

CDS Clearing and Depository Services Inc. (CDS®)

MATERIAL AMENDMENTS TO CDS PROCEDURES

CDS TRANSFER AGENT STANDARDS

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED AMENDMENTS

As Canada's central securities depository (CSD), CDS's operations interact with, and are in certain circumstances dependent and reliant on, other marketplace participants, including CDS participants, chartered banks, securities issuers, and transfer agents. As part of the continuous review of our services, systems, and operational linkages, CDS has identified the standards which transfer agents must meet in order to interact with CDS and our systems as an area in need of modernization.

CDS is considered a critical infrastructure to the Canadian marketplace and, as a result of that designation and other financial market regulations to which we are subject, CDS must adhere to the Principals for Financial Market Infrastructures (PMFIs) as defined by the Committee on Payments and Market Infrastructures of the International Organization of Securities Commission (CPMI-IOSCO). Where warranted, CDS's participation and access standards must ensure that external parties do not pose undue external operational risks to CDS, or to our stakeholders, through their use of our systems.¹ CDS must also demonstrate proactive leadership towards upholding and improving the integrity of the marketplace by reviewing and, where necessary, enhancing existing standards.

CDS has identified several important operational risks with respect to our direct interaction with transfer agents. These risks are as follows:

- CDS's eligibility, entitlement processing, and transfer operations are reliant on transfer agents' existing internal controls in mitigating the possibility of fraudulent or negligent securities transfer-related activities.
- CDS does not currently have the ability to require, or ensure, the independent verification of appropriate internal controls within transfer agencies.
- In contrast to CDS's other stakeholders, there is currently no capital requirement imposed on transfer agencies by CDS or otherwise.²
- CDS does not currently require proof of insurance coverage from CDS-approved transfer agents.

The proposed standards, which will be included in the CDS Transfer Agent Procedures³, are intended to expand the regulatory, information provision, operational, and capital adequacy requirements imposed on CDS-approved transfer agents. The proposed standards enhance the quality of safekeeping of security-holder assets, bolster anti-fraud provisions, and ensure the existence of business continuity and disaster recovery plans within CDS-approved transfer agents⁴.

¹ PFMI 17 – Operational Risk Key Consideration 17.7 “An FMI should identify the plausible sources of operational risk, both internal and external and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfillment of the FMI's obligations, including in the event of a wide-scale or major disruption.”

² Also known as regulatory capital or capital adequacy, capital requirements govern the ratio of equity to debt recorded on the liabilities and equity side of a firm's balance sheet and represent an amount a bank or other financial institution has to hold to ensure that these institutions do not take on excess leverage and become insolvent.

³ CDS Clearing and Depository Services Inc., Transfer Agent Procedures, Release 10.1 – April 7, 2014, which apply to transfer agents having signed the *Transfer Agent Agreement* and/or the *Application to Participate as Limited Purpose TA Participant* (part of the application for participation).

⁴ CDS Rule 2.2.8 *Additional Qualifications and Standards* – “CDS may set additional qualifications and standards for participation in any Service or any Function. Without limiting the generality of the foregoing, such qualifications and standards may relate to segregation of duties, qualification of personnel, internal controls and risk assessment, monitoring, communication with CDS, and any of the matters listed in Rule 2.2.7. CDS shall give notice to Participants of such qualifications and standards and of any changes to such qualifications and standards, and shall provide Participants with a reasonable time to comply with such qualifications and standards.”

CDS does not propose to amend existing transfer agent processes or the general roles that the transfer agents fulfil within the CDS environment. Rather, the proposed amendments are more appropriately made pursuant to CDS Participant Rules 2.2.7 (Standards for Participation) and 11.2.3 (Transfer Agent Participant Standards).

Background

A transfer agent is a trust company, a bank, or an intermediary that is appointed by a securities-issuing entity to maintain the issuer's records relating to its investors, their account balances and transactions, to issue and cancel securities certificates, to process investor mailings, and to resolve other investor-related issues (i.e., lost or stolen certificates). Publicly-traded companies, mutual funds, and similar entities are often widely-held, as are debt securities issued in the Canadian market. While some entities choose to act as their own transfer agents, the majority engage (or are required by securities legislation to engage) a third-party financial institution to maintain security-holder records.

