CDS Clearing and Depository Services Inc.

PROPOSED SIGNIFICANT CHANGE TO ELIMINATE CDS FEE REBATES and PROPOSED AMENDMENTS TO ELIMINATE NETWORK CONNECTIVITY FEES

NOTICE AND REQUEST FOR COMMENT

I. DESCRIPTION OF THE PROPOSED CHANGES AND BACKGROUND

A. Executive Summary

CDS Clearing and Depository Services Inc. (**"CDS"**) is proposing to make two changes to the existing fee model. The first and most significant change is the proposal to modify its fee model by eliminating the rebates that are paid annually to participants based on their respective use of CDS services. The second change is the elimination of network connectivity fees currently paid by participants. The elimination of the rebates is being proposed to ensure that the significant investment required to modernize CDS technology now, and to ensure adequate funding of ongoing future technology upgrades, can be made while enabling TMX Group Limited (**"TMX"**) to earn an appropriate rate of return on its capital investments. Modernizing CDS's technology, now and on an ongoing basis, is integral to ensuring that this systemically important clearing house continues to operate safely and efficiently for Canada's capital markets.

The proposed fee changes will impact participants differently. When all changes in this proposal are considered as a package, approximately one-third of participants (those that are billed less than $1 million in annual CDS core fees) would have an overall decrease in their CDS billings (based on 2018 results). Heavier users of CDS core services (i.e. greater than $1 million in annual CDS core fees) would have an overall increase in their CDS fees after these changes are made.

B. CDS's Post-Trade Modernization (**"PTM"**) Project

CDS's PTM project will modernize CDS's critical infrastructure by replacing CDS's principal processing system, known as CDSX, and supporting systems. Moving to a modern, scalable, reliable, and more flexible technology platform is an important and significant project for CDS and its stakeholders. CDS has reviewed alternatives to fund this essential investment and to ensure funding for ongoing investments in critical infrastructure. We have determined that eliminating CDS's fee rebates is a fair and appropriate change to make in order to fund the PTM project and to fund future technology projects, while meeting TMX's minimum expected internal rate of return (**"IRR"**) for the CDS business.

C. Eliminate Rebates

CDS currently provides two types of rebates to its participants. Both rebate types are paid on an annual, pro-rata basis, and are based on certain fees paid by participants. First, each year CDS shares with its participants 50% of any increase in annual revenue on clearing and other core services as compared to the adjusted annual revenues in the fiscal year ending on October 31, 2012. We refer to this rebate as the “50/50 Rebate”. Second, each year CDS also rebates an additional amount to participants in respect of clearing services for trades of exchange-listed securities conducted on an exchange or alternative trading system. This rebate amount, which has escalated since 2012, is now capped at $4 million per year. This rebate, which we refer to as the “Additional Rebate”, is also paid annually, on a pro-rata basis, and in arrears, based on clearing activities. CDS is proposing to permanently eliminate the 50/50 Rebate and to permanently eliminate the Additional Rebate, each as described below. Subject to regulatory approval of the proposed changes, the rebates will be phased out in two steps. Following the final step of the fee change implementation, CDS will no longer pay any annual rebates to participants.

D. Eliminate Network Connectivity Fees

CDS proposes to eliminate two types of fees that participants currently pay to connect to CDS's systems. First, participants pay monthly fees for logical units for printing and interactive sessions on the CDS mainframe; participants are charged by number of ports. These monthly fees are set out in CDS's fee schedule as code items 7500 to 7503 inclusive, as per the 2019 CDS Price Schedule. In order to attenuate the impact on participants of eliminating CDS's rebates, CDS proposes to eliminate these port and logical unit fees. Second, participants also pay monthly fees for CDS to manage the network connection between CDS and participants. CDS intends to eliminate the requirement to connect via the CDS-managed network and, instead, will allow participants to connect to CDS using their own directly-maintained connectivity. These monthly network connection fees, which we refer to as Network Fees, are set out in CDS's fee schedule as code items 7530 to 7550 inclusive.

II. NATURE AND PURPOSE OF THE CHANGES

A. CDS Modernization is Needed

CDS's critical infrastructure underpins the clearing, settlement and depository functions of the Canadian capital markets. The Governor of the Bank of Canada has designated CDS's principal processing system, CDSX, as systemically important to Canada's financial system. Regulatory requirements prescribe systems availability standards to ensure the smooth operation of this critical infrastructure. As the owner of CDS, TMX strongly supports the decision to modernize CDS systems in order that CDS will continue to meet performance standards required by the clearing and settlement business and monitored by regulators, including performance standards related to CDSX availability.

The PTM project is CDS's proactive replacement of the CDSX mainframe and modernization of supporting systems. The objective of the PTM project is to implement a technology platform that will ensure continued exceptional reliability and security while allowing greater flexibility for future systems enhancements. CDSX is approximately 20 years old and runs on mainframe technology that, while reliable, is expensive and resource-intensive to maintain. Software that is integral to CDSX risks being unsupported in the future given the diminishing size of the talent pool required to support the legacy software.

We believe that implementing a modern technology platform will enable CDS to make future systems changes more efficiently and with less risk as compared to implementing changes to the CDSX mainframe. The modernized system is also intended to offer a more intuitive user interface to participants, including the ability to customize report generation by participants. The new system is modular in design and is intended to enable CDS to scale the system more efficiently based on future capacity needs.

