

13.3 Clearing Agencies

13.3.1 OSC Notice and Request for Comment – CLS Bank International – Application for Exemption from Recognition as a Clearing Agency

OSC NOTICE AND REQUEST FOR COMMENT

CLS BANK INTERNATIONAL

APPLICATION FOR EXEMPTION FROM RECOGNITION AS A CLEARING AGENCY

A. Background

On March 1, 2011, subsection 21.2(0.1) of the *Securities Act* (Ontario) (OSA) will come into force. It will prohibit clearing agencies from carrying on business in Ontario unless they are recognized as a clearing agency or are exempt from the requirement to be recognized by order of the Ontario Securities Commission (Commission).

CLS Bank International (CLS) has applied (the Application) to the Commission for an order pursuant to section 147 of the OSA to exempt CLS from the requirement to be recognized as a clearing agency in subsection 21.2(0.1) of the OSA. CLS operates an international payment settlement system that currently settles payment instructions relating to underlying foreign exchange and derivatives transactions involving seventeen different currencies, including the Canadian dollar. CLS is a specialized banking institution based in the United States and subject to extensive regulatory oversight and/or supervision by the Board of Governors of the U.S. Federal Reserve System and the Federal Reserve Bank of New York (collectively, the U.S. Federal Reserve) and other central banks, including the Bank of Canada, whose currencies are eligible for settlement in CLS' system. The Bank of Canada has broad regulatory and oversight powers over the CLS system under the federal *Payment Clearing and Settlement Act*.

B. Draft Order

Subject to comments received, staff propose to recommend that the Commission grant an exemption substantially in the form of the draft order attached at Tab No. 4 (Draft Order) of the Application. The Draft Order grants the requested relief to CLS provided that, among other things, CLS and the CLS system continue to be supervised and regulated by the U.S. Federal Reserve and Bank of Canada, and CLS not engage in any clearing agency activity in Ontario that is not described in the Application without obtaining the prior approval of the Commission.

C. Comment Process

The Commission is publishing for public comment the Application and Draft Order. We are seeking comment on any aspect of the Application and Draft Order. You may provide your comments in writing by e-mail on or before February 20, 2011, addressed to the attention of the Secretary of the Commission, Ontario Securities Commission, 20 Queen Street West, Toronto, Ontario, M5H 3S8, e-mail: jstevenson@osc.gov.on.ca.

The confidentiality of submissions cannot be maintained as comments received during the comment period will be published.

Questions on this notice may be referred to:

Maxime Paré
Senior Legal Counsel
Market Regulation Branch
Tel: 416-593-3650
mpare@osc.gov.on.ca

Leslie Pearson
Legal Counsel
Market Regulation Branch
Tel.: 416-593-8297
lpearson@osc.gov.on.ca



McCarthy Tétrault LLP
Box 48, Suite 5300
Toronto Dominion Bank Tower
Toronto ON M5K 1E6
Canada

Michael C. Nicholas
Direct Line: 416 601-8147
Direct Fax: 416 868-0673
Email: mnicholas@mccarthy.ca

January 12, 2011

VIA EMAIL AND COURIER

Ontario Securities Commission
20 Queen Street West
Suite 1800
Toronto ON M5H 3S8

Attention: Secretary to the Commission

Dear Sirs/Mesdames:

Re: CLS Bank International - Application for an Exemption from Recognition as a Clearing Agency pursuant to Section 147 of the Securities Act (Ontario)

1.0 Background and Purpose

1.1 We act as counsel to CLS Bank International ("CLS Bank"). As described in greater detail below, CLS Bank was established in 1999 to develop a system to settle payment instructions relating to underlying foreign exchange transactions to reduce the settlement risk inherent in existing settlement mechanisms. CLS Bank began live operations in September 2002.

1.2 In 2007, CLS Bank extended its settlement services to payment instructions relating to underlying non-deliverable forward foreign exchange transactions ("NDF Instructions") and to payment instructions relating to over-the-counter ("OTC") derivative transactions ("Derivative Instructions") resulting in one-way payments across the books of CLS Bank. Settlement services in relation to Derivative Instructions are currently limited to underlying OTC credit derivative transactions but they could eventually include other types of underlying derivative transactions, such as interest rate swaps, equity derivatives and commodity derivatives subject to receipt of all necessary approvals. In the future, CLS Bank may also extend its settlement services to include payment instructions relating to underlying premium payments due on foreign exchange option transactions ("FX Option Premium Instructions").

1.3 In addition to the above-described payment settlement services, CLS Bank launched an aggregation service for FX spot transactions (the "Aggregation Service") last year.

1.4 The OTC derivative transactions underlying Derivative Instructions will be considered derivatives¹ for purposes of the *Securities Act* (Ontario) (the "Act") and can include transactions in relation to securities from time to time². CLS Bank may therefore be considered to be carrying on the business of a clearing agency in Ontario when providing settlement services to certain Canadian financial institutions in respect of Derivative Instructions based upon the definition of "clearing agency" found in section 1(1) of the Act and Ontario Securities Commission ("OSC") *Staff Notice 24-702 Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*³ ("OSC Notice 24-702"), a copy of which is attached at Tab No. 1.

¹ The term "derivative" is defined in section 1(1) of the Act to mean, in part, an option, swap, futures contract, forward contract or other financial or commodity contract or instrument whose market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest (including a value, price, rate, variable, index, event, probability or thing).

² As a practical matter, when CLS Bank settles Derivative Instructions through its automated CLS system, described below, it is unable to determine whether the underlying OTC derivative transaction is a security because it does not have access to the information that would be required to make such a determination.

³ March 19, 2010 33 OSCB 2324.

