognized trading platforms in Canada, do not offer any alternative to CDS as a destination for the "clearing" of these trades. The broker/dealers that execute trades on a recognized exchange do not have the option to direct their trades elsewhere for clearing; they have one choice - CDS. To be clear, with CDS as an industry-owned, not-for-profit utility, there was no demand for such an alternative. But when CDS becomes a for-profit subsidiary of the Maple Group, it is likely that some broker/dealers would want to at least be able to consider an alternative to CDS.

The draft recognition order does not provide the assurance that a broker/dealer would be allowed to use a competitor to CDS for clearing. Section 12 (page25) of the order attempts to address the potential that the TMX/Maple might do something, in the future, that could limit completion in clearing/settlement. But it's clear that this part of the recognition order would apply only to something new or different done by an exchange, but would not require an exchange to change current practices. In other words, if an exchange does nothing to change the current process, then the current CDS monopoly in clearing of exchange-traded equities would be enshrined forever, and that would not contravene anything in the current draft of the recognition order.

When the London Stock Exchange (LSE) and TMX discussed a merger in 2011, they stated their intention to also develop their own clearing system(s). At that time, CDS wrote to the OSC to insist that

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recognized exchanges be required to offer the broker/dealers that traded on the Canadian exchanges the ability to choose where their trades would be sent for clearing. In other words, when CDS faced a potential competitor in the combined LSE/TMX proposal, CDS advocated that broker/dealers should be provided with the ability to choose amongst competing suppliers. The recognition order should follow CDS' recommendation and provide for that ability to compete.

My suggestion is that the recognition be amended to require all recognized exchanges and trading platforms to offer the ability for a broker/dealer to choose where (i.e. which clearing agency) they want their trades sent for clearing/settlement. Alternatively, the OSC could look at the proposal CDS submitted during the comment period on the proposed LSE/TMX merger and implement CDS' recommendations in this area.

Pricing for Clearing, Settlement and Depository Services:

The OSC's draft recognition essentially freezes CDS' prices at their current levels. While this may seem like a reasonable means to address concerns over monopoly pricing behaviour, in practice it will be very difficult, if not impossible, to prevent monopoly pricing because of the complex nature of CDS' pricing and costing. In particular, CDS' current pricing already reflects some aspects of monopoly pricing behaviour. And there are important services currently provided by CDS that do not appear on CDS' price list, either because the costs of those services are included in other existing prices or because CDS (and its industry owners/users) wanted to promote certain behaviour by NOT charging for its use. It will be very difficult for the OSC to look at a Maple request to change or add pricing for "new" services and determine what is "new" and what is already covered by current fees.

Over the past decade CDS has kept the overall cost of clearing/settlement/depository virtually fixed at about \$69mm per year; an incredible achievement given that the volume of trades processed by CDS increased twelve fold from 34 million trades in 2001 to over 414 million trades in 2011. Essentially, CDS continued to provide the clearing/settlement/depository services for the incremental 380 million trades over the past decade for free. By freezing CDS' prices at current levels, the Canadian banks and broker/dealers need to prepare for ever increasing clearing/settlement costs from CDS, as volumes increase, whereas those costs have been essentially fixed for them for the past decade.

Over the past decade CDS has chosen to reduce the prices applied to "clearing" items on its price list, while at the same time either introducing new fees, or kept existing fees, relatively high in the "depository" section of CDS' price list. In part this was because CDS recognized the potential for competition (e.g. from the TMX/LSE and others) in "clearing" while at the same time understanding that it would be much more difficult for anyone to develop a competitor to CDS in the "depository" services (the technical/practical obstacles to setting up a competing depository are much higher than setting up a competing clearing agency). In other words, CDS lowered prices in the areas where it might face competition while increasing fees on the services where competition was much less likely. Between 2001 and 2011, CDS' participants faced a 50% increase in "depository" costs (from \$22.3mm to \$33.4mm) and at the same time a 22% decrease in 'clearing/settlement" costs (from \$24.1mm to \$18.7mm). CDS' overall costs to the industry remained constant but the "mix" of pricing changed dramatically. This allocation has now been "frozen" in place for Maple.

In many cases CDS, and its current owner/participants, chose not to charge at all for some services so as to encourage its use. This is especially true of "Straight-thru-Processing" interfaces. CDS does not currently charge for these interfaces because it had been a focus of the Canadian (and international)

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capital markets for the past decade to promote the use of straight-thru-processing to improve the overall efficiency of the capital markets. Maple has basically agreed not to raise the current prices on “core” services. However there are services that all users of CDS would consider “core” that are either not defined as “core” or do not even exist on CDS’ current price list. It’s not clear how a decision by Maple to start charging for what might appear, on the surface, to be a “new” service (because it wasn’t on CDS’ current price list) would be handled by the OSC.

Finally, I would urge the OSC to track a simple “all-in” industry cost of clearing/settlement as a way of measuring the cost impact of moving to for-profit clearing/settlement. This would be a simple figure calculated by dividing CDS’ revenue (after rebates) by the total number of exchange and OTC trades cleared. This method has the effect of removing all of the intricate pricing allocations and shifts described above. In 2001 this “all in” industry cost figure for CDS was \$2.03 per trade (\$68.5mm in revenue and 33.7mm trades cleared/settled); whereas in 2011 this all-in industry cost figure was: \$0.17 per trade (\$69mm in revenue and 414mm trades cleared/settled). It’s likely that this \$0.17 per trade figure will remain constant from now on (because CDS’ prices are frozen) and the increased revenue from increased volumes will accrue to Maple shareholders rather than the capital market participants at large.