B. Elimination of Rebates will Fund Technology Development for Critical Industry Infrastructure Now and in the Future

1. Rationale for Rebate Elimination

Based on the current plan and the assumptions inherent therein, the PTM project to replace the CDSX mainframe and modernize supporting systems is estimated to cost between $120 and $135 million, and is expected to have a 10 to 15 year useful life. TMX's acquisition of CDS in 2012 assumed an IRR on the CDS business based on a forecast of future operating results for CDS and certain capital requirements, such as regulatory capital and other operating capital. The IRR was also validated based on a market-based weighted average cost of capital for TMX and this was used to test the reasonableness of using the IRR as a discount rate. There were no capital considerations for the replacement of the CDSX mainframe, or for any significant technology upgrades.

If CDS does not amend the existing fee/rebate model, after taking into account the cost of the investment in the PTM project to modernize CDS systems, CDS will not meet TMX's minimum expected IRR. Incurring the costs to fund this investment in critical infrastructure is a significant change that was not contemplated at the time the CDS fee model was established in 2012. While we acknowledge the impact of this proposal on participants, CDS believes that eliminating the rebates is the most appropriate and effective alternative in order to ensure adequate funding of the PTM project and of future technology upgrade projects on an ongoing basis. Eliminating the rebates will provide the funds necessary to invest in CDS infrastructure and systems now, and in the future, while impacting participants' fees in a manner that is, according to CDS's analysis, both fair and equitable.

The impact on participants, as discussed below in section III, will be offset in part by the elimination of network connectivity fees.

2. Effect of Eliminating the Rebates

The aggregate value of rebates paid by CDS to participants fluctuates from year to year. Due to changes in clearing and other CDS core services revenue, the 50/50 Rebate amount varies from year to year. For the 2018 fiscal year, CDS rebated $6.1 million for the 50/50 Rebate. This was the largest payment since the 50/50 Rebate was implemented in 2013. The Additional Rebate value is a fixed amount (as set in CDS's Recognition Orders) that has increased from 2013 to 2016. In 2016, the Additional Rebate had reached its cap of $4 million per year. The total rebates of $10.1 million paid by CDS for 2018 represents 11% of CDS's consolidated (pre-rebate) revenues for 2018.

C. Removal of Network Connectivity Fees Softens the Impact of Rebate Elimination

1. Port and Logical Unit Fees (**"Port Fees"**)

This proposal, if approved, would eliminate the monthly Port Fees listed as code items 7500 to 7503 in the CDS fee schedule. It is common practice for financial infrastructure providers such as clearing houses and exchanges to charge access fees to participants. These access fees are charged for the resources used by the financial infrastructure provider to ensure that the access points between participants and the infrastructure's systems are maintained. Technology staff at CDS work to ensure seamless and ongoing connection into the CDS systems. At CDS, these charges are based on the number of logical units used by a participant. CDS is proposing to eliminate the Port Fees in recognition that some offset to the elimination of rebates would benefit participants, in particular those participants that are lighter users of CDS core services. Elimination of the Port Fees is contingent on CDS obtaining approval for the rebate elimination.

CDS proposes to eliminate the Port Fees at the same time that participants cease to receive rebates. (See section IV - *Implementation of the Changes*.) In 2018, participants paid $1.36 million in Port Fees.

2. Managed Network Service Fees (**"Network Fees"**)

As part of the transition to the modernized system, CDS will move participants off of the current network that connects CDS to its participants, and will have participants connect to CDS through their current network providers. This change in network connectivity will result in the elimination of the Network Fees charged to participants (code items 7530 to 7550 in the CDS fee schedule) and should not result in any additional network costs to participants. Modernizing CDS's systems will allow CDS and participants to reap the benefits that will come from moving off of the current network and will allow participants to use their own network providers to connect to CDS. We acknowledge that this change will relocate the demarcation point from participant premises to CDS premises; however, since most participants already have their own connectivity to TMX facilities, we understand that this change should not be difficult or costly to participants. In 2018, participants paid $1.48 million in Network Fees.

CDS intends to perform the cut over from the CDS managed network to participants' networks in 2020. Performing this network connection change in advance of the PTM project implementation has the benefit of ensuring that participant network connections are running smoothly in advance of, and that network connectivity work will not distract resources from, the implementation of the CDSX replacement. CDS intends to cease charging the Network Fees to a participant as soon as the transfer of network connectivity management from CDS to the participant is complete. We currently anticipate beginning this cutover during the first quarter of 2020 and we anticipate completing this cutover by the end of the third quarter of 2020. When all of the participants have moved off of the CDS-maintained connectivity network, charging for code items 7530 to 7550 in the CDS price schedule will be eliminated formally. Elimination of the Network Fees is not contingent on CDS obtaining approval for the rebate elimination.

III. IMPACT OF THE CHANGES

A. Impact to Participants

CDS is proposing the rebate elimination and partial offset after having determined that this change is a fair and equitable solution to obtain the funding for current and ongoing technology improvements that are needed to ensure the sustainability and efficiency of CDS. Each participant will be impacted differently by the proposed changes. When the rebate elimination and removal of network connectivity fees (i.e. Port Fees and Network Fees) are considered in the aggregate, approximately one-third of CDS participants will see a net reduction in their annual CDS billings. This one-third is generally found within the group of participants that already have CDS billings that are lower than other CDS participants (ie. those participants with CDS billings of less than $1 million per year). More specifically, participants will be impacted as follows:

1. Participants with Annual CDS Billings of less than $1 million

Over 74% of CDS participants (67 participants) paid less than $1 million per year in CDS fees in 2018 (the **"Lesser Fees Segment"**). For this Lesser Fees Segment, when taken in the aggregate, the impact of the rebate elimination is fully offset by the elimination of the network connectivity fees.