1.5 As a result of recent amendments to the Act that became effective on December 8, 2010, the term “clearing agency” is now defined in section 1(1) of the Act with respect to both securities and derivatives. As regards securities, the term “clearing agency” is defined to mean a person or company that,

- (a) acts as an intermediary in paying funds or delivering securities, or both, in connection with trades and other transactions in securities,
- (b) provides centralized facilities for the clearing of trades and other transactions in securities, including facilities for comparing data respecting the terms of settlement of a trade or transaction, or
- (c) provides centralized facilities as a depository of securities,

but does not include,

- (d) the Canadian Payments Association or its successors,
- (e) a stock exchange or a quotation and trade reporting system,
- (f) a registered dealer, or
- (g) a bank, trust company, loan corporation, insurance company, treasury branch, credit union or caisse populaire that, in the normal course of its authorized business in Canada, engages in an activity described in (a) above, but does not engage in an activity described in (b) or (c) above.

1.6 As regards derivatives, the term “clearing agency” is defined to mean a person or company that provides centralized facilities for the clearing and settlement of trades in derivatives that, with respect to a contract, instrument or transaction,

- (a) enables each party to the contract, instrument or transaction to substitute, through novation or otherwise, the credit of the clearing agency for the credit of the parties,
- (b) arranges or provides on a multilateral basis, for the settlement or netting of obligations resulting from such contracts, instruments or transactions executed by participants in the clearing agency, or
- (c) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the clearing agency the credit risk arising from such contracts, instruments or transactions executed by the participants,

but does not include a person or company solely because the person or company arranges or provides for,

- (d) settlement, netting or novation of obligations resulting from agreements, contracts or transactions on a bilateral basis and without a central counterparty,
- (e) settlement or netting of cash payments through the Automated Clearing Settlement System or the Large Value Transfer System, or
- (f) settlement, netting or novation of obligations resulting from a sale of a commodity in a transaction in the spot market.

1.7 OSC Notice 24-702 was published last year after amendments to the clearing agency recognition requirements of section 21.2 of the Act were proclaimed in force, effective March 1, 2011. As currently drafted, section 21.2(1) simply provides that the OSC may, on the application of a clearing agency, recognize the clearing agency if the OSC is satisfied that to do so would be in the public interest. Section 21.2(1) is therefore a permissive, rather than a mandatory, recognition provision. New section 21.2(0.1) will expressly prohibit clearing agencies from carrying on business in Ontario until they have become recognized as such by the OSC when it becomes effective on March 1, 2011.

1.8 OSC Notice 24-702 sets out OSC staff’s regulatory approach to applications for both recognition, and exemptions from recognition, as a clearing agency. It provides, among other things, that a foreign-based clearing agency that offers to provide its services or facilities to a person or company resident in Ontario will be considered to be carrying on business in Ontario.⁴ It further provides that OSC staff may recommend to the OSC that a foreign-based clearing agency be granted an exemption from recognition pursuant to section 147 of the Act if the clearing agency does not pose significant risk to the Ontario capital markets

⁴ *Ibid* at p. 2326.

and is subject to an appropriate regulatory and oversight regime in a foreign jurisdiction.⁵ Such an exemption from the clearing agency recognition requirements would effectively recognize that requiring foreign-based clearing agencies to comply with the regulatory framework applicable to domestic clearing agencies would be duplicative and inefficient when imposed in addition to the regulation of the home jurisdiction. OSC Notice 24-702 then goes on to provide that a foreign-based clearing agency that wishes to apply for an exemption from the Act's clearing agency recognition requirements must establish at the time of the application that it meets the same criteria that a domestic clearing agency must meet when applying for recognition as a clearing agency (the "Recognition Criteria") and that it must also provide a detailed description of the regulatory regime of the home jurisdiction and the regulatory requirements that are imposed on it in its home jurisdiction. The Recognition Criteria is attached as Appendix A to OSC Notice 24-702.

1.9 As described in greater detail below, CLS Bank is subject to extensive regulatory oversight and supervision by the Board of Governors of the U.S. Federal Reserve System and the Federal Reserve Bank of New York (collectively, the "U.S. Federal Reserve") as well as oversight by the central banks of those countries, including Canada, whose currencies are eligible for settlement in CLS Bank's payment system (the "Central Banks"). Within Canada, CLS Bank is also subject to supervision by the Bank of Canada as a result of its designation of the CLS system as a "clearing and settlement system" pursuant to section 4(1) of the *Payment and Clearing Settlement Act* ("PCSA").

1.10 Based upon this elaborate framework for the oversight and supervision of CLS Bank, and the related guidance provided by OSC Notice 24-702, we are writing on behalf of CLS Bank to apply for an order pursuant to section 147 of the Act exempting CLS Bank from the clearing agency recognition requirement that will be applicable to it effective March 1, 2011 as the result of the settlement services that it provides, and will continue to provide, in respect of Derivative Instructions. We have engaged in related pre-filing discussions with staff of the Market Regulation Branch respecting the information to be provided in support of the recognition exemption that is being sought pursuant to this application. As a result of these discussions, the information provided below focuses on the status and structure of CLS Bank, the operation of the CLS system, including the settlement services that CLS Bank provides in respect of Derivative Instructions, and the established framework for the regulatory oversight and supervision of CLS Bank in lieu of expressly addressing the Recognition Criteria.

2.0 CLS Bank

Status and Structure

2.1 CLS Bank is chartered as an Edge corporation under the laws of the United States. Edge corporations are banking institutions that are authorized to conduct international banking operations. They are supervised and regulated by the U.S. Federal Reserve.

2.2 CLS Bank and CLS Services Ltd. ("CLS Services") are subsidiaries of their UK parent, CLS UK Intermediate Holdings Ltd., which is in turn wholly-owned by a Swiss holding company, CLS Group Holdings AG, the ultimate holding company of the CLS Group. CLS Bank does not maintain any branches or offices other than its headquarters in New York. CLS Services is incorporated under the laws of England and Wales and is located in London. CLS UK Intermediate Holdings Ltd. is also incorporated under the laws of England and Wales, it is located in London and it maintains a representative office in Tokyo.