Transfer agents perform four main functions on behalf of securities issuers:

1. Transfer agents issue and/or cancel securities certificates to reflect changes in ownership of those securities. When a company declares a stock dividend or stock split, for example, the transfer agent issues these new shares on the instruction of the issuer.
2. Transfer agents maintain a continuous record of the registered holders of an issuer's securities. These records, known as the securities register, identify which entity or individual owns an issuer's securities and, further, describe how those securities are held—whether by a beneficial owner in certificate form, by CDS in book-entry form, or by an investor's brokerage firm in street name.
3. Transfer agents act as a communication intermediary on behalf of securities issuers. A transfer agent may also serve as an issuer's paying agent (to pay out interest, cash and stock dividends, or other distributions to security holders), as an issuer's proxy agent (ensuring the distribution of proxy-related materials), as an issuer's exchange agent (when exchanging issuer's securities in the context of a merger), as an issuer's tender or depository agent (tendering or receiving tendered shares in the context of an offer), or as an issuer's mailing agent (mailing the company's quarterly, annual, and other reports).
4. Transfer agents replace and reissue lost, destroyed, or stolen certificates.

In the Canadian context:

- Transfer agents which are not a bank⁵ or a trust company⁶ in Canada (and are therefore not subject to prudential regulation by the Office of the Superintendent of Financial Institutions (OSFI) do not fall within the jurisdiction of any single regulatory agency.
- While provincial securities law considers transfer agents to be “market participants” (and therefore subject to the jurisdiction of the provincial securities commissions), transfer agents are only subject to the “general obligation to keep records”.⁷
- Independently owned and operated transfer agents, whether or not they are Limited Purpose Transfer Agent Participants in CDS, are not *prudentially* regulated by OSFI⁸ or under provincial law.
- While the majority of transfer agents are members of the Securities Transfer Association of Canada (STAC)⁹, STAC remains a private trade organization which is neither a federal nor provincial regulator of transfer agents, is not a self-regulatory organization, and does not guarantee or provide protection to transfer agent clients or other market participants.
- Transfer agents are not currently required to meet the Canadian Standard on Assurance

⁵ Canadian banks are created and regulated pursuant to the Bank Act S.C. 1991, c.46

⁶ Canadian trust companies are created and regulated pursuant to the Trust and Loan Companies Act (S.C. 1991, c.45)

⁷ For example, Section 1 of the Securities Act (Ontario) defines “market participant” as including “... a transfer agent or registrar for securities of a reporting issuer...”

⁸ OSFI – “Office of the Superintendent of Financial Institutions, who they regulate”: <http://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx>

⁹ <https://www.stac.ca/Public/AboutUs.aspx>

Engagements (CSAE) 3416 Standard or any equivalent internal controls benchmark.

B. NATURE AND PURPOSE OF THE PROPOSED CDS TRANSFER AGENT STANDARDS

CDS proposes to implement additional standards which will be applied, after regulatory approval, to prospective CDS-approved transfer agents as part of our operating Procedures.

The following proposed standards will be applied in addition to the standards outlined in CDS Participant Rule 11- Limited Purpose Transfer Agent Participants, or as may be described in the non-participant Transfer Agent Agreement between a transfer agent and CDS.

Transfer Agent Standard	CDS-approved Transfer Agent	Existing CDS-approved Transfer Agent	Limited Purpose Transfer Agent Participant/ Trust Company	Non-participant Transfer Agent
1. Be a Trust Company under the <i>Trust and Loan Companies Act</i> , and be regulated by OSFI	Either #1 or #2	See Note below	Either #1 or #2	Either #1 or #2
2. Be a financial entity regulated by a provincial regulatory body or an appropriate SRO	Either #1 or #2	See Note below	Either #1 or #2	Either #1 or #2
3. Execute a Transfer Agent Agreement				✓
4. Provide CDS on an annual basis with evidence of good standing, in the form of a letter, certificate, or other acceptable document issued by the Transfer Agent's primary regulator	✓		✓	✓
5. Provide annual third party verification that appropriate operational controls are in place that are consistent with those to meet Canadian Standard on Assurance Engagements (CSAE) 3416 Standard requirements		✓		
6. Maintain a Financial Institution Bond (FIB) acceptable to CDS, the size of which may vary according to the operations of the transfer agent	✓	✓	✓	✓
7. Be appointed or engaged to act as the transfer agent for a minimum of ten (10) CDSX-eligible security issues, or a minimum of 5 issuers that have issued CDSX-eligible securities, at all times	✓		✓	✓
8. Provide annual audited financial statements to CDS	Upon Request	✓	Upon Request	Upon Request