Approximately 50% of participants in this Lesser Fees Segment (34 participants) will each see a net reduction in annual CDS billings. Of the remaining 33 participants in this Lesser Fees Segment, based on 2018 billings, CDS has identified the participants who CDS estimates will be impacted most adversely. There are four such participants (out of 67) who will have an increase to their CDS billings of 11 to 13 percent. This translates to an annual increase of between $10,000 and $45,000, depending on the participant. Of the Lesser Fees Segment, 19 participants would fall within a group that will be adversely impacted by an approximate increase of 5 to 10 percent, an overall annual increase of $300 to $68,000, depending on the participant.

To summarize, of the 67 participants[1] with CDS billings of less than $1 million in 2018, we expect fees to change as follows if this proposal is approved and fully implemented (based on 2018 activity levels):

- 4 participants: fees increase more than 10%
- 19 participants: fees increase between 5 and 10%
- 9 participants: fees increase by less than 5%
- 1 participant: no change
- 34 participants: fees decrease

2. Participants with Annual CDS Billings of $1 million or greater

There are 23 participants whose CDS billings exceeded $1 million in 2018 (the **"Greater Fees Segment"**). The 23 participants in the Greater Fees Segment, in aggregate, paid fees of approximately $61.6 million (before rebates) and received rebates of approximately $8.5 million in 2018. These participants represented approximately 80% of all fees paid and approximately 85% of all rebates received by participants. The impact of the removal of the rebates is highly concentrated with these 23 participants. Further concentration occurs when considering the organizations that have more than one CDS participant in their organization. When consolidating the data of multiple participants within one organization, the top 6 organizations with CDS participants represented approximately 60% of all fees paid and approximately 74% of all rebates received. The Greater Fees Segment is comprised mainly of Schedule 1 banks, large domestic dealers, and participants providing correspondent clearing services.

To summarize, of the 23 participants with CDS billings of more than $1 million in 2018, we expect fees to increase as follows if this proposal is approved and fully implemented (based on 2018 activity levels):

[1] The Canadian Derivatives Clearing Corporation (CDCC), an affiliate of CDS, is a participant in this segment. CDCC is charged fees in the same manner as non-affiliated participants. CDCC will experience a fee increase on its CDS billings if this proposal is approved.

- 1 participant: more than 18%
- 5 participants: 13 to 18%
- 10 participants: 5 to 10%
- 7 participants: less than 5%

3. CDS's Fees are Among the Least Expensive Globally

CDS submits that eliminating these rebates is appropriate because its fees are, and after the rebate elimination will continue to be, among the least expensive globally. In a report prepared for CDS by an external consultant this year, of clearing houses globally, CDS was shown to have among the lowest fees when compared to eleven peer clearing houses (central counterparties and central securities depositories). This report has been provided to CDS's regulators and an executive summary of the report has been posted for CDS participants on the PTM project portal. CDS's posted fee schedule was the basis for this analysis. This benchmarking, therefore, excluded the impact of annual rebates paid to CDS participants. Thus fees paid by CDS participants were in fact lower than the fees used for benchmarking purposes for the report.

In our view, a key factor in assessing the fairness and reasonableness of this proposal is benchmarking CDS's fees against fees for comparable services in other countries. As set out in more detail in section IX below, CDS fees charged to its participants are lowest globally for fixed income clearing and settlement, and are lowest for over-the-counter equity clearing and settlement. CDS on-exchange clearing and settlement fees for equities trades are second lowest globally, with only DTCC in the U.S. coming in as a lower cost provider of clearing services to equities trades transacted on-exchange. Importantly, even subsequent to the elimination of the rebates, CDS's position as one of the lowest cost providers of clearing and settlement services in the world, would remain unchanged. CDS participants would continue to benefit from some of the most cost-effective clearing house services in the world, after the fee rebates are eliminated.

B. Impact to CDS

As stated above, CDS paid total rebates of $10.1 million for 2018. This represents 11% of CDS's consolidated (pre-rebate) revenues in 2018. CDS expects that eliminating the rebates will also have the effect of increasing CDS's EBIT margin to a level that is closer to the average of its global peers that have similar ownership structures. Importantly to TMX as the parent company to CDS, it is anticipated that eliminating the rebates and network connectivity fees will result in the CDS business meeting TMX's minimum expected IRR (discount rate) on capital. Also, this would establish an appropriate funding model for existing and future technology investment. CDS is of the view that it is both commercially appropriate and in the public interest to permit CDS to set fees at a level that provides TMX with an appropriate rate of return.

C. Comparison to PFMIs

This proposal is consistent with the CPMI-IOSCO Principles for Financial Markets Infrastructures (**"PFMIs"**)[2]. For example, one of several key considerations described in Principle 21 - *Efficiency and Effectiveness* is the notion that a financial market infrastructure (**"FMI"**) should be designed to meet the needs of its participants, in particular with regard to the use of technology and procedures. Paragraph 3.21.2 in the PFMIs provides that, in designing an efficient system, an FMI should consider the practicality and costs for participants and that the FMI's technical arrangements should be sufficiently flexible to respond to changing demand and new technologies. We submit that the PTM project is essential to ensure that CDS is well positioned to adapt to both changing market demands and to rapidly changing technologies. We submit that the proposed fee changes would allow CDS to continue as a highly efficient, and cost effective, FMI operator, now and in the future.