2.3 CLS Bank operates the CLS system pursuant to the CLS Bank International Rules (the "Rules"). CLS Services provides CLS system operations and support, vendor support, information technology, security services and other support services to, and under the direction of, CLS Bank pursuant to a Master Services Agreement between CLS Bank and CLS Services.

2.4 CLS Bank permits participation in the CLS system by two different types of members. Members who maintain an account with CLS Bank (an "Account") are referred to as Settlement Members. Members who do not maintain an Account are referred to as User Members. Each User Member must be sponsored by a Settlement Member. Both Settlement Members and User Members (in either case a "Member") are required, as a condition of membership, to execute an agreement with CLS Bank. The Rules are governed by English law. Settlement Member Agreements and User Member Agreements are governed by New York law.

2.5 An applicant for approval as a Settlement Member must meet stringent membership requirements that are set forth in the Rules. Settlement Member membership requirements include, among other things, an established operating capability, acceptable regulatory oversight, minimum capital and capital ratio requirements and minimum credit ratings. As noted above, an applicant for approval as a Settlement Member must also establish a settlement account with CLS Bank.

2.6 CLS Bank currently settles payment instructions ("Instructions") relating to underlying transactions ("Transactions") involving seventeen different currencies ("Eligible Currencies") comprising the Australian dollar; Canadian dollar; Danish krone; euro; Hong Kong dollar; Israeli shekel; Japanese yen; Mexican peso; New Zealand dollar; Norwegian krone; Singapore dollar;

⁵ *Ibid.*

South African rand; South Korean won; Swedish krona; Swiss franc; UK pound sterling; and U.S. dollar and it also intends to settle payment instructions relating to Transactions involving other currencies subject to receipt of all necessary approvals. It currently has Members that have their head or home offices located in Australia, Belgium, Canada, Denmark, England, France, Germany, Hong Kong, Israel, Italy, Japan, Luxembourg, Netherlands, Norway, Scotland, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland and the United States.

2.7 Settlement Members with their head or home offices in Canada comprise four banks (the “Canadian Members”). Each Canadian Member is listed in Schedule 1 to the *Bank Act* (Canada) and is located in Ontario. It is also anticipated that an additional Schedule I bank will soon become a Settlement Member. It is also located in Ontario.

2.8 CLS Bank and/or the CLS system has been designated as follows in each of the following jurisdictions:

European Union	-	as a “designated system” under the EC Settlement Finality Directive.
Australia	-	as a “netting market” under the <i>Payment Systems and Netting Act 1998</i> .
Canada	-	as a “clearing and settlement system” under the <i>Payment Clearing and Settlement Act</i> (Canada).
Hong Kong	-	as a “designated system” under the Clearing and Settlement Systems Ordinance.
Israel	-	as a “designated supervised system” under the Payment Systems Law, 5768-2008.
New Zealand	-	as a “designated settlement system” under the <i>Reserve Bank of New Zealand Act</i> .
Singapore	-	as a “designated system” under the <i>Payment and Settlement Systems (Finality and Netting) Act 2002</i> .
South Africa	-	as a “designated settlement system” under the <i>National Payment Amendment Act, 2004</i> .
South Korea	-	as a “designated payment and settlement system” under the Law Concerning Debtor Rehabilitation and Bankruptcy.

The CLS System

2.9 CLS Bank has adopted a “continuous linked settlement” model as the basis for the CLS system. Continuous linked settlement is a process for settling payment instructions in respect of underlying Transactions that is intended to eliminate settlement risk attributable to the existence of time zones and their effects on the variable hours of operation of financial centres throughout the world.⁶

2.10 Each Member may participate in the CLS system by submitting Instructions in relation to a particular Transaction to the CLS system in accordance with a submission process that may or may not involve CLS proprietary software licensed to the Member. Each Member that submits Instructions identifies itself to CLS Bank through the use of an identification code. Each Instruction identifies, among other things, the parties to the underlying Transaction and the Member that is expected to submit a corresponding Instruction in relation to the same underlying Transaction. Each Instruction is processed by the CLS system (i.e. authenticated, edit checked, validated, and, in most cases, matched) and, if determined to be eligible for settlement, is settled across the books and records of CLS Bank by the simultaneous entry of debits and credits to the Accounts of the relevant Settlement Members identified in the Instructions.

2.11 As noted above, CLS Bank maintains an Account in respect of each Settlement Member. Each Account is a single, multi-currency account in respect of each Eligible Currency that is used for the settlement of all Instructions that are submitted by either the Settlement Member or a User Member that has been sponsored by the Settlement Member.

2.12 As regards each Account, the relevant Settlement Member may be permitted to have negative balances in some Eligible Currencies (each, a “Short Position”) if there are offsetting positive balances in the other Eligible Currencies (each, a “Long Position”), such that the overall account balance of the Settlement Member (the “Account Balance”) is positive. The Account Balance is calculated as the sum of the positive and negative balances for each Eligible Currency in the relevant Account (each, a “Currency Balance”) after each Currency Balance has been converted to the base currency of U.S. dollars. In all cases, the obligations and entitlements of each of CLS Bank and a Settlement Member in respect of the Settlement Member’s Account is a net amount that is equal to the Account Balance less all interest, fees, costs and expenses that are due from the Settlement Member.

⁶ Crawford, Bradley, *Payment, Clearing and Settlement in Canada*, Volume 1, Canada Law Book Inc., 2002, p.616

2.13 The distinction between funding and settlement is critical to an appreciation of the CLS system. Funding occurs on a multilaterally netted basis between CLS Bank and each of its Settlement Members, while the settlement of Instructions occurs individually on a gross basis between Settlement Members across the books of CLS Bank. Although the two processes are separate, they are linked and run in parallel operationally.

