CDS Clearing and Depository Services Inc. (CDS®)

Proposed Amendments to CDS Fee Schedule re Central Counterparty (CCP) Services Failure to Receive

NOTICE AND REQUEST FOR COMMENT

DESCRIPTION OF THE SERVICE AND PROPOSED AMENDMENTS TO FEE SCHEDULE

CDS proposes to amend the Central Counterparty (CCP) Services Failure to Receive Incidental Fee (CDS billing code 9905) currently listed on its Fee Schedule, and is requesting approval to increase this Incidental fee from CAD$1,000 to $10,000. CDS provides this Notice and Request for Comment in accordance with the fee review requirements of each of CDS's principal regulators and pursuant to the Terms and Conditions of the Ontario Securities Commission's ("OSC") Recognition Order, to Article 26.6 of Recognition Decision 2012-PDG-0142 of the Autorité des marchés financiers du Québec ("AMF"), and to Section 9 of the British Columbia Securities Commission ("BCSC") Recognition Order, each as amended.

NATURE AND PURPOSE OF PROPOSED AMENDMENTS

In the CCP Service operated by CDS - the Continuous Net Settlement ("CNS") Service - transactions between Participants in the same (fungible) securities, with the same value date, are novated (that is, a transaction between Participant A and Participant B becomes two transactions - between Participant A and CDS and between CDS and Participant B) and netted, creating outstanding obligations between each participant and CDS. A CNS Participant has, consequently, a CNS obligation "to deliver" (the participant is required to deliver securities and receive payment) or a CNS obligation "to receive" (the participant is required to receive securities and make payment). The CNS "to deliver" and "to receive" obligations for Participants offset one another and net to zero.

If, however, a Participant fails to fulfill its outstanding CNS obligations, CDS will be unable to settle a corresponding obligation to one or more Participants. If, for example, a Participant due to receive securities fails to do so, and to make the corresponding payment, the CCP will be short funds, and will not have the funds to settle with one or more Participants who have an obligation to deliver securities.

A "Failure to Receive" in the CCP service occurs when the delivering Participant has the required securities available, but the receiving Participant is unable or unwilling to receive the securities and make corresponding payment on value date because the participant has, for whatever reason, insufficient funds, line of credit, or aggregate collateral value ("ACV")[1]. In a Trade for Trade (TFT) -bilateral - settlement scenario, when a Participant fails to receive, the delivering Participant may make a claim against the receiving Participant to compensate for the loss of the use of funds by the Participant who should otherwise have been paid. This claims process is described in detail in Chapter 9 - CCP Fails-to-receive interest mark and fee in the CDS Procedure and User Guide entitled Trade and Settlement Procedures (available here: https://www.cds.ca/resource/en/67).

In CNS in its current state, there is no direct relationship between the delivering Participant and the receiving Participant; as described above, the CCP has novated the original confirmed bilateral transaction and CDS is now interposed between the original parties. A direct interest claim by the delivering Participant cannot, therefore, be made against the receiving Participant. CDSX automatically identifies each CNS Fail to Receive at the beginning of Payment Exchange and calculates a fail mark, an amount that is collected by CDS from the Fail to Receive Participant and distributed to the corresponding delivering Participant. The formula for calculating the fail mark is set out in Chapter 9 of CDS's Trade and Settlement Procedures, and reflects the financing cost of the failure to settle on value date; that is, the cost of funds by reference to a published interest rate used in the industry.

In addition to the fail mark, which is calculated based on the value of the transaction, CDS also charges a disincentive fee to Participants who fail to receive at the beginning of Payment Exchange - the Central

[1] The dollar value that CDSX assigns to securities in a participant's general account which represents collateral if a participant defaults on their payment obligations.

Counterparty (CCP) Services Failure to Receive Incidental Fee. This fee - currently CAD$1,000 per day irrespective of the number of failed CNS positions or currency - is charged to the Fail to Receive Participant and is reflected on their CDS invoice at month's end.

