CDS Clearing and Depository Services Inc. (CDS®)

MATERIAL AMENDMENTS TO CDS PROCEDURES

AMENDMENTS RELATED TO THE INTRODUCTION OF A CNS PARTICIPANT DEFAULT FUND

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the CDS Participant Procedures ("Amendments") relate to the operation of the newly created Participant Default Fund ("Default Fund"). This Notice describes technical details to be included in the CDS Participant Procedures ("Procedures"). Corresponding changes to the CDS Participant Rules ("Rules") are described in the "Material Amendments to CDS Rules. Amendments Related to the Introduction of a CNS Participant Default Fund," to be published concurrently with this Notice.

CDS's Recognition Orders require the observance, as soon as possible, of the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMI"). Further to PFMI self-assessments submitted by CDS to its regulators, CDS identified the need to create a default fund. Under the PFMIs, default funds are fundamental risk management tools for CCPs. They are prefunded default arrangements composed of assets that have been contributed by a CCP's participants and which may be drawn upon by the CCP in certain circumstances to cover losses or liquidity pressures resulting from participant defaults.

Timely observance of the PFMIs by CDS is required by CDS's regulators under its recognition order requirements:

- Autorité des Marchés Financiers: Reconnaissance de Services de dépôt et de compensation CDS inc. à titre de chambre de compensation en vertu de la *Loi sur les valeurs mobilières,* L.R.Q., c. V-1.1 – Part III, paragraph 43.1
- Ontario Securities Commission The Canadian Depository for Securities Limited and CDS Clearing and Depository Service Inc. Order; Section 144 of the Act, the Current Recognition Order – Part II: (Terms and Conditions Applicable to CDS Ltd. and CDS Clearing), Paragraph 9.1
- British Columbia Securities Commission requires CDS to comply with the terms and conditions of the order of the Ontario Securities Commission.

Proposed Amendments

Under the proposal, CDS's CNS Function will have a simple "waterfall" structure to protect itself and its members from losses due to a CNS Participant default. The CNS default waterfall will be designed with the following collateral funds:

1. CNS Participant Fund Collateral

   As an established component of the CDS Risk Model, the CNS Participant Fund collateral is composed of the square root sum of squares of (i) the CNS outstanding position component collateral and (ii) the CNS mark-to-market ("MTM") component collateral, as described below:

- CNS Outstanding Position Component Collateral: Collateral to cover losses incurred in the unwinding of a defaulting participant's outstanding positions. The amount of collateral is determined using a Value-at-Risk ("VaR") approach, and is set to cover all losses up to a 99% confidence level in normal market conditions. This means that, for a given participant, the probability of losses exceeding their posted collateral is 1%.

- CNS MTM Component Collateral: Collateral to cover unpaid MTM.

2. CNS Default Fund Collateral

Losses arising from a CNS Participant default will first be covered by the defaulting Participant's CNS Participant Fund collateral. Uncollateralized losses will then be charged against the defaulting Participant's CNS Default Fund collateral.

- CNS Default Fund Collateral: CNS Participants contribute collateral to the CNS CCP Default Fund.

If the defaulter's CNS service collateral is fully exhausted CDS will then look to the surviving CNS Participants to cover any residual losses. Residual losses will be allocated pro-rata to the surviving CNS participants the allocation will be in the form of a call to fund the loss allocation.

The size of the Default Fund will be determined by first accumulating CNS stress losses for the prior quarter, ranking the losses from smallest loss to largest loss and identifying the largest stress loss. For instance, the largest 0.5% of the ranked stress losses is equivalent to the 99.5% Tail VaR. Next, an average of the prior two months will be calculated to ultimately determine the size of the CNS Default Fund. A two-month equally-weighted moving average is likely to be less procyclical and less volatile than using a month-by-month methodology.

Once the size of the Default Fund has been determined, each CNS Participant will make a pro-rata contribution to the Default Fund based on their average CNS collateral requirement for the prior two months.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the Procedures align corresponding changes to CDS's Participant Rules and CDS's Risk Mode.

Participating in CDS Services

Section 14.2: Central Counterparty Funds. The Amendments describe risks which the CNS Participant Fund and the CNS Default Fund are designed to mitigate.

Chapter 16: CNS Participant & CNS Default Funds. The Amendments describe risks the CNS Participant Fund and the CNS Default Fund are designed to mitigate, collateral eligibility and the calculations used to determine collateral requirements.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

(a) CDS Clearing – The Amendments will ensure CDS's observance of the PFMIs and adoption of a recognized international standard for market infrastructures. The Amendments will also enhance risk management by fortifying CDS's waterfall structure.

(b) CDS Participants – The Amendments will benefit Participants by providing them with access to a market infrastructure that meets global standards.