2.14 Funding is the process by which a Settlement Member makes pay-ins of a currency to CLS Bank (a “Pay-In”) through the payment systems that are approved by CLS Bank for effecting such payments. CLS Bank maintains an account with each Central Bank. In Canada, CLS Bank maintains its account with the Bank of Canada. Each Settlement Member’s Account at CLS Bank consists of a Currency Balance for each Eligible Currency, and only Eligible Currencies are eligible for settlement across the books of CLS Bank. As part of the funding process, CLS Bank credits a Settlement Member’s Account when it is notified of Pay-Ins received in CLS Bank’s Central Bank accounts for the benefit of that Settlement Member. In connection with pay-outs to Settlement Members (each, a “Pay-Out”), CLS Bank disburses funds from its Central Bank accounts through the relevant Approved Payment Systems and debits the relevant Settlement Member’s Account accordingly.

2.15 Settlement Members make Pay-Ins in accordance with Pay-In schedules issued by CLS Bank. CLS Bank settles Instructions and makes Pay-Outs of related proceeds throughout its operating process. Settlement occurs when CLS Bank simultaneously debits and credits the Accounts of the relevant Settlement Members in accordance with Instructions that were submitted by the Settlement Members and/or the User Members sponsored by them. As described above, each Instruction is settled individually on a gross basis and is not netted against other Instructions.

2.16 CLS Bank does not act as a central counterparty. CLS Bank does not guarantee settlement nor does it become a counterparty to any of the underlying Transactions to which Instructions are related. Settlement will not occur if Instructions are not eligible for settlement because, for example, an Account would not have a positive Account Balance post settlement. All settled Instructions are final and binding on each of the Members. Generally speaking, unsettled Instructions are rejected at the end of the relevant settlement date.

2.17 Settlement can be completed before all funding has been paid in because, as noted above, a Settlement Member may have one or more Short Positions in its Account provided it also has Long Positions that provide for a positive Account Balance. However, funding may continue for up to three hours after settlement has taken place, depending upon the Eligible Currency. Settlement Members are required to cover any Short Positions before the end of each business day by making Pay-Ins of outstanding amounts.

2.18 In the event CLS Bank does not have sufficient funds in a particular Eligible Currency to make a Pay-Out in that currency to Members, CLS Bank may draw upon liquidity facilities, by means of a foreign exchange swap or purchase, that it maintains with financial institutions (“Liquidity Facilities”) to obtain the currency required to make the Pay-Out. CLS Bank draws on its Liquidity Facilities for the sole purpose of making Pay-Outs after Instructions have settled because Liquidity Facilities are not used for the purpose of settling Instructions. Insufficient funds in a particular Eligible Currency may arise where a Settlement Member has failed to satisfy its Pay-In obligations in respect of that currency. The costs associated with CLS Bank’s draw on its Liquidity Facility are charged to the Settlement Member responsible for the currency shortfall.

2.19 In the event that a Settlement Member fails to meet its obligations to CLS Bank, any resulting loss to a Member or a Liquidity Provider is allocated to the other Members in accordance with loss allocation procedures that are prescribed by the Rules.

Settlement Services in Respect of Derivative Instructions

2.20 Prior to 2007, the settlement services offered by CLS Bank were limited to the settlement of Instructions in relation to underlying foreign exchange transactions that included, without limitation, single deliverable foreign exchange spot or forward transactions, a single leg of deliverable foreign exchange swap transactions, single exercised deliverable foreign exchange options and other similar deliverable foreign exchange transactions (collectively, “FX Transactions”). In 2007, CLS Bank extended its settlement services to the settlement of NDF Instructions and Derivative Instructions. CLS Bank’s settlement services may also be further extended to include the settlement of FX Option Premium Instructions.

2.21 CLS Bank’s settlement services were extended to include the settlement of Derivative Instructions following its selection as the Central Settlement Provider for a Trade Information Warehouse (the “Warehouse”) that has been established by DTCC Deriv/SERV LLC (“DTCC”), a wholly-owned subsidiary of the Depository Trust & Clearing Corporation.

2.22 DTCC designed the Warehouse in response to concerns that had been expressed by certain regulatory authorities, in particular the U.S. Federal Reserve and the UK Financial Services Authority, regarding insufficient documentation in respect of OTC credit derivative transactions. The Warehouse is intended to provide a comprehensive, centralized trade database with the most up-to-date record of each OTC credit derivative transaction, as well as a central processing capability to standardize and automate “downstream” processing of payments and other post-confirmation processes. DTCC administers the Warehouse by:

- centrally calculating the payments for those OTC credit derivatives for which the Warehouse maintains the official legal record; and
- matching/affirming payments for those OTC credit derivative transactions for which the Warehouse maintains basic economic information.

2.23 As the central settlement provider for the Warehouse, CLS Bank settles Derivative Instructions received from The Warehouse Trust Company, LLC⁷ ("Warehouse Trust") in relation to underlying OTC credit derivative transactions that are maintained in the Warehouse ("Warehouse Derivatives") in a manner that is similar to the manner in which it settles Instructions in relation to underlying FX Transactions. Members submit Instructions directly to the CLS system in relation to Warehouse Derivatives ("Warehouse Derivative Instructions") through Warehouse Trust. Each Warehouse Derivative Instruction specifies the payment amount in an Eligible Currency that is due under one or more Warehouse Derivatives. The payment amount may be a net amount between the two parties to one or more Warehouse Derivatives. If so, the netted amount is calculated by DTCC based upon records maintained for Warehouse Derivatives.

2.24 Only those institutions that are Members are eligible to participate in the settlement services that are provided by CLS Bank in respect of Warehouse Derivative Instructions utilizing Warehouse Trust as agent for the transmission of such Instructions. The underlying Warehouse Derivatives may, however, be proprietary to the Member or they may be third party customer transactions.

