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**Re: Submission to the Ontario and Québec Securities Regulators on the proposed transaction of the TMX Group and the London Stock Exchange Group**

## Introduction

On February 9, 2011, the TMX Group Inc. (TMX) announced its intention to merge with the London Stock Exchange plc. (LSE). The Canadian Depository for Securities Limited (CDS) is pleased to have the opportunity to make a submission to the Ontario Securities Commission and the Autorité des marchés financiers on the merits of this proposed merger with respect to the competitiveness and efficiency of the Canadian capital markets.

## Strategic Issues

Much of the focus on the merits of the proposed merger will understandably be on the strategic importance of the listing and trading roles to be played by the merged entity in the efficient and effective functioning of the Canadian capital markets. A number of well-qualified respondents will submit their thoughts on these important aspects of the proposed merger. CDS's contribution to the discussion on strategic issues is limited to the implications of these strategic issues to the clearing, settlement and systemic risk implications resulting from the proposed merger.

TMX currently enjoys a powerful position in the Canadian capital markets due to the success of its listing and derivatives businesses, which are near monopolies. Although its equity trading business is subject to significant competition, the TMX Group still accounts for between 60-65% of the daily volume of equity trading in Canada. On a global scale, TMX is a niche player having carved out a successful role as a market for resource stocks.

## Future Directions

In the joint submission, dated May 13, 2011, of the LSE and TMX to the Ontario Securities Commission, they state under section F. Improved Competitive Position:

> "In our industry, there have been several waves of combinations, as exchange operators around the world have begun to strengthen their collective positioning by joining forces. These combinations have occurred in response partly to an increase in competition and partly due to developments in technology, which have facilitated new entrants and resulted in changing demands from exchange customers, including demand for new products and services. Pooling ownership has allowed exchange operators to combine their resources to achieve greater economies of scale in connection with investments in technology and other areas needed to serve investors and market participants at competitive prices, while extending their reach internationally. Many of these combinations have occurred across national boundaries and even across continents."

Their Application also contemplates the future expansion of the merged organization through transactions with other parties.[1] And the Chief Executive Officers of both the LSE and TMX have publicly stated that they are in favour of the vertical integration of their respective trading and clearing organizations.

Accordingly, it may be expected that the merged organization will seek additional acquisitions of exchange operators once this initial transaction has been completed. Companies can be successful in the long run as niche players or as dominant players within their markets. Where it is difficult to survive is as a mid-size player, since the level of investment required to maintain market share approaches that of the dominant players, while revenue and profitability cannot sustain the investment needed. To this point, TMX has been doubly successful by being the dominant player in Canada and a successful niche player on a global basis. The merger with LSE threatens to change this successful dynamic. The combined entity (LTMX Group) will be a mid-size player on a global basis which means there will be challenges when competing with larger competitors. These challenges will very likely require LTMX to continue to grow through further mergers and/or acquisitions. LTMX's continued expansion will complicate the ability of the Canadian regulators to deal with the situation where a systemically important system to the Canadian financial system is controlled, directly or indirectly, by a publicly owned, for-profit, foreign entity, a foreign entity that could be in a constant state of change, at least for the foreseeable future.

## Systemic Issues

In addition to considering the strategically important functions of listing and trading, consideration also needs to be given to the impact of the proposed merger on the post-trading activities of clearing, settlement, custody and client record-keeping. When considering the Canadian capital markets' value chain, it is relevant to note that systemic importance (i.e., the ability of the market to continue to function in periods of economic stress) is attached to the clearing and settlement processes rather than to the listing and trading roles that are the principal domains of exchanges and alternative trading systems. By the time the merger, if approved, takes effect, it is planned by the Bank of Canada that the Canadian Derivatives Clearing Corporation (CDCC), a wholly-owned subsidiary of the TMX, will have been designated as operating a systemically important system within the Canadian financial system.[2]

In this submission to the security commissions, CDS focuses its comments on the implications of the proposed merger for those elements of the post-trade environment in Canada for which CDS has primary responsibility (i.e., cash market clearing, settlement and custody). CDS recommends that consideration be given to the implications of having a systemically important system being

