CCMA Canadian Capital Markets Association
ACMC Association canadienne des marchés des capitaux

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Re: Discussion Paper 24-401 on Straight-Through Processing and Proposed National Instrument 24-101 Post-Trade Matching and Settlement

The CCMA has had many discussions with capital market participants impacted by the revised NI 24-101. Generally reception has been positive acknowledging the effort the CSA expended to listen to comments provided in 2004 and to make changes addressing the majority of these issues. The securities industry is increasingly investing in technology to automate both front and back offices. Implementing these technology solutions requires both process and behavioural changes to be made. In our view NI 24-101 will help speed up this conversion process.

In developing this response we have held meetings and discussions with representatives of the broker dealer, investment management and custodian communities as well as with various infrastructure providers to the industry.

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We believe we have identified a consensus viewpoint but our comments may not be unanimously supported by the entire industry.

Overall our support for the instrument is high and we hope this is evident in our responses to the specific questions set out in the Request for Comments that accompanied the draft instrument. Nevertheless, our members have expressed concerns in four areas that we would like to highlight.

- Definition of institutional investor

We understand the CSA's desire to broaden the scope of the instrument to include activity by firms that may not engage a commercial custodian; prime brokerage arrangements with hedge fund managers for example. We believe this can be readily accomplished by simply applying the instrument to delivery against payment/receipt against payment (DAP/RAP) accounts where trades clear through a central clearing agency, and by extending the definition of a custodian to include a registered dealer. For greater certainty you may wish to refer to 'COD' accounts although common industry parlance appears to treat DAP/RAP accounts and Cash on Delivery (COD) accounts as equivalent.

- Milestone transition

We agree with the phased approach the CSA has taken. However, the jump from 70% matched by noon on T+1 to 80% matched on T, where the definition of T is 7:30 EST, is enormous. This could lead to excessive exception reporting thereby undermining the effectiveness of the instrument.

In addition to making the incremental targets more reasonable, we recommend extending the end-of-day deadline for trade date from 7:30 PM to 11:59 PM. Detailed rationale is provided in our response to question 7 below. We believe this will improve the achieve-ability of the trade-matching targets, provide better comparison with US matching rates, and improve general industry acceptance of the instrument.

- Final performance target

We believe the 98% threshold is too high and recommend eliminating this fourth milestone. Again our rationale is set out in detail below. In brief, however, this recognizes the concentrated nature of the Canadian capital markets where a 2% variance can be caused by a single event/client situation triggering exception reporting in spite of substantially achieving a high level of trade matching in all other respects.

- Reporting format

The trigger for exception reporting is based on matched trades. The proposed performance targets do not expressly recognize the differing roles and

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responsibilities of the registered dealer, custodian and institutional investor (and its agents) in the matching process. We would suggest that registered dealer reporting be triggered by a failure to enter trades in accordance with the timelines rather than matching. Entering trades is, of course, a prerequisite to trade matching. However, it appears unfair to impose exception reporting on a registered dealer who has met necessary order entry objectives, where custodian or investment manager action/inaction has caused a failure to match. We recognize the dealer will ultimately need to decide whether to continue doing business with a perennially late investment manager.

Our detailed responses to the questions raised in the Request for Comments follow:

Question 1. Should the definition of " institutional investor" be broader or narrower?

Our understanding of the definition is based both on our reading of the draft Instrument as well as the notes set out in the companion policy. We understand its intent is to include all accounts settling transactions in a DAP/RAP manner with a commercial custodian as well as accounts, other than those belonging to individual investors, with investment assets of $10,000,000 or more. In the case of accounts with investment assets of over $10,000,000, we understand the intention is to capture the activity of 'Prime Brokerage' operations often used for the management of hedge funds.

Overall, we do not consider this definition to be either too broad or too narrow. However, there is potential for confusion with respect to trading activity of entities such as hedge funds. Many trades by such clients may take place at one dealer with settlement being affected against the 'prime broker' who acts as custodian. Such trades are considered DAP/RAP in nature and are subject to matching through the central depository. Other trades for these same clients may be executed and settled at the 'prime broker' and therefore do not require matching at the central depository/clearing agency.