2.25 Like NDF Instructions, Warehouse Derivative Instructions are commingled with foreign exchange Instructions for settlement processing purposes. CLS Bank calculates funding requirements from its Settlement Members by taking into account Instructions in relation to all underlying Transactions that are in the process of being settled. Accordingly, all Pay-Ins and Pay-Outs relating to settlement for all Instructions, including Warehouse Derivative Instructions, continue to be made as between Settlement Members and CLS Bank. The settlement of Instructions involves CLS Bank's account with Bank of Canada only when a payment is required to be made in Canadian dollars by either a Settlement Member or CLS Bank.

2.26 At the present time, the Warehouse supports nine currencies comprising the Australian dollar; Canadian dollar; euro; Hong Kong dollar; Japanese yen; Singapore dollar; Swiss franc; UK pound sterling; and U.S. dollar, each of which is an Eligible Currency. Although the focus of the Warehouse is currently limited to OTC credit derivatives in these currencies, DTCC may expand its Warehouse services to other types of OTC derivatives transactions, and to other Eligible Currencies, in the future. This would serve to further enhance the range of settlement services that would be provided by CLS Bank in its role as central settlement provider for the Warehouse. CLS Bank would have to seek and obtain regulatory approval before agreeing to settle any payments related to such expanded activities.

2.27 As alluded to above, OTC derivative transactions underlying Derivative Instructions, including Warehouse Derivatives, would be considered derivatives and may, or may not, be considered transactions in relation to securities for purposes of the Act, and, in particular, the clearing agency recognition requirements of the Act that are described below.

The Aggregation Service

2.28 Last year, CLS Aggregation Services LLC ("CLSAS"), a separate company owned 51% by CLS Bank and 49% by Traiana Inc., began offering the Aggregation Service. The Aggregation Service is a stand-alone service offering from CLSAS that has no direct interface with the settlement services offered by CLS Bank. This initiative is intended to address potential Member middle/back office capacity issues caused by high frequency, low value FX trades attributable to, among other things, algorithmic trading and retail aggregators, as well as the desire to lower the Member's transaction process costs for such trades.

2.29 The Aggregation Service "aggregates" FX spot trades (FX forward trades, NDFs and FX option premium trades are not currently eligible for processing in the Aggregation Service). The Aggregation Service compresses into one or more aggregated transactions all matched FX spot trades between two trading parties that have not been previously aggregated by the Aggregation Service and involve the same buy currency from one trading party in exchange for another sell currency to the other trading party with respect to such matched FX trades. The result of the compression is one or more aggregated transactions that represent the cumulative amount of buy currency against the cumulative amount of sell currency from the two trading parties.

3.0 Regulatory Oversight and Supervision of CLS Bank

Oversight by U.S. Federal Reserve

3.1 As indicated above, CLS Bank is chartered as an Edge corporation under the laws of the United States and, as such, it is a U.S. banking institution that is authorized to conduct international banking operations. As an Edge corporation, CLS Bank is supervised and regulated by the U.S. Federal Reserve.

⁷ Warehouse Trust is a limited purpose trust company that is wholly-owned by DTCC and regulated by the Board of Governors of the U.S. Federal Reserve and the New York State Banking Department.

Cooperative Oversight by Central Banks

3.2 The U.S. Federal Reserve and the Central Banks have established a cooperative oversight arrangement for CLS Bank that is governed by, and conducted in accordance with, the Protocol for the Cooperative Oversight Arrangement of CLS (the "Protocol"). The Protocol is premised upon the principles for international cooperative oversight that are contained in the "Central Bank Oversight of Payment and Settlement Systems" report of the Committee on Payment and Settlement Systems of the Group of Ten countries. The Protocol provides a mechanism for the mutual assistance of the participating Central Banks to facilitate the fulfilment of their individual responsibilities in pursuit of their shared public policy objectives for the safety and efficiency of payment and settlement systems and their focus on the stability of the financial system. The Core Principles for Systemically Important Payment Systems serve as minimum standards against which CLS Bank is assessed by participating Central Banks pursuant to the Protocol. A copy of the Protocol is attached at Tab No. 2. The Central Banks also receive extensive information regarding the CLS system through their participation on the CLS Oversight Committee established by the Protocol.

Oversight by Bank of Canada and OSFI

3.3 As the Canadian dollar is an Eligible Currency for purposes of the CLS system, Bank of Canada is a participating Central Bank under the Protocol. It also has a domestic responsibility for supervision of CLS Bank as a result of the PCSA which imposes a responsibility on Bank of Canada to supervise clearing and settlement systems that could be operated in a manner that could pose systemic risk. In keeping with such responsibility, Bank of Canada has designated the CLS system, as well as the Large Value Transfer System and CDSX, operated by CDS Clearing and Depository Services Inc., as clearing and settlement systems that could be operated in a manner that could pose systemic risk pursuant to section 4(1) of the PCSA. As a bank, CLS Bank is also subject to the prospect of regulatory oversight by the Office of the Superintendent of Financial Institutions ("OSFI") pursuant to the *Bank Act* (Canada).

Oversight by Other Central Banks

3.4 As described above, in addition to the CLS system's designation as a clearing and settlement system by Bank of Canada pursuant to Section 4(1) of the PCSA, CLS Bank and/or the CLS system have been the subject to similar designations in each of the European Union, Australia, Hong Kong, Israel, New Zealand, Singapore, South Africa and South Korea.