IV. IMPLEMENTATION OF THE CHANGES

CDS proposes to implement the fee changes to coincide with the progression of systems changes and certain key implementations, as described below.

A. Network Fees Elimination (Code Items 7530 to 7550)

CDS will cease to charge the Network Fees on a participant-by-participant basis as soon as the cutover from the CDS-operated network to a participant's network has been completed. CDS is targeting the change in network connection to take place during the period from the first quarter of 2020 to the end of the third quarter of 2020.

B. Rebates Phase Out

CDS proposes to phase out the rebates in two steps, to align with the progression of the PTM Project. This will provide participants with an established horizon to account for the impact of the phase-out. Step one is an elimination of 50% of the rebates for the year 2020. For the year 2020, participants will receive half of the 50/50 Rebate (amount to be subject to revenues earned in 2020) and half of the Additional Rebate[3]. These will be the final rebates paid to participants. Step two is the complete elimination of rebates, which means that rebates will not be paid for activity in 2021.

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[2] Published in April 2012 by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO).

[3] The Additional Rebate is earned over the 12 month period ending October 31. Therefore in 2020 two amounts will be paid: $2 million (which is 50% of the current $4 million) and 2/12 of $2M to recognize November and December of 2020.

C. Port Fees Elimination

The Port Fees (code items 7500 to 7503 in the CDS price schedule) will be eliminated effective January 1, 2022. CDS proposed the elimination of these fees as an offset against the impact of the rebates elimination, thus these monthly fees will cease to be charged effective January 1, 2022.

D. Implementation Timeline Proposal: Summary

- Q1/20 to Q4/20: Network Fees for a participant will be eliminated as soon as the participant has transitioned off of the CDS-managed network connection.

- End of year 2020: 50% of each rebate is eliminated. Participants will receive half of the 50/50 Rebate for calendar year 2020, and half of the Additional Rebate (i.e. $2.0 million) for the 12 month period ending October 31, 2020. Participants will receive half of the Additional Rebate for the 2 month stub period from November 1 to December 31, 2020 (i.e. $2.0 million prorated for 2 months or $333,000).

- End of year 2021: 100% of each rebate is eliminated. No rebates will be paid for participant activity in 2021 and beyond.

- January 2022: Port Fees are eliminated effective January 1, 2022. Participants' final Port Fees charged will be for the month ending December 31, 2021. In January 2022 and going forward, the Port Fees will no longer be charged to participants.

- Q1/22: Anticipated launch of the modernized system/completion of the PTM project.

V. DEVELOPMENT OF THE CHANGES

A. Principles Considered

In developing the proposal, CDS took into account the key principles that underpin the framework for regulatory review of CDS fees, as set out in Multilateral CSA Staff Notice 24-313 (the **"CSA Staff Notice"**)[4]. These principles include ensuring that there is fair access to CDS's services and an equitable allocation of fees that are applied on a non-discriminatory basis. These principles also recognize that CDS's fee structure must be commercially reasonable while providing CDS with sufficient resources to provide clearing, settlement and depository services at a level which satisfies CDS's performance standards.

[4] (2015), 38 OSCB 4458. *Multilateral CSA Staff Notice 24-313 CSA Staff's Review of Proposed Amendments to Fee Schedule of The Canadian Depository for Securities Limited (CDS Limited) and CDS Clearing and Depository Services Inc. (CDS Clearing) (collectively, CDS)*. May 14, 2015.

The overall objective of the review of CDS fees by our principal regulators is to determine whether the proposed fees are fair, equitable, and appropriate, and whether the fees are in balance with the need for CDS to maintain sufficient resources to provide critical functions.[5] The CSA Staff Notice lists a number of factors that the Canadian Securities Administrators will take into account when reviewing CDS fee proposals to understand whether the desired outcomes are being met, including:

- the potential impact of the proposed fee change to the safety and efficiency of, and competition within, Canada's capital market;
- the anticipated impact to CDS's customers;
- views expressed by customers and other stakeholders during a consultation;
- the reasons for the fee change;
- how other businesses and revenues of CDS would be impacted;
- the projected change in revenue for CDS;
- historic and projected costs of CDS in providing the particular service;
- the movement of overhead and direct costs between CDS's services, and between core and non-core services;
- how the proposed fees benchmark to fees for comparable services in other jurisdictions; and
- how the proposed fees will be rolled out and implemented.

In developing the proposal to eliminate rebates, we took into account all of these factors to ensure that we proposed a change that would balance the fairness and appropriateness of the fee change and its impact on participants, with the need for CDS to maintain sufficient resources to operate its critical functions in a commercially reasonable manner and provide TMX with an appropriate rate of return on its capital investments made in CDS. In particular, we calculated the potential impact of these changes on each participant (based on 2018 data) and have shared this information with each participant and with CDS's regulators. Aggregate impacts are provided in section III of this application. CDS took into account certain feedback that was provided during our extensive stakeholder consultation process. This process is summarized in section V(B) below, and stakeholder reactions are discussed in section VII, below. Underpinning all of our analysis and activity on this matter is the benchmarking of fees globally that was prepared by an external consultant, summarized in section IX(B), which shows that, even after implementation of the proposed changes, CDS is one of the lowest cost providers, and in some cases, the lowest cost provider, of clearing and settlement services globally.

[5] Ibid p. 4459.