For greater clarity and simplicity, therefore, we suggest the definition simply refer to clients to whom DAP/RAP privileges have been extended whose trades clear through a Centralized Clearing Agency.

Question 2. Does the definition of "trade-matching party" capture all the relevant entities involved in the institutional trade matching process?

The definition is reasonably clear for trades executed on behalf of institutional accounts that maintain their assets at an independent/commercial custodian. It is less clear with respect to those clients, such as hedge funds, who use a

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broker as custodian of their assets. For clarity, we suggest the definition of custodian include a registered dealer. Together with our suggestion regarding the definition of "Institutional Investor" (above) this would help clarify which entities and which trades are to be captured under the instrument.

Question 3. The scope of the matching requirements of the Instrument is limited to DAP or RAP trades. Should the requirements be expanded to include other trades executed on behalf of an institutional investor? Should the requirements capture trades executed with or on behalf of an institutional investor settled without the involvement of a custodian?

Please refer to our response to Question 1.

Whether Institutional trades settle using the services of an independent custodian (commercial custodian) or are settled using a broker as custodian the trades are still considered to be DAP/RAP trades as long as they are cleared through a Central Clearing Agency and will therefore be captured in the process.

Question 4. Are each of these methods (compliance agreement and signed written statement) equally effective to ensure that the trade-matching parties will match their trades by the end of T? Should trade-matching parties be given a choice of which method to use?

We believe that providing trade related parties with a choice of either using a compliance agreement or a signed written statement allows flexibility and administrative simplicity. Either form of documentation should be equally effective in creating awareness and the sense of urgency and commitment necessary to accelerate trade matching following execution. Based on industry experience, negotiating terms of bi-lateral or multi-lateral agreements will be simplified even further if a standard template is used so that all dealers are, in effect, requiring the same undertakings in their trading relationships with institutional clients and/or their agents.

However, we are concerned that, without a reasonable transition period following implementation of the instrument, most broker/dealers as well as institutional clients and their agents are at risk of serious business disruption. It is unreasonable to expect dealers to refuse to serve the needs of their existing clients should the required documentation not be in place immediately following implementation of the instrument (anticipated in August 2006). As an alternative, we suggest that the documentation requirement be immediate for new institutional accounts opened (new clients) but that the requirement for pre-existing relationships be subject to a transition period coincident with the first exception reporting deadline (i.e., by the end of Q1 2007). In the absence of a reasonable transition period for the new documentation, we believe compliance failures on this dimension would be rampant and thereby

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undermine the effectiveness of the instrument.

Question 5. Will exception reports enable practical compliance monitoring and assessment of the trade matching requirements?

Exception reporting under the instrument consists of identifying the reason(s) why established trade matching rates have not been met by individual reporting entities (Exhibit A) and identifying the plans of individual reporting entities to correct such matching failures in the future (Exhibit B).

Exception reporting by participants that fail to meet the required transitional matching percentages may (eventually) enable practical monitoring. However, initial reporting, particularly in terms of "Exhibit A" - reasons for failing to meet matching percentages - are susceptible/prone to reciprocal or conflicting claims based on different opinions regarding when a trade was entered vs. when it was matched. (For instance, late trade matching will follow late trade entry). Eventually, trade related parties will cooperate and the resulting exception reporting will enable practical monitoring of trade matching performance only.

However, we believe that exception reporting for the dealer community should be triggered not by matching failures but by failure to entry trades in accordance with the timelines. Trade entry is a prerequisite for trade matching so to the extent trade entry has been completed in time for matching activities to occur we believe the dealer should not be held accountable in terms of filing exception reports for trade-matching failures

In addition to exception reporting, field audits of registrants' management of documentation requirements (Compliance Agreement/Written Statement) will be required as well as reviews of individual exception reports (exhibit A).

Question 6. Is it necessary to require custodians to do exception reporting in order to properly monitor compliance with this instrument?