Note: Existing CDS-approved transfer agents that are not Trust Services companies regulated by OSFI, or an appropriate SRO or government agency, will not be required to obtain a trust service license. Existing CDS-approved transfer agents will, however, be required to provide:

1. Annual third party verification that appropriate operational controls are in place that are consistent with those required to meet the requirements of the Canadian Standard on Assurance Engagements (CSAE) 3416 Standard
2. Financial Institution Bond (FIB)
3. Annual audited financial statements

Non-Participant Transfer Agents under a Transfer Agent Agreement

The existing Transfer Agent Agreements all refer to, and incorporate by reference, the Transfer Agent Procedures (as they may be amended from time to time). The proposed amendments to the procedures will apply to those entities operating under a Transfer Agent Agreement

The proposed standards ensure

- PFMI Compliance – PFMI Key Control 17.7 requires an FMI to identify, monitor, and manage the risks that key participants, other FMIs, and service and utility providers might pose to its operations.
- CDS operates within its established risk appetite; the proposed standards for transfer agents mitigate operational and financial risk spillover to CDS.
- Application of uniformed standards for transfer agents that interact with CDS on an operational level.
- Reduction of operational risks via the implementation, review, and monitoring of, cyber security standards, Business Continuity standards, fraud prevention processes, and internal controls to ensure the integrity of transfer agent and issuer records.
- Financial discipline by transfer agents through adherence to applicable capital adequacy requirements and in order to maintain good standing, a transfer agent's Financial Institution Bond (FIB) and mitigate operational risks.
- Reduction of the risk of fraudulent securities issuance and transfer-related activity.
- CDS maintains a leadership role in ensuring marketplace integrity.

C. IMPACT OF THE PROPOSED AMENDMENTS

Limited Purpose Transfer Agents and non-Participant Transfer Agents seeking registration as trust companies may experience delays in receiving the requested approval(s), which most often results from the complexities presented in the application, the provision of incomplete information by the applicant in support of the application, and/or a failure on the part of the applicant to sufficiently address additional information requests from OSFI in a timely manner.

Competition

CDS does not expect that the proposed amendments will have a material impact on CDS-approved Transfer Agents or on the existing, competitive marketplace for transfer agency and/or registrar services. CDS has taken significant care in the formulation of the proposed standards to ensure that transfer agent entities are treated equally while simultaneously hewing to CDS's critical risk management and mitigation requirements.

Risks and Compliance Costs

IOSCO/PFMI guidelines require CDS to identify internal and external sources of operational risks. CDS operates a robust risk management program that includes a focus on general financial and operational risks. Requiring Limited Purpose TA Participants and non-participant transfer agents to comply with operational risk management guidelines applicable to trust companies will help CDS better understand and be comfortable with the external operational risk posed by Transfer Agent participants.

Financial Risks – CDS Participant Rule 11.2.4 prohibits Transfer Agent participants from participating in the settlement process, from using or offering Lines of Credit, or from using CDSX's functionality. Transfer Agent participant activities, therefore, do not impose any financial risks to CDS or to primary Participants.

Operational Risks – The proposed Transfer Agent Standards will require Transfer Agent Participants submit to oversight by a primary regulator. Regulated entities are generally required to implement certain operational risk management practices (as outlined, for example, in the draft OSFI Operational Risk

Management Guidelines covering federally-regulated financial institutions). Adhering to those guidelines will help TA Participants manage their operational risks to an acceptable level, which in turn helps mitigate the impact of operational risks the Transfer Agent Participants pose to CDS as external entities.

Comparison to International Standards

As noted above, CDS's compliance with the PFMI (and with any domestic regulation that gives such principles the force of law) is of primary and critical import to CDS as Canada's CSD.

The proposed standards constitute the operationalization of PFMI Key Control 17.7 of Principle 17 – Operational Risk.

D. DESCRIPTION OF THE DRAFTING PROCESS

Development Context and Drafting Process

Subsequent to an internal review, the CDS Board of Directors approved the implementation of additional standards for both Limited Purpose Transfer Agent Participants and transfer agents subject to a Transfer Agent Agreement.

CDS procedure amendments are developed by CDS's Business Development group, and subsequently reviewed and approved by CDS's Strategic Development Review Committee (SDRC). The SDRC reviews, prioritizes and oversees CDS-related systems development and other changes proposed by

Participants and CDS. The SDRC's membership includes representatives from a cross-section of the CDS participant community and meets on a monthly basis.

The proposed standards, and these amendments, were reviewed and approved by the SDRC on July 21, 2016.