B. Consultation with Stakeholders

1. Process

CDS's Recognition Order requires that it not seek regulatory approval for fee increases on core services unless there is a significant change from current circumstances. In our view, the need to replace CDSX and the corresponding need to change the fee model to address the cost of this major systems overhaul and future significant technology upgrades, is such a significant change. The cost of the PTM project, currently estimated to be between $120 and $135 million, is approximately 80% of the original purchase consideration for the acquisition of CDS by TMX in 2012. Given that the acquisition cost of CDS did not include capital considerations for the replacement of the CDSX mainframe or other significant technology upgrades, we believe that the need to fund this modernization investment is a significant change. As the rebate elimination is a meaningful change that will impact adversely a number of participants, CDS has taken unprecedented steps to perform additional consultations with stakeholders in order to understand potential impacts and to obtain feedback from those most impacted by the proposed changes.

CDS began by meeting with regulators to advise of the significant change of circumstances being brought by the PTM project, and the need to review CDS's fee model to address the costs related to this technology modernization project. Following these regulatory meetings, CDS held consultations with some of its largest participants in summer, 2019, in order to gauge the impact of our proposal on the participants who collectively received approximately 70% of the rebates paid in 2018. It was important to have discussions with this subset of participants, as they are CDS's largest customers (on a transaction and fees paid basis) and, consequently, the largest beneficiaries of the rebates. Outright dismissal of our proposal by this subset would have required CDS to reconsider the proposal entirely. Of this group, CDS received responses ranging from understanding and support, to non-objections and non-committal responses. On the basis of these responses, CDS determined to proceed with further rebate elimination discussions and stakeholder presentations, and the decision was made to put forth the proposal to eliminate the network connectivity fees to partially offset the rebate elimination.

During the fall, CDS held two events to present the proposed rebate elimination and offset to participants. In September, the changes were proposed at participant meetings held in Toronto and Vancouver. Questions raised by participants during these sessions have been collated and are addressed in section VII, below. At these meetings, two participants - both smaller, independent dealers - expressed dissatisfaction with the proposed rebate elimination. Those comments are captured and addressed in section VII.

All participants have received a copy of the presentation materials, which are also available through the PTM project portal. Importantly, CDS provided each participant with its individual impact assessment on September 26, 2019, which shows 2018 CDS fees charged, rebates made for 2018 activity, and network connectivity fees charged in 2018. CDS continued to meet individually with participants during the fall, and maintained an open offer to meet with any participant that wanted to ask questions or provide comments in private.

CDS has also presented this proposal to IIROC's Finance and Operations Advisory Section and to the IIAC's Small and Independent Dealers Committee. Understanding the impact of the rebate elimination on smaller dealers is an important outcome from these consultations, and we believe that the removal of the network connectivity fees is a change that, for over 50% of small dealers, will cancel out the adverse impact that the rebate elimination otherwise would have.

2. CDS's Response to Feedback

This fee proposal incorporates two main changes that were made during the consultation process, to address certain concerns raised by participants. CDS's original proposal in spring, 2019 was an immediate and full elimination of the rebates, with no offset. During our early consultations, participants commented that CDS should make efforts to soften the impact of this change. In response to this feedback, CDS changed its original proposal and developed the proposal that was presented to all participants this fall, which included (i) a phase-in of the rebate elimination, and (ii) a partial offset of the rebate elimination by eliminating connectivity fees. Then, after the consultations that occurred this fall during which a few participants voiced concern with the proposal, CDS determined that it could be beneficial to the industry to cut over from the existing network connection in 2020, in advance of major PTM project changes that will take place in 2021. This enables the Network Fees (code items 7530 to 7550) to be eliminated sooner, once a participant has cutover from the CDS-operated network. Bringing forward the elimination of the Network Fees is a change from the proposal that was presented to participants this fall, which will have the effect of implementing some of the offset to the rebate elimination at an earlier date, which is beneficial to participants.

C. Formal Fee Review and Approval Process

The proposal to eliminate the rebates has been discussed by the CDS Board of Directors during meetings in the spring, summer, and fall of 2019. Since initiating consultations with participants, management has regularly reported progress and feedback resulting from these consultations to the Board.

In finalizing this proposal, and in addition to the consultation described in section V(B) above, CDS has followed prescribed fee change process requirements, which include:

- the review and consideration by the CDS Fee Committee[6] at a Fee Committee meeting, held on October 8, 2019;
- the review by the Risk Management and Audit Committee of the Board (RMAC), and recommendation by RMAC to the Board to file the fee changes, at a meeting held on October 31, 2019; and
- the review by the Board and authorization by the Board to management to proceed with filing an application to CDS's primary regulators to eliminate the fee rebate and eliminate the network connectivity fees, at a meeting held on October 31, 2019.

VI. HISTORY OF CDS AND THE FEE REBATE

A. CDS

CDS operates the depository and the clearing and settlement system for equities and fixed income securities in Canada, and is the sole provider of these services for the Canadian cash market. Prior to the transaction in 2012 which resulted in TMX owning CDS, CDS was owned jointly by six Schedule I banks, TMX Group Inc. and IIROC (representing the ownership interest of its investment dealer members), and was effectively operated on a cost recovery basis. An acquisition known as the "Maple Transaction" led to CDS's current ownership structure whereby TMX (owner of Toronto Stock Exchange and TSX Venture Exchange, among other financial services businesses), a widely-held public company, owns CDS. The Canadian regulatory authorities, when reviewing the CDS portion of the proposed Maple Transaction, considered certain key issues in determining whether the transaction was in the public interest, namely[7]:

- the implications of "vertical integration" of trading, clearing, settlement and depository infrastructure under common ownership;
- the "reorientation" of CDS from a cost-recovery industry utility to a for-profit commercial enterprise;
- the potential for TMX to act anti-competitively in the pricing of clearing, settlement and depository services; and
- the maintenance of fair access to clearing, settlement, and depository services by market participants not affiliated with TMX.