We consider that compliance with the Instrument entails enforcing the documentation requirements, monitoring and reporting trade confirmation rates and initiating corrective actions when specified confirmation rates are not being met.

Monitoring the extent to which trade confirmation rates for dealer participants are meeting the established thresholds can best be done through direct reporting by CDS to the regulator.

CDS will also make available to its participants (brokers and custodians) additional, participant-specific reporting that will allow them to identify the trade entry and confirmation rates affecting their measured performance (i.e., whether a particular custodian or broker has not been able to confirm trades on a timely basis). These will inevitably lead to discussions among trade related

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parties that identify root causes of failures to confirm trades on time.

Through this process, reporting Brokers can analyze their results and report to their regulators as required.

This will not, however, provide the regulator with any information on the trade matching rates of non-broker registrants that are contemplated in the instrument.

Non-broker registrants such as ICPM's may rely on their own internal systems/operations for information regarding trade matching. In many cases, they will not have direct knowledge of trade matching rates but will rely on reporting from the custodian(s) they and their clients employ. However, it will be difficult to reconcile confirmation rates calculated and reported by the buy-side firms with specific reporting developed by individual brokers or even industry averages. Nevertheless, reporting by buy-side firms (who are registrants) should act as an incentive to achieve reasonable, target matching rates by re-enforcing the undertakings/statements made by way of the compliance agreements/written statements they have executed.

As a general business practice, custodians already monitor their clients operations for compliance with their own operational and fee agreements. Adding formal exception reporting at the custodian level should not be necessary for either monitoring compliance with the instrument overall or by way of adding incentives to change behaviour.

Question 7. Is it feasible for trade-matching parties to achieve a 7:30 p.m. on T matching rate of 98% by July 1, 2008, even without the use of a matching service utility in the Canadian Capital Markets?

We believe there are three aspects to this question:
- Is a trade matching utility necessary for significantly accelerated Institutional Trade Matching?
- Is a 7:30 cut-off time a reasonable definition of T (trade date); and
- Is the ultimate goal of having 98% of all institutional trades matched on Trade Date achievable?

- <u>The need/desirability of trade Matching Utilities:</u>

The systems functionality and operational processes currently available to industry participants are sufficient for achieving high levels of institutional trade matching without the use of a 'trade matching utility'.

Changes in the behaviour of individual participants including: the use of real-time trade entry; increased use of Block Settlement; the establishment of earlier cut off times as industry best practice; data standards for buy-side firms and other procedural changes will allow more timely matching of trade details.

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We believe the use of a trade matching facility by participants should be strictly an economic choice. If it makes sense for individual participants or groups of participants to engage the services of one or more trade matching facilities as an alternative to other, existing processes then market forces should be allowed to determine that need.

Mandating the use of a trade matching facility is not appropriate.

- <u>The Definition of T</u>

(The use of 7:30 PM on trade date as the end of "T" for reporting purposes:)

We believe that establishing the end of day at 7:30 p.m. for measurement purposes puts an unfair burden on the Canadian industry in comparison with other markets, particularly the U.S.

We understand that the 7:30 PM processing deadline for CDS may be necessary for the orderly management of internal systems and end of day routines. However, using this same deadline to measure trade-matching performance is not only unnecessary but can lead to trade activity congestion as participants, already engaged in intense end of day processing, concentrate even more trade entry activity at CDS immediately before the deadline.

We believe the technology exists to utilize a separate deadline for measuring trade-matching performance that is based on the more intuitively correct end-of-day, of, say 11:59 PM. Indeed, changes are needed to current reporting processes CDS to accommodate the first proposed trade-matching deadline of noon on T+1.

Using 11:59 PM has advantages of:
- aligning trade-matching performance comparisons with US calculations;
- relieving some of the end of day trade entry congestion caused by tighter deadlines; and
- better accommodating existing trade transmission schedules imposed by major application providers. (such as ADP)

- <u>Trade Matching Performance target of 98%:</u>

We agree it is necessary to significantly improve the rate at which institutional trades are matched, to ensure the competitiveness of the Canadian Capital Markets. Nevertheless, we consider the objective of 98% of all trades matched by July 1, 2008, to be unreasonable and we suggest as an alternative that the threshold be set at 90%. Our rationale follows:

-The competitiveness of individual participants, or the industry as a whole, is assured where the vast majority of transactions are processed in an automated manor. Certainly 90% captures the vast majority while

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- accommodating the few individual clients who may from time to time be unable to achieve automated matching within the established time frames.