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1 "The number of Canadian directors on Mergeco's board may be reduced if Mergeco expands its operations through a transaction with another party and takes on directors from the other party's board as a result or if Mergeco adds directors who are resident outside Canada and Europe." (2011) 34 OSCB 5717

2 Bank of Canada's web site: http://www.bankofcanada.ca/financial-system/payments/oversight-activities-during-2010/

controlled, directly or indirectly, by a foreign entity. In addition, CDS expects that a competitive clearing environment will evolve if the proposed merger is allowed to proceed and because of this, there would need to be appropriate safeguards put in place to ensure the on-going safety, operational efficiency and cost-effectiveness of the post-trade environment in Canada.

## The Canadian Depository for Securities Limited

CDS, through its wholly-owned subsidiary, CDS Clearing and Depository Services Inc. (CDS Clearing) is Canada's clearing, settlement and depository organization for the cash markets in equities, fixed income[3] and money market. CDS Clearing clears and settles cash trades originating from both the over-the-counter (OTC) market and the organized markets (i.e., exchanges and alternative trading systems) and operates central counter-party (CCP) services for both fixed income and equity trading. CDS is owned by the Canadian capital markets industry[4] and currently operates on a cost-recovery basis for the benefit of the industry.

## The systemic importance of clearing and settlement systems

Under the terms of the Payment Clearing and Settlement Act (PCSA), the Bank of Canada (the Bank) has a mandate to identify clearing and settlement systems in Canada that could be operated in a manner that could pose systemic risk. "Systemic risk refers to domino or spillover effects where the inability of one financial institution to fulfil its payment obligations results in the inability of other financial institutions to fulfil theirs, or in the failure of a clearing house."[5] The operator of any system that is designated by the Bank as being systemically important must satisfy the Bank that the appropriate risk controls are in place within and around the system to deal with concerns related to systemic risk.

> When deciding if a system should be designated under the PCSA, the Bank considers:
>
> - the size of individual payment obligations and the size of the aggregate value of payment obligations on any given day
> - the size of payment obligations owed to and by participants in the system relative to each participant's capital
> - the role played by the system in supporting transactions in financial markets or the economy more generally.[6]

The system used by CDS Clearing for clearing, settlement and depository is CDSX®. In 2003, in accordance with the terms of the PCSA, the Bank designated CDSX[7] as being of systemic importance to the Canadian financial system. On a daily basis, CDS clears and settles transactions, including entitlement payments, with an average total value of $283 billion. At its end-of-day payment exchange process, this total value is reduced to an average of $6.5 billion in netted debit and credit payments between participants.

As a result of CDCC being awarded the clearing function for trading in fixed income securities, the Bank plans to designate the clearing system operated by CDCC, a wholly-owned subsidiary of the TMX Group, once the new service commences operation.[8]

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3 In December 2009, the Canadian securities industry awarded fixed income clearing to the Canadian Derivatives Clearing Corporation (CDCC). CDS is currently working with CDCC to put in place a joint solution that will allow specified fixed income trades to be directed to CDCC for clearing. Settlement will remain at CDS Clearing.

4 CDS's shareholders are the six large Schedule 1 banks (66.7%), the Investment Industry Regulatory Organization of Canada (15.2%) and the TMX Group (18.1%).

5 http://www.bankofcanada.ca/en/financial/financial_leg.html#1

6 http://www.bankofcanada.ca/en/financial/financial_leg.html#2

7 The predecessor system to CDSX, the Debt Clearing System (DCS), was also designated under the terms of the PCSA.

8 Phase 1 implementation is currently scheduled for October 24, 2011.

It is relevant to note that the listing and trading systems operated by the TMX Group, the other exchanges and alternative trading system (ATS) operators, while being strategically important, are not considered as systemically important for the effective functioning of the Canadian capital markets (i.e., it is the clearing and settlement systems that are designated, not the trading systems). For this reason, combined with the experience and lessons learned through the 2008 financial crisis, CDS believes that considerable attention needs to be paid to the impact of the proposed merger on the clearing environment in Canada in addition to the other post-trade functions (i.e., settlement, custody and client record-keeping).