4.0 Clearing Agency Recognition Requirements

4.1 The Act regulates the activities of clearing agencies in Ontario by prescribing a process for their recognition pursuant to 21.2 of the Act. As currently drafted, section 21.2(1) simply provides that the OSC may, on the application of a clearing agency, recognize the clearing agency if the OSC is satisfied that to do so would be in the public interest. Although section 21.2(1) is currently permissive only, because it does not expressly prohibit a clearing agency from acting as such without being recognized by the OSC, new section 21.2(0.1) will impose a mandatory recognition requirement on clearing agencies effective March 1, 2011. Section 21.2(0.1) will provide that no person or company shall carry on business in Ontario as a clearing agency unless the person or company is recognized by the OSC under section 21.2(0.1) as a clearing agency.

5.0 Application for an Exemption from Clearing Agency Recognition Requirement

5.1 As described above, having extended its settlement services to include settlement services in relation to Derivative Instructions, CLS Bank is prepared to acknowledge that it is a clearing agency for purposes of the Act. Although the matter is not free from doubt, CLS Bank is also prepared to acknowledge that it will be considered to be carrying on the business of a clearing agency in Ontario for purposes of section 21.2(0.1) of the Act when it becomes effective on March 1, 2011 based upon related guidance that is provide by OSC Notice 24-702.⁸

5.2 As described above, CLS Bank is already subject to extensive regulatory oversight and/or supervision by the U.S. Federal Reserve, the Central Banks and Bank of Canada. These institutions have the requisite expertise to effectively monitor and supervise the payment settlement system that is operated by CLS Bank. It is therefore unlikely that any additional regulatory oversight by the OSC could make a meaningful contribution to the existing regulatory framework for CLS Bank.

5.3 In the light of the foregoing, CLS Bank hereby applies for an order pursuant to section 147 of the Act granting an exemption from the clearing agency recognition requirements of section 21.2 of the Act effective March 1, 2011 or such other date on which section 21.2(0.1) of the Act becomes effective.

⁸ *Supra*, note 1 at p. 2326.

6.0 Submissions in Support of the Exemption Sought by CLS Bank

6.1 It is our submission that the exemptive relief sought by CLS Bank should be granted for the following reasons:

- (a) Members of CLS Bank are, and will continue to be, limited to financial institutions that are capable of meeting the CLS Bank membership requirements that are set out in the Rules;
- (b) the services that are offered by CLS Bank are, first and foremost, payment settlement services and any related clearing or data processing activity that is conducted by CLS Bank in connection with any underlying transaction in relation to derivatives and/or securities is entirely incidental to its primary function of settling Instructions, including Derivative Instructions, since CLS Bank has nothing to do with the entering into of underlying Transactions;
- (c) as an Edge corporation operating an international payment system, CLS Bank and the CLS system are subject to regulatory oversight and supervision by the U.S. Federal Reserve;
- (d) CLS Bank and the CLS system are also subject to a cooperative oversight arrangement among the U.S. Federal Reserve and the Central Banks, including Bank of Canada, that is governed by, and conducted in accordance with, the Protocol;
- (e) Bank of Canada, and each of the other Central Banks, receive extensive information regarding the CLS system through their participation on the CLS Oversight Committee established by the Protocol;
- (f) within Canada, CLS Bank is also subject to regulatory oversight by Bank of Canada and the prospect of regulatory oversight by OSFI pursuant to the PCSA and the Bank Act (Canada), respectively, and this regulatory framework is consistent with the way in which CLS Bank is regulated as a bank and/or the operator of the CLS system in all other jurisdictions; and
- (g) there is no public interest to be served by adding an additional layer of oversight to the above-described regulatory framework.

7.0 Authorization Letter, Draft Decision Document and Filing Fees

7.1 In support of the clearing agency recognition exemption that is sought by way of this application, we attach or enclose the following:

- (a) an authorization letter of CLS Bank authorizing the filing of this application by us and confirming the truth of the facts contained herein is attached at Tab No. 3;
- (b) a draft order pursuant to section 147 of the Act (the "Draft Order") is attached at Tab No. 4; and
- (c) a cheque payable to the OSC in the amount of \$5,250 is enclosed in satisfaction of the applicable filing fee.

7.2 I invite you to call me at your convenience to discuss any questions or comments that you may have in relation to any aspect of this application or the Draft Order.

Yours truly,

"Michael C. Nicholas"

Michael C. Nicholas
MCN/cb

c: Maxime Paré
Antoinette Leung
Ontario Securities Commission

James Holdcroft
David Skoblow
Lauren Alter-Baumann
CLS Bank International

Henry Wiercinski
McCarthy Tétrault LLP

Tab No. 1

**OSC STAFF NOTICE 24-702
REGULATORY APPROACH TO RECOGNITION
AND EXEMPTION FROM RECOGNITION OF CLEARING AGENCIES**

OSC Staff Notice 24-702 can be viewed via the following link:

http://www.osc.gov.on.ca/documents/en/Securities-Category2/sn_20100319_24-702_clearing-agencies.pdf

Tab No. 2

**PROTOCOL FOR THE COOPERATIVE
OVERSIGHT ARRANGEMENT OF CLS**

*The Protocol for the Cooperative Oversight Arrangement of CLS can be viewed via the following link:
http://www.federalreserve.gov/paymentsystems/cls_protocol.htm*

Tab No. 3



David V. Skoblow
Executive Vice President and General Counsel

39 Broadway
29th floor
New York, NY 10006

Tel: +1 (212) 943-2296
Fax: +1 (212) 363-6998
dskoblow@cls-bank.com

January 12, 2011

VIA COURIER

Ontario Securities Commission
20 Queen Street West
Suite 1800
Toronto ON M5H 3S8

Attention: Secretary to the Commission

Dear Sirs/Mesdames:

Re: CLS Bank International – Application for Exemption from Recognition as a Clearing Agency pursuant to Section 147 of the Securities Act (Ontario)

The undersigned hereby authorizes the making and filing of the attached application letter by McCarthy Tétrault LLP and confirms the truth of the facts contained therein.