- Setting the threshold at 98% could trigger exception reporting based on the performance of a single client and would not therefore fairly reflect the overall capabilities of the reporting entity. Quite simply, the bar would be set too high given the relatively concentrated nature of institutional trading in the Canadian Capital Markets and the economic value of ITM in the absence of a move to T+ 1 settlement.

- Without sufficient leeway/forgiveness in performance targets, the instrument may be seen as excessively strict and punitive; triggering exception reporting as a result of minor operational variations. 2% is too little allowance for operational variations, particularly where many still challenge the economic and risk management benefits of matching trades on T.

- Even with a threshold set at 90%, those institutional clients who may have caused a broker to fail to achieve targeted matching rates would likely have to report in respect of their own operations. This ensures that the incentive aspect of establishing performance targets is maintained without placing an unreasonable burden on individual broker participants who have otherwise operated in compliance with the instrument.

For these reasons we suggest the 4th milestone poses an unfair burden on the industry.

Question 8. Are the transitional percentages outlined in Part 10 of the Instrument practical? Please, provide reasons for your answer.

The reasonableness of transitional matching percentages varies.

The initial target (70% confirmed by noon on T+1) appears to be achievable for some industry leading brokers but remains a stretch goal for many. The next transitional target (80% on T) moves the confirmation percentage up to 80% and shortens the time line by one day. This is not a practical increment to achieve over a six-month period for several reasons:

- Incremental improvement in ITM will first require improvement to the rate of order entry achieved by broker/dealers since trades must be entered before they can be confirmed. Since many dealers employ batch related trade processing routines to transmit trade details to CDS, adoption of (virtual) real-time trade entry processes are required and the lead times necessary to accomplish this are in the range of 6 months and longer;

- The information required for brokers to enter trades (generally trade allocation details) is provided by investment managers and may not be available in time for the broker to meet the CDS cut-off of 7:30 PM;

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- Use of value weighted average pricing, best fill order management or other trading techniques prevents intra-day trade detail communication in many cases;

- Existing fund accounting routines delay some managers from communicating trade details until T+1; (a practice that will need to change but that will take time); and

- Any trade entry that occurs after this cut-off is automatically recorded on the next day (T+1 for example).

Extending the measurement deadline to 11:59PM will facilitate comparison with other jurisdictions (in particular the US). Development of reporting capability independent of CDS settlement and processing deadlines is feasible. Defining T at 11:59 p.m. will also allow the processing of numerous trades held at CDS after close of 7:30 p.m. but before the current system reboot at 10 – 11 p.m.

Current industry practice among buy-side firms indicates that the most trade details (to either custodians or brokers) are released in a concentrated time period after the markets close and before noon on T+1. In fact, we estimate that over 25% of current institutional trade volume details (from buy-side firms) is not currently released on Trade Date. The release of this information by buy-side firms is, in most cases, a pre-requisite for both trade entry and trade confirmation activities. Changing buy-side firm practices to accelerate the release of trade details will be necessary to accelerate ITM. This is a major change especially with the rapidity of the milestones trigger changes form 70% to 80%

We believe the transitional matching percentages should increase from 70% to 80% by noon on T+1 before moving the timeline from T+1 to Trade date.

In closing we would like to reiterate our support for accelerating Institutional Trade Matching and we are grateful for the impetus this instrument will have by way of encouraging industry participants to move forward with systems and procedural changes, already recognized as desirable, but so far without sufficient priority. We believe our suggested changes and overall comments set out above will not undermine the objectives or effectiveness of the instrument and we look forward to working towards our shared objective of improving ITM performance in Canadian capital markets.

Yours truly,

Executive Director