### Current post-trade clearing environment in Canada

Clearing in the post-trade environment in Canada is currently split between the cash market which is handled by CDS Clearing and the derivatives market which is largely handled by CDCC. Once the development work is completed and implementation has taken place, CDS and CDCC will share responsibility for clearing certain fixed income trades. CDCC will act as the central counter-party for these trades.

CDS Clearing operates in an "open" environment, meaning that trades are accepted from all approved exchanges and alternative trading systems. CDS is neither organizationally nor corporately aligned with, or within, any other legal entity. The other major clearinghouse in Canada, CDCC, is wholly-owned by the TMX. At the moment, CDCC exclusively clears derivative trades that are executed on the Montreal Exchange ("ME"), which is also wholly-owned by the TMX.

### Post-trade settlement environment in Canada

Trade settlement (i.e., the exchange of a security position between a seller and a buyer against payment) is performed by CDS Clearing, including the settlement of derivative trades requiring the movement of securities between seller and buyer. Since the vast majority of trade settlement occurs electronically against security positions that are maintained in custody ledgers held by CDS Clearing, the trade settlement function is considered to be inextricably linked to the depository system owned and operated by CDS Clearing.

### Clearing and settlement systems and market competitiveness

Clearing and settlement systems are characterized by high fixed costs and low variable costs. The high fixed costs are a result of the degree of technology and automation that is required to efficiently process the volume of trades that are typical in today's environment. Consequently, scale is highly relevant to the per-unit costs in each of these businesses.

In Canada, the volume of equity trades coming from exchanges and alternative trading systems has increased from a daily average of 218,000 trades in 2005 to a daily average of 1,447,360 trades in the first quarter of 2011, an increase of 6.6 times. Over the same period, the price of clearing an exchange trade has gone from 18 cents per trade in 2005 to less than 1 cent per trade today, a difference of more than 18 times, amply reflecting the economies of scale and price efficiencies that can be achieved if appropriate cost management and governance processes are in place.

Given the economy of scale advantages that are available to the operator of a clearing and settlement system, the question becomes who receives the benefit of these advantages? In Canada, through the operation of CDS Clearing on a cost-recovery basis, the advantages gained in the processing of cash market trades are passed through to industry participants in the form of volume discounts, year-end rebates and annual price reductions, thereby contributing to the overall competitiveness of the market. In other markets, where the clearing and settlement functions are aligned with the trading platform operator, the benefits are often retained for the benefit of the shareholders. In a pricing study recently conducted by CDS[9], it is apparent that the lowest pricing comes in markets where the clearing and settlement operator is an industry utility operating on a cost-recovery basis. Trading platform operators that are publicly owned and that also own the associated clearing function tend to generate a significant portion of their overall profitability from the clearing function.

## Possible effects of the merger

CDS continues to have the same concerns vis-à-vis changes in the clearing landscape that were expressed in its submission to the Autorité des marchés financiers (AMF) in 2008 when the TSX Group Inc. sought to merge with the ME to create the TMX. In addition, the fact that the clearing system operated by CDCC is planned to be designated by the Bank by the end of 2011 as being systemically important to the Canadian financial system raises systemic risk issues that were not present in 2008.

In their public statements on the future direction of the merged entity, both the TMX and the LSE have indicated that the merged entity will expand its clearing capacity.[10] Given the revenue growth and cost synergies that need to be achieved to make the proposed merger economically worthwhile to its shareholders, the merged entity may well look to put in place a uniform clearing process in each of the markets within which it operates and will want to own the clearing process(es).[11] It is CDS's view that the creation of a wholly-owned clearing function by the merged entity to serve the cash equities market will almost certainly increase the aggregate cost of clearing services in the Canadian market to the detriment of the market's competitiveness. The bifurcation of the clearing process between CDS Clearing and the merged entity and the resultant loss in scale will lead to an overall increase in clearing costs and possibly in other post-trade costs. Whereas merging the listing and trading capacities of the two exchanges may lead to enhanced scale, it is possible that extending the services provided by the merged entity will have the opposite effect in the post-trade processing environment, particularly trade clearing.