CLS BANK INTERNATIONAL

“David V. Skoblow”

Name: David V. Skoblow
Title: Executive Vice President and General Counsel

Tab No. 4

DRAFT: January 18, 2011

March 1, 2011

**IN THE MATTER OF
THE SECURITIES ACT,
R.S.O. 1990, CHAPTER S.5, AS AMENDED
(the Act)**

AND

**IN THE MATTER OF
CLS BANK INTERNATIONAL**

AND

CLS SERVICES LTD.

DECISION

(Section 147 of the Act)

UPON the Ontario Securities Commission (the Commission) having received an application (the Application) from CLS Bank International (the Applicant) for a decision pursuant to section 147 of the Act exempting the Applicant and CLS Services Ltd. ("CLS Services") from the clearing agency recognition requirement of subsection 21.2(0.1) of the Act (the Requested Relief);

AND UPON considering the Application and the recommendation of staff of the Commission;

AND UPON the Applicant having represented to the Commission that:

1. The Applicant is chartered as an Edge corporation under the laws of the United States and, as such, it is a banking institution that is authorized to conduct international banking operations.
2. The Applicant and CLS Services are wholly-owned subsidiaries of CLS UK Intermediate Holdings Ltd. (CLS Intermediate Holdings).
3. Each of CLS Services and CLS Intermediate Holdings is incorporated under the laws of England and Wales and is located in London, England. CLS Intermediate Holdings also maintains a representative office in Tokyo, Japan.
4. CLS Intermediate Holdings is a wholly-owned subsidiary of CLS Group Holdings AG, a Swiss company that is the ultimate holding company of the CLS Group.
5. The Applicant was established in 1999 to develop a system to settle payment instructions relating to underlying foreign exchange transactions to reduce the settlement risk inherent in then existing settlement mechanisms. It began live operations in September 2002 using its automated CLS system.
6. The Applicant currently settles payment instructions relating to underlying transactions (Transactions) that involve seventeen different currencies (Eligible Currencies) comprising the Australian dollar; the Canadian dollar; the Danish krone; the euro; the Hong Kong dollar; the Israeli shekel; the Japanese yen; the Mexican peso; the New Zealand dollar; the Norwegian krone; the Singapore dollar; the South African rand; the South Korean won; the Swedish krona; the Swiss franc; the UK pound sterling; and the US dollar and it also intends to settle payment instructions relating to Transactions involving other currencies subject to receipt of all necessary approvals.
7. The CLS system is a continuous linked settlement system for settling payments in relation to Transactions that is intended to eliminate settlement risk attributable to the existence of time zones.
8. The Applicant operates the CLS system pursuant to the CLS Bank International Rules (the Rules). The Rules are governed by English law.

9. CLS Services provides CLS system operations and support, vendor support, information technology, security services and other support services to, and under the direction of, the Applicant pursuant to a Master Services Agreement between the Applicant and CLS Services.
10. The Applicant permits participation in the CLS system by two different types of members. Members who maintain an account with the Applicant (an Account) are referred to as Settlement Members and members who do not maintain an Account are referred to as User Members. Each User Member must be sponsored by a Settlement Member. Both Settlement Members and User Members (in either case, a Member) are required, as a condition of membership, to execute an agreement with the Applicant that is governed by New York law.
11. An applicant for approval as a Settlement Member must meet stringent membership requirements that are set forth in the Rules and that include, among other things, an established operating capability, acceptable regulatory oversight, minimum capital and capital ratio requirements and minimum credit ratings.
12. Each Member participates in the CLS system by submitting payment instructions in relation to a Transaction to the CLS system in accordance with a submission process that identifies the Member to the Applicant through the use of an identification code. Each payment instruction identifies, among other things, the parties to the Transaction and the Member that is expected to submit a corresponding payment instruction in relation to the same Transaction. Each payment instruction is processed by the CLS system and, if determined to be eligible for settlement, is settled across the books and records of the Applicant by the simultaneous entry of debits and credits to the Accounts of the relevant Settlement Members identified in the payment instructions.
13. The Account that the Applicant maintains for each Settlement Member is a single, multi-currency account in respect of each Eligible Currency. The Account is used for the settlement of all payment instructions that are submitted by either the Settlement Member or a User Member that has been sponsored by the Settlement Member.
14. Within its Account a Settlement Member may be permitted to have negative balances in some Eligible Currencies if there are offsetting positive balances in the other Eligible Currencies such that the overall Account balance of the Settlement Member (the Account Balance) is positive. The Account Balance is calculated as the sum of the positive and negative balances for each Eligible Currency in the Account (each, a Currency Balance) after each Currency Balance has been converted to the base currency of U.S. dollars.
15. The Applicant maintains an account with the central monetary authority of each country that issues an Eligible Currency (each, a Central Bank). In Canada, the Applicant maintains its account with Bank of Canada. As part of the funding process for Accounts, the applicant credits the relevant Currency Balance within a Settlement Member's Account whenever the Applicant receives a pay-in of the relevant currency in the Applicant's relevant Central Bank account. The Applicant also disburses funds from its Central Bank accounts and debits the relevant Settlement Member's Account accordingly.
16. Settlement of payment instructions occurs when the Applicant simultaneously debits and credits the Accounts of the relevant Settlement Members in accordance with the payment instructions that were submitted by the Settlement Members and/or the User Members sponsored by them. Each payment instruction is settled individually on a gross basis and is not netted against other payment instructions.
17. The Applicant does not guarantee settlement nor does it become a counterparty to any of the Transactions to which payment instructions are related. Settlement will not occur if payment instructions are not eligible for settlement because, for example, an Account would not have a positive Account Balance post settlement. All settled payment instructions are final and binding on each of the Members. Generally speaking, unsettled payment instructions are rejected at the end of the relevant settlement date.
18. Members currently have their head or home offices in Australia, Belgium, Canada, Denmark, England, France, Germany, Hong Kong, Israel, Italy, Japan, Luxembourg, Netherlands, Norway, Scotland, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland and the United States. In the future, it is likely that CLS Bank will have Members with their head or home offices in other jurisdictions provided CLS Bank's requirements are met including receipt of all necessary approvals.
19. Settlement Members located in Canada comprise four banks located in Ontario that are listed in Schedule 1 to the *Bank Act* (Canada).
20. As an Edge corporation, the Applicant is supervised and regulated by the Board of Governors of the U.S. Federal Reserve System and the Federal Reserve Bank of New York (collectively, the U.S. Federal Reserve).