Both the fail mark and the Central Counterparty (CCP) Services Failure to Receive Incidental Fee are disincentive - penalty - fees intended to influence Participant settlement behavior, to discourage Fails to Receive, to improve the consistency of the CNS settlement process, and to ensure that Participants in a position to deliver are not financially disadvantaged.

Review of the occurrence of Fail to Receive situations during a 14 month period (April, 2020 to May, 2021) revealed that Fails to Receive do occur occasionally, notwithstanding the fail mark and the Central Counterparty (CCP) Services Failure to Receive Incidental Fee. An average of six (6) Failure to Receive events occurred per month, however the dollar value of the majority (62 percent) of the events was under $1MM ($USD and $CAD combined). The tendency illustrated in the data reviewed indicates that failed transactions are more likely to be operational in nature, not necessarily an indication of the financial health of a Participant.

CDS Participant Rules 3.5.2 (and also Rule 7.3.8) permits CDS to charge fees for Services, including "fees for the failure to comply with the Legal Documents". As such, CDS is proposing to increase the Central Counterparty (CCP) Services Failure to Receive Incidental Fee from $1000 to $10,000, with the intent of further improving the consistency of CNS settlement. CDS anticipates that the proposed increase will constitute a sufficient deterrent and will further reduce the frequency of Failures to Receive within CNS at the start of Payment Exchange.

IMPACT OF PROPOSED AMENDMENTS

In CDSX, settlements are facilitated by pairing off Participants with an obligation to deliver to CNS, and which have sufficient available position, with Participants with an obligation to receive from CNS, and which have sufficient funds/ACV, to pay for the securities. Securities are then moved directly from the delivering Participant Ledger to the Receiving Participants ledger and, simultaneously, both parties' funds accounts are updated to complete the settlement of the CNS obligations. In the event that a Participant is unable to make delivery to CNS because there is no Participant, on the other side of CNS, in a position to pay to receive that position, then the CNS obligation will not settle. A seller's ability to settle is contingent on the buyer's ability to purchase, rather than on the CCP's ability to perform on its obligations in non-default (normal course) situations, and is addressed in Participant Rule 7.3.8 - Partial Settlement and Delayed Settlement. CDS has procedures and capabilities in place which enable CDS to settle in place of a Defaulting Participant in the event that a default has been declared.

The new system, currently in development (the Post Trade Modernization initiative - "PTM") will implement a CNS Central Ledger that will facilitate the settlement of all Participant obligations to deliver to CNS, providing the CCP has sufficient funds/ACV to pay for the securities. Positions in the CNS Central Ledger will enable the settlement of all Participant obligations to receive from CNS providing the Participant(s) have sufficient funds/ACV to pay for the securities. Under this model, CNS will be in position to manage a default scenario and ensure that the CCP is able to make good on central counterparty obligations in the most effective, efficient, and timely manner.

In the current system (CDSX) there are no automated alerts emailed to the Failed to Receive Participant. Currently, CDS monitors daily internal generated reports and reaches out to the Participants who are identified as failed to receive in CNS to ensure the failed-to-receive Participant is taking the appropriate action to settle their CNS obligation before start of Payment Exchange. These actions include moving securities to increase their ACV or entering a funds deposit to increase their system available funds account or/and requesting for an extension on Payment Exchange. Once implemented under PTM, the new system will generate alerts which will include CNS position details in order to notify the Fail to Receive Participant of the failed CNS obligation.

The proposed amendment to increase the Central Counterparty (CCP) Services Failure to Receive Incidental Fee is intended primarily to discourage potential Failures to Receive (FTR) where a market participant pays the current FTR fee ($1,000) rather than the fee for delaying Payment Exchange ($5,000); the increased disincentive fee is also intended to facilitate CDS's calibration of the system's liquidity needs (via existing credit facility) to support the management of the FTRs prior to the implementation of the new system.

