CDS Clearing and Depository Services Inc. (CDS®)

Proposed Amendments to CDS Fee Schedule re CNS Liquidity Facility

NOTICE AND REQUEST FOR COMMENT

DESCRIPTION OF THE SERVICE AND PROPOSED AMENDMENTS TO FEE SCHEDULE

CDS proposes to amend its Fee Schedule for certain services which have been, and are currently, provided to CDS Participants. As a recognized clearing agency under the Ontario *Securities Act* and the British Columbia *Securities Act*, and a recognized clearing house under the Quebec *Securities Act,* CDS is providing this Notice and Request for Comment in accordance with the recognition requirements of each of these jurisdictions. CDS is requesting regulatory approval for the proposed pass-through charge related to central counterparty clearing Continuous Net Settlement service (“CNS Service”) pursuant to Sections 7.6 and 7.8 of Schedule B – Terms and Conditions of the Ontario Securities Commission’s (“OSC”) Recognition Order, pursuant to Articles 26.6 and 26.9 of Recognition Decision 2012-PDG-0142 of the *Autorité des marchés financiers du Québec* (“AMF”), and pursuant to Section 9 of the British Columbia Securities Commission (“BCSC”) Recognition Order, each as amended. A list of the proposed fee schedule amendments appears in Appendix “A” attached to this Notice.

The CNS Services provide CDS Participants who are themselves CNS-eligible with central counterparty (CCP) clearing for transactions in equity securities executed on Canadian exchanges and trading venues.

As a CCP, CDS guarantees settlement of the novated CNS trades and has the contractual obligation to continue settling its participants’ CCP transactions even in the event of a default of one or more of those participants. CDS’s compliance with its domestic regulatory framework, which includes compliance with the Principles for Financial Market Infrastructures (PFMIs), requires that CDS mitigate the liquidity risk resulting from the critical financial services offered, in this case guaranteed settlement. CDS’s liquidity exposure is based on its obligation to step into the shoes of a defaulting participant and make a defaulter’s counterparties whole. The CNS Service liquidity exposure estimate in 2017 was $2 billion, an estimate sized for a 97% degree of confidence with respect to the estimated distribution of potential liquidity exposures under normal market conditions. A 97% degree of confidence is equivalent to less than one observation of per month (on average) in which a liquidity exposure is greater than the FMI’s qualifying liquid resources.

In 2018 this estimate will be adjusted upwards to reflect new Cover 1 standards of 100% confidence under extreme but plausible market conditions.

CDS’s ongoing PFMI review process has determined that existing CDS liquidity is insufficient to adequately mitigate this liquidity risk and, in order to do so, CDS has recommended the implementation of a stand-by credit facility (“the CNS Liquidity Facility”) with a syndicate of Canadian banks in an amount equivalent to the estimated liquidity risk. The CNS Liquidity Facility will include an accordion feature that will allow an on-demand increase to a pre-determined cap level CDS proposes to recover the costs of the CNS Liquidity Facility from the CDS participants who use CNS services, in proportion to the risk that they generate in the system. The implementation of the CNS Liquidity Facility has been recommended by the CDS Risk Advisory Committee and approved by the CDS Board of Directors. CDS has negotiated and implemented the CNS Liquidity Facility, effective as of March 27, 2018, and proposes to implement the proposed fees and fee changes as soon as practicable, subject to regulatory approval.

The proposed pass-through charge is based on the following guiding principles:

1. The Principles for Financial Market Infrastructures require that an FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all

relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under 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 generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions

2. An FMI should have effective operational and analytical tools to identify, measure, and monitor its settlement and funding flows on an ongoing and timely basis, including its use of intraday liquidity.
3. For the purpose of meeting its minimum liquid resource requirement, an FMI's qualifying liquid resources in each currency include cash at the central bank of issue and at creditworthy commercial banks, committed lines of credit, committed foreign exchange swaps, and committed repos, as well as highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions.
4. Fees should comply with CDS's regulatory framework and be equitably allocated.
5. Fees should be based on the service cost and the operational risk of service delivery, and direct costs should be passed on to the users of the service.

CDS has consulted with a wide variety of stakeholders to ensure that the proposed pass-through charge is consistent with the value provided, is easy to understand, is applied uniformly, and reflects the risk management offered by CDS as a central hub for securities processing. The proposed amendments to the CDS Fee Schedule introduce a CNS Liquidity Facility Pass-Through Charge, a charge which represents cost-recovery of the fees paid by CDS to the lending syndicate for the maintenance of the CNS Liquidity Facility.