21. The U.S. Federal Reserve and the Central Banks have established a cooperative oversight arrangement that is governed by, and conducted in accordance with, the Protocol for the Cooperative Oversight Arrangement of CLS (the Protocol). The Protocol is premised upon the principles for international cooperative oversight that are contained in the “Central Bank Oversight of Payment and Settlement Systems” report of the Committee on Payment and Settlement Systems of the Group of Ten countries. The Protocol provides a mechanism for the mutual assistance of the participating Central Banks to facilitate the fulfillment of their individual responsibilities in pursuit of their shared public policy objectives for the safety and efficiency of payment and settlement systems and their focus on the stability of the financial system.
22. Bank of Canada is a participating Central Bank under the Protocol. It also has a domestic responsibility for the supervision of CLS Bank as a result of its designation of the CLS system as a clearing and settlement system that could be operated in a manner that could pose systemic risk pursuant to section 4(1) of the *Payment Clearing and Settlement Act* (Canada) (“PCSA”). CLS Bank and/or the CLS system have been the subject of similar designations in each of the European Union, Australia, Hong Kong, Israel, New Zealand, Singapore, South Africa and South Korea.
23. Bank of Canada and the other Central Banks also receive extensive information regarding the CLS system through their participation on the CLS Oversight Committee established by the Protocol.
24. Prior to 2007, the settlement services offered by the Applicant were limited to the settlement of payment instructions in relation to underlying foreign exchange (FX) Transactions.
25. During 2007, the Applicant extended its settlement services to include the settlement of payment instructions in relation to underlying non-deliverable forward foreign exchange Transactions and the settlement of payment instructions in relation to underlying over-the-counter (OTC) derivative Transactions (Derivative Instructions) resulting in one-way payments across the books of CLS Bank. Settlement services in relation to Derivative Instructions are currently limited to underlying OTC credit derivative transactions but they could eventually include other types of underlying derivative transactions, such as interest rate swaps, equity derivatives and commodity derivatives subject to receipt of all necessary approvals. CLS Bank’s settlement services may also be extended to include the settlement of FX option premium payment instructions.
26. The extension of CLS Bank’s settlement services to the settlement of Derivative Instructions followed its selection as the central settlement provider for a Trade Information Warehouse (the Warehouse) that has been established by DTCC Deriv/SERV LLC (DTCC), a wholly-owned subsidiary of Depository Trust & Clearing Corporation.
27. The Warehouse was designed by DTCC in response to concerns expressed by certain regulatory authorities, including the U.S. Federal Reserve and the UK Financial Services Authority, regarding insufficient documentation in respect of OTC credit derivative transactions. The Warehouse is intended to provide a comprehensive, centralized trade database with the most up-to-date record of each OTC credit derivative transaction, as well as a central processing capability to standardize and automate “downstream” processing of payments and other post-confirmation processes.
28. As the central settlement provider for the Warehouse, the Applicant settles Derivative Instructions received from The Warehouse Trust Company, LLC (Warehouse Trust) in relation to underlying OTC derivative transactions that are maintained in the Warehouse (Warehouse Derivatives) in a manner that is similar to the manner in which it settles payment instructions in relation to underlying FX Transactions, although settlement only results in a one-way payment. Members submit instructions in relation to Warehouse Derivatives (Warehouse Derivative Instructions) directly to the CLS system through Warehouse Trust. Each Warehouse Derivative Instruction specifies the payment amount in an Eligible Currency that is due under one or more Warehouse Derivatives. Warehouse Trust is a limited purpose trust company that is wholly-owned by DTCC and regulated by the Board of Governors of the U.S. Federal Reserve System and the New York State Banking Department.
29. Only those institutions that are Members are eligible to participate in the settlement services that are provided by the Applicant in respect of Warehouse Derivative Instructions utilizing Warehouse Trust as agent for the transmission of the Warehouse Derivative Instructions. The underlying Warehouse Derivatives may, however, be proprietary to the Member or they may be third party customer transactions.
30. Although CLS Bank is currently settling Derivative Instructions submitted by Members through Warehouse Trust in relation to OTC credit derivatives involving nine Eligible Currencies, in the future DTCC may request CLS Bank to settle Derivative Instructions in relation to other types of OTC derivative transactions involving any Eligible Currencies or OTC credit derivatives involving other Eligible Currencies. CLS Bank would have to seek and obtain regulatory approval before agreeing to settle any payments related to such expanded activities.

31. OTC derivative transactions underlying Derivative Instructions, including Warehouse Derivatives, are considered derivatives and can include transactions in relation to securities for purpose of the Act and the Applicant may therefore be considered to be carrying on the business of a clearing agency in Ontario for purposes of the Act.

AND UPON the Commission being satisfied that to do so would not be prejudicial to the public interest;

IT IS THE DECISION of the Commission pursuant to section 147 of the Act that the Requested Relief is hereby granted provided that:

1. the Applicant and the CLS system continue to be supervised and regulated by the U.S. Federal Reserve and Bank of Canada;
2. the Applicant does not engage in any clearing agency activity that is not described in the Application without obtaining the prior approval of the Commission;
3. the Applicant will provide such information as may be requested from time to time by, and otherwise cooperate with, the Commission and its staff subject to any applicable privacy or other laws governing the sharing of information and the protection of personal information.