## Competitive clearing environment

CDS has serious reservations about having more than one clearing process per asset class and the resultant loss in scale and cost efficiency. However, CDS recognizes that a competitive clearing environment in Canada may well develop in both the cash and derivatives market space. Before the TMX/LSE merged entity is permitted to assume responsibility for the clearing of cash equity market trades created on its own trading platforms there should be a full regulatory examination of a number of important policy issues, such as:

- oversight of a systemically important system
- trade ownership
- switching costs to market participants
- intellectual property rights in the post-trade processing environment
- open access and pricing
- clearinghouse ownership and governance.

9 The results of this price study are available on CDS's website at www.cds.ca.

10 "The Merged Group will also aim to create further post-trade processing efficiencies along the lifecycle of a trade through improving and expanding LSEG's and TMX's post-trade offering. Both Montreal's and Borsa Italiana's strong regional post-trade operations provide capabilities across asset classes that can be used to develop international post-trade solutions in exchange-traded and OTC markets." http://www.londonstockexchange.com/about-the-exchange/media-relations/press-releases/2011/tmxandlsegjoinforces.htm

11 It is certainly possible that there could a separate clearing system for derivative trades from that used for cash trades.

## Oversight of a systemically important system

To understand the concerns expressed in this section on the implications of having a systemically important system owned, directly or indirectly, by a publicly owned, for-profit, foreign entity, it is important for the reader to understand the scenario that CDS anticipates occurring once the merger has taken place. The anticipated scenario has two important dimensions:

1. the merged entity will look to put in place and maintain a uniform clearing system to serve all of the markets within which it operates.
2. the merged entity will subsequently expand into other markets beyond London, Toronto, Montreal and Milan through further mergers and/or acquisitions.

The concern over a uniform clearing system centres on the allocation of scarce resources in the maintenance of this system, particularly since the system will have been designated as systemically important to the Canadian financial system. Practically, and for the sake of efficiency, the maintenance team for the uniform clearing system is most likely to be in a single geographic location. The demands of each market for changes to the clearing system will need to be prioritized, scheduled and implemented. Regression testing to ensure that changes requested by one market do not adversely affect other markets would be an important consideration in the change management methodology that would need to be put in place. If the clearing system is not maintained in Canada for all markets, the complexities of ensuring that Canadian demands on the clearing system are given the necessary priority and attention will become even more difficult, perhaps even impossible. Consequently, it would appear prudent for regulators to insist that the maintenance of any systemically important clearing system operated in Canada remain in Canada and that the Canadian regulators are made aware of any use of the clearing system in other markets and the conditions that are to apply in this multi-market environment.

## Trade ownership

There are a number of possibilities when considering the question of who “owns” a trade after it has been created on an organized trading platform. Possible owners are the participants to the trade or the market operator (i.e., the exchange or alternative trading system operator). Regulators could also provide direction through the issuance of a requirement to direct clearing activity based upon the lowest cost of execution.

It is CDS’s view that the market participants and not the trading platform operators own the trades and should, therefore, be able to decide on the destination of the trade for clearing purposes. This is the position that has been taken in Europe via the Markets in Financial Instruments Directive (MiFID) and the *Code of Conduct*, albeit with slower results than anticipated. Allowing participants to choose the clearing destination would likely also be consistent with any regulatory directive towards the lowest cost of execution since cost would be a primary criterion when participants are deciding on which clearing process to use.

## Switching costs to market participants

The only way that participant switching costs to a new clearing process can be avoided or at least minimized is if the new clearing process behaves identically to the current CDSX clearing process. Even then, it will be necessary for industry-wide testing of the revamped clearing process, including inter-operability between clearing houses, to ensure that the insertion of the new system into the clearing and settlement process does not produce unintended consequences within either CDSX or the participants’ systems of books and records. Participants should not be forced to incur these switching costs because of a unilateral decision made by a trading platform operator. If participants are given the choice of where to send trades for clearing, participants will thereby be given the choice of whether or not to incur the switching costs.