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[6] The CDS Fee Committee is an advisory committee that consists of participants and other stakeholders, and CDS's regulators may attend as observers. The Co-Chairs (one of whom is CDS management, the other of whom is a participant employee) of the CDS Fee Committee provide a report of the meeting to the Risk Management and Audit Committee of the CDS Board.

[7] (2015), 38 OSCB 4456. *Multilateral CSA Staff Notice 24-313 CSA Staff's Review of Proposed Amendments to Fee Schedule of The Canadian Depository for Securities Limited (CDS Limited) and CDS Clearing and Depository Services Inc. (CDS Clearing) (collectively, CDS)*. May 14, 2015.

To address these key issues, the applicable regulatory authorities imposed extensive and stringent additional terms and conditions on CDS, including enhanced ongoing oversight of CDS. The 50/50 Rebate and the Additional Rebate were also proposed to the regulators during the Maple Transaction, and incorporated by the Ontario Securities Commission (**"OSC"**) and the Autorité des marchés financiers (**"AMF"**) into their CDS decision documents.

Some of the fee-related restrictions in CDS's recognition orders include:

- All fees imposed must be equitably allocated
- Fees cannot have the effect of creating unreasonable barriers to access
- The process of setting fees must be fair and appropriate
- The fee model must be transparent
- Discounts that are conditional upon the purchases of other services are not permitted
- Fees cannot provide discounts based on a participant's activity level
- The process for setting fees shall provide for meaningful input from the fee participant committee
- An independent auditor must provide an annual report on CDS's compliance with the fee and rebate model
- CDS must maintain an internal cost allocation model for the allocation of costs or transfer of prices between CDS and its affiliates, approved by the provincial regulators and audited annually by an independent auditor
- Fees charged for services shall not reflect the cost or expense incurred by CDS in connection with an activity of CDS's that is not related to that service
- CDS must provide to regulators a report on its fees, including benchmarking, every three years

B. Rebates Introduced in the Maple Transaction[8]

During the comment period and public hearings related to the Maple Transaction, some participants expressed a concern that the Maple Transaction could affect CDS clearing fees, particularly for on-exchange clearing, and participants also expressed a concern that CDS, under Maple ownership, could set fees or access requirements in a manner that could discriminate against other marketplaces and smaller participants. To address these concerns, a large number of fee-related restrictions were imposed on CDS (listed in section VI(A) above), and the 50/50 Rebate and the Additional Rebate were established. This, despite the fact that fees for CDS clearing services at the time of the Maple Transaction in 2012, which remain in place today, had recently been set at a price level that was a 29% decrease from the 2011 published fees. Maple's intention was to craft a model of CDS fees in a for-profit regime that preserved certain elements of the industry

[8] See (2012), 35 OSC Bulletin (Supp-2) 103-105, May 3, 2012 for the relevant excerpt from Maple's letter regarding changes to the Maple Transaction regulatory application.

utility model, in particular strong industry participation in CDS governance, but that also would bring the benefits of cost management and innovation that can come from a for-profit model. To additionally address participant pricing concerns at the time of the Maple Transaction, the 50/50 Rebate was proposed as was the Additional Rebate, which was intended to be reflective of synergies and efficiencies Maple expected to achieve as part of the Maple Transaction. The 50/50 Rebate was an offering that, while somewhat reflective of CDS practices prior to the Maple Transaction, is not sensible in a for-profit entity. Indicative of this is the fact that CDS is an outlier among its peers, where fee rebates are not used by other clearing houses that are operated in a for-profit model. The rebate model is unique to CDS. By contrast, it is not unusual for member-owned clearing houses to use rebate models, as was the case for CDS prior to the Maple Transaction. Rebates paid by CDS to participants prior to the Maple Transaction were reflective of positive retained earnings after capital and operating budgets were set for the following year. While rebates may be an effective way to operate for member-owned clearing providers, when used in a for-profit model as designed in the current CDS fee model, they do not provide for any flexibility to fund important technology projects or other capital-intensive investments.

Further, we note that volume projections made by CDS management at the time of the Maple Transaction were used to provide an estimate of rebate values as compared to the status quo. These projections were also used to calculate the expected return on investment to Maple (now TMX) for the CDS acquisition. The anticipated increases in volumes as projected by CDS management at the time of the Maple Transaction did not materialize, leading to actual results that are different from results that were estimated at the time of the Maple Transaction.

VII. STAKEHOLDER REACTIONS

For transparency and to facilitate the review of this proposal by all stakeholders, we provide below a number of reactions and questions that CDS has received.

A. Questions and Comments Raised During Participant Presentations

1. ***Question*:** What alternatives to the rebate elimination were considered?

   ***Answer*:** CDS has determined that an important change in its funding model is necessary to implement not only the PTM project but also all future systems developments. Therefore, a meaningful change to the funding model was required. The two main alternatives considered, to ensure that adequate revenue would be retained by CDS, were (i) a fee increase, or (ii) elimination of the rebates. Please see our more detailed response in the "*Alternatives Considered*" section VIII.