Subject to regulatory approval and appropriate notice to stakeholders, CDS intends to implement the proposed amendments in the second quarter of 2018 effective from the date of implementation of liquidity facility.

NATURE, PURPOSE AND IMPACT OF THE PROPOSED AMENDMENTS

Background

The implementation of the CNS Liquidity Facility is, as noted above, required to ensure CDS's PFMI compliance, as CDS does not currently have a liquidity facility in place to cover the liquidity risk generated by the CNS Service. The implementation, and continued availability, of the CNS Liquidity Facility will give rise to significant commitment fees payable to the providers of the CNS Credit Facility and will generate a significant expense for CDS. The existing fee structure for the CNS Service, which consists of per-transaction fees for trades and settlements such as exchange trades – reported, CNS eligible exchange trades netted, CNS netted and novated positions, BNS CNS batch settlement and CNS real-time settlement, does not contemplate either the need for emergency liquidity facility, or the means to recover the costs for such a facility; the CNS Service was originally implemented and operated on a cost-recovery basis and the associated fees have not been revised. In consequence, the costs associated with the implementation and maintenance of the CNS Liquidity Facility represents a significant change in circumstances and requires changes to the structure of CDS fees related to the CNS Service.

Proposed Pass-Through Charge

CDS is proposing to implement a pass-through charge to recover the costs associated with the CNS Liquidity Facility. While the proposed changes will affect CDS Participants by increasing the costs for the use of CNS Services, the proposed charge is structured to be revenue-neutral to CDS when taking into consideration the incremental cost of expanding the liquidity facility and diversifying the lenders and do not include any margin or markup on the costs to CDS of the CNS Liquidity Facility.

CDS's costs for the maintenance of the CNS Liquidity Facility will be established on an annual basis by CDS and the syndicate of lending banks, and will be based on the size of the Liquidity Facility and on prevailing credit conditions. CDS estimates that the fees charged to CDS for this facility, for 2018, will be approximately $4 million. These fees will be allocated pro rata amongst CNS participants according to the liquidity risk that they generate through their use of the system. For purposes of this allocation, a participant's generated risk consists of the CNS Participant's average daily buy obligations (long positions), calculated *before* the Batch Net Settlement process, and as measured over the course of the immediately trailing fiscal quarter. As a consequence of this methodology, CDS will not accrue any marginal revenue in the process of assessing the pass-through charge, and is, in effect, underwriting the cost of the liquidity facility on behalf of the CNS Participants.

The proposed fee is calculated by the following formula:

$$\frac{Participant's\ CNS\ Avg\ Daily\ Buy\ Obligation\ during\ prev\ Quarter}{Total\ CNS\ Avg\ Daily\ Buy\ Obligation\ during\ prev\ Quarter} \times Annual\ Liquidity\ Facility\ Fees$$

The proposed charge will be billed quarterly, in arrears, in order to recover the cost of the CNS Liquidity Facility to CDS. The cost of the Liquidity Facility comprises an annual commitment fee paid at the beginning of the term, and an annual standby fee paid monthly. As noted above the costs of the Liquidity Facility will be negotiated annual; for the facility implemented on March 27, 2018 the annual commitment fee is $0.8 million and the annual standby fee is $ 3.2 million (16 basis points, paid monthly). As noted above, in the aggregate, this increased cost represents a significant change to the cost of providing the Services.

The impact on CNS Participants is proportionate to their use of the CNS Service. CDS has estimated the amounts that would have been invoiced to CNS-eligible Participants based on a Liquidity Facility cost of $4 million and on participants' average daily buy obligations for the period Nov 1 2016 to Nov 30 2017. The annual fees allocated to each of the 38 CNS-eligible Participants for this sample 12-month period range from approximately $4,000 to approximately $560,000. The distribution of the costs is as follows:

- Charge distribution:
  - $1000.00 - $10,000.00: 14 CNS Participants
  - $10,000.00 - $30,000.00: Seven CNS Participants
  - $30,000.00 - $75,000.00: Six CNS Participants
  - $75,000.00 - $560,000.00: 11 CNS Participants

For this sample period, large bank dealers bear approximately 61% of the proposed Liquidity Facility Pass-Through Charge.