THE FEE SETTING PROCESS

Development Context

The CNS Central Ledger which is a component of PTM, will facilitate the settlement of all Participant obligations to deliver to CNS providing the CCP has sufficient funds/ACV to pay for the securities. Positions in a Central Ledger will enable the settlement of all to-receive Participant obligations from CNS, providing the Participant(s) have sufficient funds/ACV to pay for the securities. CNS will, therefore, be in position to manage a default scenario and ensure that it is designed to honour its obligations in the most effective, efficient, and timely manner as is required by global regulatory standards.

The proposed amendments to the Fee Schedule, which increase the the Central Counterparty (CCP) Failure to Receive fee from $1000 to $10,000, is in furtherance of CDS' PFMI commitments, was submitted to the CDS Participant Fee Committee for review and comment at a meeting of the Committee on November 22, 2022. The CDS Fee Committee did not disapprove of CDS's proceeding with the submission of the proposed fee to the CDS Board of Directors and, subject to their assent, submission for regulatory approval.

Alternatives Considered

The CDS Participant Rules require participants in CCP services to settle on value date (Rule 7.3.7 and 7.4.7). CDS may consider consistent failure to settle as one of the factors in determining whether or not to exercise its discretionary power to suspend a participant: failure to settle on value date is not automatically grounds for suspension, but may indicate that the participant "is in such financial or operating condition that its continuation as a Participant would cause material disruption to the Services or would jeopardize the interests of CDS or other Participants" (Rule 9.1.2).

COMPARISON TO INTERNATIONAL CLEARING AGENCIES

As part of this proposed amendment drafting, CDS benchmarked the proposed disincentive fee against similar fees/fines levied by CCPs in other jurisdictions.

Fixed Income Clearing Corporation (FICC), one of the operating subsidiaries of the Depository Trust & Clearing Corporation (DTCC), collects interest of 3% on the settlement value of the trade minus the Target Fed Funds rate in effect the day before the settlement day. CDS determined that 95.3% of the theoretical fines levied against CDS Members who failed-to-receive during the 14 month review period would have been for less than $1000. Consequently, if CDS were to adopt a similar formula, the disincentive power of the fines would have minimal impact and would not result in changes to settlement behavior.

The National Securities Clearing Corporation ("NSCC"), another operating subsidiary of DTCC, clears and settles trades in a continuous net settlement environment similar to the CDSX CCP. NSCC does not apply settlement risk edits to deliverers and receivers of the CNS position when settlement is attempted, and does not have an automatic process to make interest claims on either side of a CNS position that fails to settle on settlement date. Deliveries into CNS at NSCC settle with the CCP and there are no opportunities for the receiver of the CNS position to not pay their obligation into the CCP.

ASX Clear is the clearing house for the Australian financial market; it clears and settles trades in a continuous net settlement environment similar to the CDSX CCP. ASX imposes a fine based on 0.10% of the value of the shortfall, with a minimum fail fee of $100 AUD, and a maximum fail fee capped at $5000 AUD. CDS has determined that 62.3% of the theoretical fines levied against CDS Members who failed during the 14 month review period would have been for less than $1000. Consequently, if CDS were to adopt a similar formula, the disincentive power of the fines would have minimal impact, and would not result in changes to settlement behavior.

PUBLIC INTEREST

CDS submits that the proposed fee Central Counterparty (CCP) Failure to Receive, 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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With a copy to: Tony Hoffmann, Senior Legal Counsel (tony.hoffmann@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:

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

Appendix A: Proposed Central Counterparty (CCP) Services Failure to Receive Fee

Current Fee Description	Billing Definition	Existing fee	Proposed Fee
Central Counterparty (CCP) Services Failure to Receive	Charge per day for failure to receive delivery of securities to settle an outstanding CNS settlement position prior to the start of Payment Exchange.	CAD $1000.00	CAD $10,000