2. ***Question*****:** What has changed that explains the increase in the cost of the PTM project and the need for rebate elimination? The CDS modernization was not expected to cost the participants anything.

   Answer**:** The original budget for the PTM project was too modest. As the initial stages of the project progressed, it became clear that a much larger budget would be required to modernize CDSX. CDS management made an error in its initial estimation process; the original project budget grossly underestimated the effort needed to develop business requirements and perform systems and user acceptance testing. By comparison, the last systems overhaul at CDS, to create CDSX, took place in 2000 and cost approximately $70 million. CDS has brought in a new project team, under new CDS management, to execute the PTM project.

3. ***Question*****:** Isn't this the slippery slope to CDS continually increasing fees?

   Answer**:** No. The CDS Recognition Order has very prescriptive fee requirements. Our fees are the most heavily regulated of any CSD or CCP globally, based on our review of other jurisdictions. CDS cannot change its fees without the involvement of our participant advisory committee, review by the CDS Board of Directors, and a public comment process. After public comment, approval of the BCSC, OSC, and AMF is needed prior to the implementation of new or increased fees. CDS's core clearing fees cannot be increased unless there has been a significant change of circumstances. The PTM project, which requires substantial funding, is precisely this type of significant change. In light of these restrictions, this proposal to eliminate rebates should not be viewed as a slippery slope; rather, it should be viewed as an event driven by a significant change in circumstances, being the need to replace CDSX and fund the PTM project as well as to fund future investment in the critical infrastructure that CDS operates.

B. Other Feedback Received During Consultations

1. A stakeholder suggested that there is an inherent conflict within the ownership structure of TMX, so revenue retained by CDS will disproportionately benefit TMX owners.

   Answer**:** This comment reflects a misunderstanding. TMX is a widely-held public company. At the time of the Maple Transaction, certain TMX shareholders were parties to nomination agreements that ensured representation on the TMX Board of Directors for these shareholders, who owned approximately 78% of TMX shares. These nomination agreements expired over a year ago. There are no longer any agreements that provide rights to any entities that became shareholders at the time of the Maple

Transaction, and the original Maple shareholders today own approximately 23% of TMX shares[9]. In any event, the CDS Board of Directors is (and has always been) comprised of members different from the TMX Board of Directors, and pursuant to CDS's Recognition Orders, the CDS Board of Directors must include at least one-third independent directors and one-third directors who represent participants. We acknowledge that TMX affiliates are important service providers to CDS within the TMX enterprise organizational structure, and that CDS is an important business segment of TMX. The existing governance model (including separate boards and distinct regulatory frameworks), however, prevents precisely the type of bias or favouritism that is referenced in the comment. The CDS Board of Directors and CDS management are deeply cognizant of CDS's public interest mandate, and CDS has been, and continues to be, operated on that basis.

2. ***Question*:** Can the rebates be eliminated after the PTM project has gone live? Otherwise, participants are paying for the systems enhancement before the benefit is realized by the participants.

   ***Answer*:** CDS has considered delaying the rebate elimination until the end of the PTM project implementation. As is currently planned, under our phased-in timing, participants will receive 50% of the rebates for their 2020 activity level, and activity in 2021 will not be subject to rebates. The effect to participants of the full rebate elimination is intended to align fairly closely with the implementation of the modernized system, which is expected to be launched during the first quarter of 2022. If this proposal is approved, participants will not receive rebates that they would have typically received at the end of 2021 and in January 2022.

3. ***Question*:** Why is a permanent rebate elimination required? Why not a temporary break?

   ***Answer*:** CDS has determined that an important change in its funding model is necessary to implement not only the PTM project but also all future systems developments, to maintain the safety of this critical capital markets infrastructure. Therefore, a meaningful change to the fee model is needed to fund future investment in CDS's critical infrastructure as well. Please see our response in the "*Alternatives Considered*" section VIII(B).

[9] Ownership information is based on the most recent information available to TMX.

VIII. ALTERNATIVES CONSIDERED

A. Increase Fees for Core Services

In a for-profit model, increased revenue is needed to fund capital investment without reducing the rate of return. CDS's choice was to fund the PTM project either through increased fees or through reduced rebates. We believe that increasing fees would have been a significantly more complex path to achieving the same outcome as eliminating rebates; CDS and our stakeholders would have been required to review a large number of individual service price increases in the CDS fee schedule, calculate applicable increases, and consult on these multiple prices. In addition to the time and resource costs imposed on our stakeholders in the course of such a review, the broadly diverse nature of CDS's participant base, and the significant size differences between participants would have, in all likelihood, resulted in a more extensive, and possibly less equitable, adverse impact on participants if fees were to be increased. By contrast, the rebates are comprised of two components that are simple to calculate, and for which "pro forma" style examples can be (and have been) put to the participants (based on 2018 results). The proposal to eliminate the rebate is easy to understand, and results in a fee model under which the posted fee is the full price of the service, rather than its current state, which is a list of services posted at a "pre-rebate" price. Overall, CDS determined that the elimination of the rebates, as opposed to specific and broad-based fee increases, was the most efficient and equitable approach.

B. Permanent Rebate Elimination vs Temporary Rebate Holiday

CDS is proposing the rebate elimination not only to fund the PTM project, but to fund future technology projects on an ongoing basis. The modernized system to be launched at the end of 2021/early 2022 is expected to have a 10 to 15 year useful life. In a for-profit model, it is not efficient to give rebate holidays from time to time in order to fund infrastructure projects; it is more efficient to price services in a manner that enables the entity to use revenue to both operate the business and make capital investments as needed from time to time. We believe that eliminating the rebates is an appropriate change that we expect will allow for both stable and effective provision of our services and for ongoing capital investment while simultaneously meeting TMX's minimum expected IRR for the CDS business.