Fixed Income Clearing and OTC Derivative Clearing (page 44 and page 118):

The undertakings made by Maple to the AMF with respect to fixed income clearing are based on an incorrect understanding of the current situation with respect to fixed income “clearing”.

As far as the Ontario Securities Act is concerned, CDCC does not currently provide “clearing” for fixed income transactions. What CDCC currently provides for a small subset of repo transactions is “netting/novation”. In general, two processes are usually included in the definition of “clearing” for Over the Counter (OTC) Trades:

- a) A process for ensuring the agreement to the details of the trade between the two counterparties
- b) Netting/novation of the agreed upon trades to a central counterparty.

The Ontario Securities Act also includes in its definition of “clearing” the “settlement” of trades and acting as a “depository”. The Act does not include netting/novation in its definition of “clearing”. This may be an oversight in the Ontario Securities Act, but as far as Ontario is concerned CDS provides the “clearing” of all fixed income transactions in Canada, including the few repos processed by CDCC.

The first process described above (a) is mandatory for all OTC Trades. The netting/novation process (b) is optional. The latest CPSS-IOSCO recommendations suggest markets should carefully consider whether it makes sense to do b) for their market. The Maple undertakings to the AMF include that Maple will “not do anything to cause CDCC, directly or indirectly, to cease..... b) its development as a leading clearing agency for fixed income transactions...”.

CDS currently clears and settles and is the depository for about 65,000 OTC Trades worth between \$300 Billion and \$350 Billion every day; the vast majority of this value being fixed income transactions. Of this, about 100 trades worth between \$5 billion to \$10 billion are netted by CDCC. CDS provides the “clearing” for those transactions before they ever reach CDCC and CDS provides the settlement and risk management for that settlement after CDCC has netted them. In other words CDCC currently provides

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one process (netting) for a tiny fraction of the fixed income transactions done in the Canadian markets on a given day.

It may be that the AMF and Maple meant to undertake to continue “netting/novation” for some fixed income at CDCC. But that’s not what the undertaking given by Maple to the AMF says it will do. The undertaking says that it will move fixed income clearing away from the organization that currently processes \$350 billion per day to the organization that does a small fraction of the processing for \$10billion of this amount.

The development of an OTC Derivative platform implies knowledge and expertise in two distinct areas: “OTC Clearing”, which is a process; and “Derivatives”, which is a product. CDCC has the product and risk management knowledge/expertise for Derivatives but does not have the required expertise in OTC clearing. CDS has the OTC Clearing knowledge/expertise but not the product knowledge in Derivatives. I applaud the passion with which the AMF defends and promotes their local markets. However, I’m not sure what the Maple group would do if the OSC was equally as passionate and insisted that since all fixed income and all OTC clearing is actually provided by CDS, that those processes had to remain at CDS in the future for both fixed income and OTC Derivatives. But what hopefully some regulator, somewhere in Canada, will recognize and insist on is that the best expertise and knowledge of both the processes and products should be used no matter where it exists in Canada. The Maple group should be allowed to source the development of their systems from wherever the best knowledge and experience resides, whether that be Montreal and/or Toronto and/or Vancouver, Calgary or anywhere else that has the skills. If it’s not possible to agree on that then the capital markets regulators in this country are implicitly agreeing to promote mediocrity.

Cross-Margining Benefits (page 86)

It’s clear that Maple expects one of the major benefits of combining CDS and CDCC together is a reduction in collateral required for the Derivatives markets. The estimate given by Maple is \$750mm. It’s important for the regulators that are considering the Maple proposal to consider this number in the context of the overall Canadian clearing/settlement.

First, the estimated \$750mm reduction should be considered in the context of the overall amount of collateral used in clearing/settlement in Canada. At the end of 2011, CDS had approx. \$3.7 BILLION in collateral pledged to it by Canadian banks and dealers. Almost none of this would change with cross-margining because almost all of this collateral is in place to address payment risks, not the market risks from the CCP’s operated by CDCC and CDS where the hoped for collateral reduction would be generated.

Second, what is important to the market as a whole is not the amount of collateral saved but the cost of providing that collateral. Currently, many market participants consider the cost of collateral to be zero because they have excess collateral available. That may not always be true but even when it is not zero the cost of collateral is typically calculated as the difference between the cost of raising the money to buy the collateral and the return generated by the collateral (e.g. interest on government bonds). Even if a cost of collateral were applied to the hoped-for \$750mm reduction, there might be a savings of maybe a million dollars for the entire Canadian capital markets.

Third, cross-margining between the derivative and cash markets implies risk sharing amongst the participants in those groups. That is the major “cost” of cross-margining and the benefits of collateral reduction which may accrue to the derivatives segment of the capital markets will only be realized if the

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non-derivatives segment agrees to take on an increased share of the risks. The way this combined risk is shared and allocated will be a major topic of consideration for regulators.

The OSC's draft recognition order for the Maple Proposal has addressed many of the concerns raised by various segments of the Canadian Capital markets. And it seems to provide a reasonable framework within which Maple can conduct their business. As with anything this complex, the devil is in the detail and in the implementation and I hope some of the comments above will prove useful to the OSC in the coming months and years.

Sincerely,

Gary Stephenson,
Director, Paramax Solutions