## Intellectual property rights

As indicated in the previous point about switching costs, CDS has a great deal of intellectual capital invested in the design of the post-trade processing environment in Canada, including the clearing functions that comprise a substantial part of CDSX. Part of this intellectual capital is the interaction between CDSX, its participants and the various external systems operated on behalf of participants (often referred to as the “plumbing”). CDS has designed message formats and file formats to enable this interaction to take place in a predictable, repeatable way. CDS’s intellectual property rights would need to be preserved should the merged entity want to enter into the clearing of cash market trades. The merged entity would either need to license these intellectual property rights from CDS or redesign the post-trade processing environment and thereby potentially increase the switching and on-going operating costs to the industry.

## Open access and pricing

In a competitive clearing environment, it is possible that a participant would want to send a trade to a clearinghouse that is not associated with the trading platform upon which the trade was created. It is also possible that the selected clearing system would be associated with a competing trading platform.

In order to avoid cross subsidization between trading and clearing costs and thereby ensure a level playing field in a competitive trading and clearing environment, it is recommended that the regulators consider a requirement for all clearing houses, including CDS and any clearing house owned by the merged entity, to provide an open access whereby clearing services are offered on equal pricing terms to any participant irrespective of the trading platform used.

## Clearing house ownership and governance

Upon completion of the proposed merger, the two board seats and 18.1 per cent ownership interest in CDS that are currently controlled by the TMX would be controlled by the merged entity. CDS would find itself in an untenable position if the merged entity decided to offer an alternative clearing service to CDSX for cash market equity trades. CDS and the merged entity would then be in direct competition. Consequently, should the merged entity decide to offer clearing service for cash market equity trades, it should be required to divest itself of its current 18.1 per cent ownership of CDS and its two board seats, concurrent with the introduction of its own clearing service.

## Conclusion

While it is entirely appropriate to focus on the strategic importance of the listing and trading services provided by the TMX in determining the desirability of allowing a merger with the LSE, the potential impact of this merger on the post-trade activities of clearing, settlement, custody and client accounting are critical to the safe and efficient functioning of the Canadian financial system. As indicated earlier in this submission, it is the clearing and settlement systems that are considered to be of systemic importance to the Canadian capital markets rather than the listing and trading services. Should the merger be allowed to proceed, consideration should be given to the following:

1. The provincial securities regulators need to examine the implications of systemically important clearing systems being owned, directly or indirectly, by foreign entities and whether conditions need to be placed on such systems to ensure that they are appropriately governed by Canadian regulators.

2. One possible condition that the securities regulators should consider is that any clearing system which is of systemic importance to the Canadian securities markets should be maintained in Canada and any expansion of the role of this clearing system for use in other markets should be approved by Canadian regulators.
3. Regulations should be put in place to facilitate a truly competitive clearing environment. These regulations should include the right for participants to direct trades to the clearing system of their choice, the requirement for approved clearinghouses to have inter-operable agreements in place and the requirement for clearinghouses to offer open access and equitable pricing.
4. The TMX should be required to divest itself of its shares in CDS and to give up its board seats if the merged entity decides to enter into the clearing of cash market equity trades.

## Submission of CDS Management

In view of the potential or perceived conflicts of interest applicable to a significant number of the directors on CDS's board, this submission is made by the executive management of CDS and is not intended to represent the position of any individual director or the board as a whole. The executive management of CDS will be pleased to respond to any questions that the provincial securities regulators may have on the content of our submission. The undersigned can be reached by telephone at (416) 365-3574 or by e-mail at igilhooley@cds.ca.

Yours truly,

Ian A. Gilhooley

Ian A. Gilhooley
President and Chief Executive Officer

## About CDS Clearing

CDS Clearing and Depository Services Inc. (a subsidiary of The Canadian Depository for Securities Limited) is Canada's national securities depository, clearing and settlement hub - supporting Canada's equity, fixed income and money markets, holding almost C$4 trillion on deposit and handling over 360 million domestic and cross-border security trades annually. CDS's ongoing commitment to minimise risk for market participants and its sophisticated credit risk model have earned it a top global ranking from Thomas Murray, the specialist custody rating, risk management and research firm.