(c) & (d) Other Market Participants and Securities and Financial Markets in General – The Amendments will help mitigate systemic risk to Canadian capital markets

C.1 Competition

The Amendments apply to all CDS Participants who currently use, or may choose in the future to use, the CNS CCP service. From a fair access perspective, no CDS Participant will be disadvantaged or otherwise prejudiced with the introduction of these changes.

C.2 Risks and Compliance Costs

The Amendments to the processing of a CNS CCP service Participant default will result in changes to CDS's Risk Model and the resulting management of financial risks in CDS's clearing, settlement and depository services. CDS does not foresee other risks or compliance costs accruing to CDS Participants or other stakeholders.

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

The PFMIs are minimum international standards for enhancing the safety and efficiency of clearing, settlement and recording arrangements. The standards aim to limit systemic risk and foster transparency and financial stability. They apply to CCPs, central securities depositories ("CSDs") and security settlement systems ("SSS"). CDS engages in all three of these market infrastructure activities. According to the terms of CDS's recognition order requirements, CDS is required to observe PFMIs as soon as possible.

PFMI Principle 4 (Credit Risk) states that a CCP "should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions."[1] A CCP should cover a residual portion of its losses with non-defaulting participants' resources through a pooling-of-resources arrangement, such as a default fund.[2]

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

CDS prepared documents describing the proposed CNS Default Fund risk mitigation strategy which were tabled at the Risk Advisory Committee ("RAC"), a CDS Participant committee that meets monthly.

[1] CPSS-IOSCO, "Principles for financial market infrastructures" (April 2012), Principle 4.
[2] *Ibid.*, "Approaches to loss allocation" p. 157.

D.2 Procedure Drafting Process

The Amendments will be presented to the Strategic Development Review Committee ("SDRC"). The SDRC reviews proposed Procedure changes that may have operating or systems development implications to Participants, and the SDRC may propose additional or alternative system or operating changes to CDS. The SDRC's membership includes representatives from a cross-section of the CDS Participant community which meets monthly.

D.3 Issues Considered

Consideration was given to the operational impacts that the enhancements might create for CDS Participants as outlined in section C of this Notice.

D.4 Consultation

This Amendment was initiated by CDS. CDS received input from the RAC on the concept and methodology underlying this Amendment, while the LDG commented on its legal drafting. The SDRC is expected to comment on the operational aspects of this Amendment as described in "Material Amendments to CDS Procedures. Amendments Related to the Introduction of a CNS Participant Default Fund" to be published concurrently with this Notice.

CDS Customer Service account managers will provide ongoing communication and status updates of proposed changes to clients and will solicit input on those changes.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings and monthly meetings with service bureaus to discuss potential development impacts to them. As a courtesy, development initiatives are presented to the Investment Industry Regulatory Organization of Canada's ("IIROC") Financial Administrators Section ("FAS") working group.

D.5 Alternatives Considered

Alternatives with minor variations on the proposed waterfall were considered. The proposed methodology is the result of input received from the members of the RAC.

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®, 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".

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 SYSTEM CHANGES

E.1 CDS

There are no technological system changes required by CDS.

E.2 CDS Participants

There are no technological system changes required by CDS Participants.

E.3 Other Market Participants

There are no technological system changes required by CDS Participant service bureaus.

F. COMPARISON TO OTHER CLEARING AGENCIES

A similar mechanism is used by the National Securities Clearing Corporation ("NSCC"), the securities CCP in the United States. Rule 4 of the NSCC "Rules & Procedures" (August 8, 2014) discusses "Clearing Fund" which is NSCC's equivalent CDS's proposed Default Fund. Further commentary is provided in the "NSCC Member Handbook" (December 2013) which confirms that where a deficiency remains, "NSCC would satisfy the deficiency by utilizing the Clearing Fund and assessing its Members as provided in its Rules. The process, in general, allocates any remaining liabilities pro rata among the non-defaulting Members based upon the Member's usage of the service to which the loss relates."

Default fund is a fundamental concept in the PFMIs. It is expected to be universally adopted amongst PFMI observing CCPs worldwide. Many CCPs already have such a fund in place CDS compared the method used to the determine the Default Fund to its global peers and found that it was consistent with the implemented practices or practices intended to be implemented of other CCPs. In fact, a default fund is a common feature of most other CCPs worldwide (e.g. Singapore's CDP "Clearing Fund" in Rule 7 and Eurex Clearing AG "Lines of Defence waterfall in Rule 6).

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 to:

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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:

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CDS will make available to the public, upon request, all comments received during the comment period.

I. PROPOSED CDS PROCEDURE AMENDMENTS

Access the proposed amendments to the CDS Procedures on the User documentation revisions web page (http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-UserDocumentation?Open).