Competition

The proposed amendments to the Fee Schedule for the CNS Service are not expected to have an impact on competition for CDS or its Participants, whether or not such participants are CNS-eligible, and whether or not the participants in fact use the CNS Service. The Liquidity Facility is being implemented in order to ensure CDS's compliance with the PFMIs and all CNS Participants will be charged proportionate to the liquidity risk that they each introduce into the CNS Service; this allocation principle is consistent with CDS's business practice and with CDS's obligations under its regulatory framework.

CDS has reviewed the specific impact of the proposed amendments on the Canadian Derivatives Clearing Corporation (CDCC) in its role as a participant, and has determined that CDCC, which is neither CNS-eligible nor uses the CNS Service, is not impacted by the proposed amendments.

THE FEE SETTING PROCESS

Development Context

The proposed amendments to the Fee Schedule was submitted to the CDS Participant Fee Committee for review and comment. The CDS Fee Committee recommended CDS's proceeding with the submission of the proposed charge for regulatory approval.

Prior to submission for regulatory approval, the proposed charge was tabled with the CDS Board of Directors for review and comment. The Board made no changes to the proposed charge as presented by CDS management and instructed CDS to proceed to submit the proposed charge for regulatory approval.

Consultation

In preparing the recommendation to introduce the CNS Liquidity Facility CDS consulted with a broad array of stakeholders. Included in the discussion and formation of the recommendation was CDS' Risk Management Committee, the external Risk Advisory Committee, the Risk Management and Audit Committee of CDS' Board of Directors, the CDS Fee Committee, as well as individual discussions with various Participants who use the CNS Service.

Alternatives Considered

The provision of CNS Service is not commercially or financially viable without recovering the direct costs of the CNS Service, including the costs of ensuring sufficient liquidity.

CDS considers the cost recovery model described in this Notice and Request for Comment, which provides for the direct pass-through to CNS Participants of the annual costs associated with the CNS Liquidity Facility, to be the most fair and equitable method of recovering the direct costs of the required liquidity.

In order and fund the implementation and maintenance of CNS Liquidity Facility to close the PFMI gap a new charge entitled "CNS Liquidity Facility Pass-Through Charge" will be implemented and will not be included for purposes of the rebate program. The proposed charge will appear in the CDS Fee Schedule, as follows:

Code	Product Description	Billing Definition	Price
TBD	CNS Liquidity Facility Pass-Through Charge	Recovery of CDS cost of CNS Liquidity Facility, based on previous quarter's activity. The fee is charged according to the following formula: (CNS Participant's CNS average daily buy obligation during the previous quarter, measured pre-BNS / Total CNS average daily buy obligation during the previous quarter, measured pre-BNS) X the annual fees charged to CDS for the stand-by CNS Liquidity Facility.	As Calculated

COMPARISON TO INTERNATIONAL CLEARING AGENCIES

While CDS's CNS Service is considered to be a CCP service, the implementation of that service-type, CDS's Financial Risk Model, and our market position in relation to CDS's global comparators all combine to make a direct comparison to those comparators challenging. Entities operating CCPs in other jurisdictions are, however, each expected, by their respective regulators and legislation, to be PFMI compliant as regards liquidity risk. CDS's closest analog is the National Securities Clearing Corporation (NSCC) in the United States. NSCC has approximately $11 billion USD in bank liquidity and $5 billion via the DTCC commercial paper program. The NSCC is generally compliant with the liquidity risk PFMI, and though there are important differences between CDS and NSCC (NSCC is owned by its members, and is exponentially larger in scale than CDS, permitting a different risk allocation model), CDS is proposing the CNS Liquidity Facility, and the associated fees, in order more closely to mirror this comparator from the perspective of the management and mitigation of liquidity risk in CDS's CCP service.

PUBLIC INTEREST

CDS submits that the proposed charge for the CNS Liquidity Facility, as developed and described in this Notice, are not contrary to the public interest.

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 or the Autorité des marchés financiers' Bulletin to:

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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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Comments received by CDS during the comment period will be made available to the public.

Appendix A: Proposed CNS Liquidity Facility Fee

Current Fee Description	Fee Description	Existing fee	Proposed Fee
CNS Liquidity Facility Fee Pass-Through Charge	Recovery of CDS cost of CNS Liquidity Facility, based on previous quarter's activity. The fee is charged according to the following formula: (CNS Participant's CNS average daily buy obligation during the previous quarter, measured pre-BNS / Total CNS average daily buy obligation during the previous quarter, measured pre-BNS) X the annual fees charged to CDS for the stand-by CNS Liquidity Facility.	*No Fee*	As calculated