Issues Considered

CDS undertook to develop any necessary changes to permit the implementation of the revised standards. The foregoing standards are to be applied *in addition to* the participation standards as outlined in CDS Participant Rule 11 and, more specifically, Rule 11.2.3.

Generally, Rule 11.2.3 requires that a Transfer Agent Participant (or, by virtue of the Transfer Agent Agreement, non-Participant transfer agents) demonstrate its capacity accurately to fulfill its commitments to, and operational requirements of CDS and our Participants; maintain a sufficient duty of care in restricting network access to CDS; maintain appropriate security precautions with respect to authentication and credentials; and maintain appropriate security standards in respect of information exchange with CDS and with our Participants.

Consultation

The approval to proceed with the implementation of the proposed standards was given by the CDS Board of Directors on May 5, 2016. On April 25, 2016 CDS met with representatives of the Securities Transfer Association of Canada (STAC) to review the proposed standards, and agreement with this proposal was received on July 5, 2016 from STAC's senior representative. The proposed standards, and these amendments, were reviewed and approved by the SDRC on July 21, 2016.

Implementation Plan

Transfer agents seeking participation with, or approval by, CDS that are unable to provide the required evidence of compliance with the proposed standards will not be eligible either as a Non Participant Transfer Agent under a TA Agreement or a Limited Purpose Transfer Agent Participants/Trust Company.

Prospective Transfer Agents will be required to meet the Transfer Agent Standards.

The amendments to the procedures will become effective upon approval by CDS's recognizing regulators (as described below) following public notice and comment.

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*.

E. TECHNOLOGICAL SYSTEM CHANGES

CDS, CDS Participants and Other Market Participants

No technological system changes are required in order to implement the proposed standards.

F. COMPARISON TO OTHER CLEARING AGENCIES

By contrast to the Canadian marketplace, transfer agents in the United States must register with, and are regulated by, the United States Securities & Exchange Commission (SEC)¹⁰ and are subject to the reporting and other requirements of the Depository Trust & Clearing Corporation (DTCC). CDS's proposed standards are intended to ensure that the requirements of the Canadian marketplace reflect, to the extent possible, a similar degree of regulation, oversight, and reporting. The U.S. regulatory framework is also in flux.

On December 15, 2015, for example, The Securities Exchange Commission proposed key changes (see below) to Transfer Agent (TA) Rule 30c-3 (refer to Release no. 34-76743, File No. S7-27-15). The last revisions adopted were in 1977 and the rules have remained essentially the same since. The release includes proposed rulemaking in specific areas such as transfer agent registration, reporting requirements, safeguarding of funds and securities, revision of obsolete or outdated rules, in addition to addressing processing of book-entry securities, broker-dealer recordkeeping for beneficial owners, transfer agents to mutual funds, and administration of issuer plans. Key proposed transfer agent rule changes are as follows:

- Expand information collected by Forms TA-1 and TA-2; provide in electronic format to enhance aggregation, comparison and analysis.
- Arrangements between a registered TA and an issuer be set forth in a written agreement addressing TA services to be provided, fee schedule, and requirements for handing over TA records to the successor TA.
- Enhance requirements for the safeguarding of issuer and security holder funds and securities.
- Anti-fraud provision to specific activities of TA's.
- Require plans for business continuity and disaster recovery.
- Establish procedures regarding the use of information technology, including safeguarding personally identifiable information.
- Revise recordkeeping requirements to fully capture the scope of a TA's business activities.
- Conform and update various terms and definitions to reflect modern systems and usage; eliminate obsolete rules.

¹⁰ In the United States, section 17A(c) of the *Securities Exchange Act of 1934*, 48 Stat. 881, 15 USC. § 78a [*Exchange Act*] requires that transfer agents be registered with the SEC, or if the transfer agent is a bank, with a bank regulatory agency. The SEC has enacted rules for all registered transfer agents which include minimum performance standards. The SEC also conducts inspections of transfer agents. See Securities and Exchange Commission, "Transfer agents", online: <http://www.sec.gov/divisions/marketreg/mrtransfer.shtml>.

G. PUBLIC INTEREST ASSESSMENT

CDS has determined that the proposed amendments are not contrary to the public interest.

H. COMMENTS

Comments on the proposed 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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Email: fdaly@cds.ca

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 TRANSFER AGENT STANDARDS AMENDMENTS

Access the proposed amendments to the CDS Procedures on the User documentation revisions web page at <http://www.cds.ca/cds-services/user-resources/user-documentation>.