IX. GLOBAL COMPARISON TO OTHER CLEARING AGENCIES

A. Rebates are a Unique Model

CDS has engaged an external consultant on four occasions since 2011 to perform a global benchmarking fee review for clearing house services. As mentioned in section III(A)(3), the most recent fee benchmarking was completed in 2019 and the external consultant's report was submitted to regulators and an executive summary of the report has been posted for CDS participants on the PTM project portal. In the course of the benchmarking exercise, the external consultant was unable to find any clearing houses with similar ownership structures to CDS that provided rebates to its clients. While the concept of participant rebates and drawdowns may be used by clearing houses that are member-owned (for example, DTCC), the concept of participant rebates is atypical in a for-profit clearing house model. By contrast, there are a number of clearing houses that provide discounts to their fees based on participant activity (eg. discounts for high volumes). Discounts are not the same as a rebate concept. Since the Maple Transaction, CDS has been prohibited under its recognition orders from providing discounts based on a participant's activity level.

B. Global Fee Benchmarking, 2019

The external consultant's 2019 report, which utilized CDS's posted fees (i.e. fees before any rebates paid), found that CDS is an extremely low-priced provider of clearing and settlement services, with prices that rival those of DTCC. DTCC is widely considered to be the lowest cost provider of these services in the world. CDS was found to be the lowest cost provider (clearing and settlement fees) for OTC transactions (equity and fixed income) and for on-exchange fixed income transactions. CDS is the second lowest cost provider of on-exchange equity security transactions (clearing and settlement fees), second only to DTCC. For custody-related fees, CDS was found to be the fourth-lowest for fixed income securities. For custody of equities, benchmarking is difficult as the approach to equity custody pricing used by CDS and DTCC is unique as compared to global peers, as the charges in the US and Canada are based on volume (positions and share totals) rather than value. A straight comparison for equity custody as against DTCC is also difficult to perform as DTCC's customers benefit from tiered volume discounts, which CDS does not offer (and is not permitted to offer pursuant to its recognition orders).

We believe that CDS's low clearing and settlement fees relative to our global comparators are demonstrable evidence of the efficient and high-value service that CDS already provides to its participants. As stated above, in performing the analysis that led to these rankings, the external consultant used CDS's posted fees, and did not take into account the rebates that would have had the effect of CDS's fees being even lower. Put another way, this benchmarking has been performed as though the rebates did not exist; the impact of eliminating the rebates will not change the fact that CDS is an extremely low cost provider of clearing and settlement services globally.

X. PUBLIC INTEREST

CDS submits that the proposed changes described in this notice are not contrary to the public interest.

XI. COMMENTS

Comments on the proposed changes should be in writing and submitted by Tuesday, February 18, 2020 to:

Wayne S. M. Ralph
Chief Operating Officer
CDS Clearing and Depository Services Inc.
100 Adelaide Street West
Toronto, Ontario
Email: wayne.ralph@tmx.com

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:

Me Philippe Lebel
Secrétaire général, et directeur général des affaires juridiques
Autorité des marchés financiers
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Comments received during the comment period will be made available to the public.

APPENDIX

Excerpt of CDS Fee Schedule showing Network Connectivity Fees to be Eliminated

7500	TCP/IP (Frame Relay) Port and Up to 16 LUs	Monthly charge for Logical Units (LUs) of Terminals/Printers per port. Per port LUs should be less than or equal to 16.	54.50
7501	TCP/IP Port and 17-256 LUs	Total per month flat fee per port, if LUs on the port are more than 17 but less than or equal to 256. No charges against first tier will be applied	1,451.25
7502	TCP/IP Port and 257-512 LUs	Total per month flat fee per port, if LUs on the port are more than 257 but less than or equal to 512. No charges against first and second tiers will be applied	2,177.00
7503	TCP/IP Port and 513 LUs and Over	Total per month flat fee per port, if LUs on the port are more than 512. No charges against above tiers will be applied	2,903.00
7530	Enhanced IPVPN + BIHS + Single Firewall	Charge per month flat fee per connection	1,046.00
7531	Enhanced IPVPN + BIHS + Dual Firewall	Charge per month flat fee per connection	1,106.00
7532	T1 IPVPN + BIHS + Single Firewall	Charge per month flat fee per connection	1,178.00
7533	T1 IPVPN + BIHS + Dual Firewall	Charge per month flat fee per connection	1,238.00
7534	Dual T1 IPVPN + Dual Firewall	Charge per month flat fee per connection	2,174.00
7535	Secured Sockets Layer (SSL)	Charge per month flat fee per connection	20.00
7540	Site-to-site connection	Charge per month flat fee per connection	251.00
7536	Fractional T1 gIPVPN + ADSL + Single Firewall	Charge per month flat fee per connection	1,870.00
7537	Fractional T1 gIPVPN + ADSL + Dual Firewall	Charge per month flat fee per connection	1,930.00
7538	T1 gIPVPN + SDSL + Single Firewall	Charge per month flat fee per connection	2,299.00
7539	T1 gIPVPN + SDSL+ Dual Firewall	Charge per month flat fee per connection	2,359.00
7550	Network and Data Processing Move/Add	Labour charges for physical and logical changes	1,000.00