

CDS Clearing and Depository Services Inc. (CDS[®])

MATERIAL AMENDMENTS TO CDS RULES

AMENDMENTS RELATED TO THE INTRODUCTION OF A CNS PARTICIPANT DEFAULT FUND

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS RULE AMENDMENTS

The proposed rule amendments to the CDS Participant Rules (“Amendments”) introduce new rules related to the creation of the Participant Default Fund (“Default Fund”). The Default Fund will be a new fund of the Continuous Net Settlement (“CNS”) Function (i.e. CDS’s central counterparty (“CCP”) service). Details on how the Default Fund will be operationalized are described in the “Material Amendments to CDS Procedures. Amendments Related to the Introduction of a CNS Participant Default Fund” to be published concurrently with this Notice.

The proposed Amendments respond to CDS’s recognition order requirements to observe, as soon as possible, CPSS-IOSCO Principles for Financial Market Infrastructures (“PFMI”) requirements. Further to PFMI self-assessments submitted by CDS to its regulators, CDS identified the need to create a default fund. Under the PFMIs, default funds are fundamental risk management tools for CCPs. They are prefunded default arrangements composed of assets that have been contributed by a CCP’s participants and which may be drawn upon by the CCP in certain circumstances to cover losses or liquidity pressures resulting from participant defaults.

Timely observance of the PFMIs is expected by CDS’s regulators under CDS’s recognition order requirements:

- Autorité des Marchés Financiers. Reconnaissance de Services de dépôt et de compensation CDS inc. à titre de chambre de compensation en vertu de la *Loi sur les valeurs mobilières*, L.R.Q., c. V-1.1 – Part III, paragraph 43.1.
- Ontario Securities Commission. The Canadian Depository for Securities Limited and CDS Clearing and Depository Service Inc. Order; Section 144 of the Act, the Current Recognition Order – Part II: (Terms and Conditions Applicable to CDS Ltd. and CDS Clearing), Paragraph 9.1.
- British Columbia Securities Commission requires CDS to comply with the terms and conditions of the order of the Ontario Securities Commission.

PFMI Principle 4 (Credit Risk) states that a CCP “should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.”¹ A CCP should cover a residual portion of its losses with non-defaulting participants’ resources through a pooling-of-resources arrangement, such as a default fund.²

¹ CPSS-IOSCO, “Principles for financial market infrastructures” (April 2012), Principle 4.

² *Ibid.*, “Approaches to loss allocation” p. 157.

Under the Amendments, CDS's CNS Function will have a simple "waterfall" structure to protect itself and its members from losses due to a CNS participant default. Under this waterfall, losses arising from a CNS participant default will first be covered by the defaulting participant's CNS Participant Fund collateral until fully depleted. Such a Participant Fund currently exists and is described in Rules 5.7. and 5.8 of the CDS Participant Rules. Next, any remaining uncollateralized loss will be drawn from the defaulting participant's Default Fund collateral. If collateral from the defaulter's Participant Fund and Default Fund is completely depleted, and residual losses remain, CDS will next look to the surviving CNS participants to cover any residual losses. Residual losses will be allocated pro-rata to the surviving CNS participants. The allocation will be in the form of a call to fund the loss allocation.

B. NATURE AND PURPOSE OF THE PROPOSED CDS RULE AMENDMENTS

The Amendments to the Rules establish the framework for the Default Fund. How the Default Fund will be operationalized is described in the "Material Amendments to CDS Procedures. Amendments Related to the Introduction of a CNS Participant Default Fund" to be published concurrently with this Notice. A description of the Amendments (Rule 5.7 (Credit Rings for Funds) and Rule 5.8 (Funds Security Interests)) is provided in Appendix A to this Notice.

C. IMPACT OF THE PROPOSED CDS RULE AMENDMENTS

The proposed Rule amendments will provide CDS:

- Compliance with the CPSS-IOSCO PFMI and CDS's Recognition Orders
- The required enhancements to CDS's risk management infrastructure to foster increased legal, financial, operational and reputational risk mitigation, and benefiting CDS's Participants and the Canadian financial markets in general.

Further, CDS's Participants will benefit through:

- Enhanced safety and efficiency in payment, clearing and settlement.
- Reduced systemic risk.
- Greater transparency and financial stability.

C.1 Competition

The proposed Rule amendments apply to all CDS Participants who currently use, or may choose in the future to use, the CNS CCP service. From a fair access perspective, no CDS Participant will be disadvantaged or otherwise prejudiced with the introduction of these changes.

C.2 Risks and Compliance Costs

The proposed amendments to the processing of a CNS CCP service Participant default will result in changes to CDS's Risk Model and the resulting management of financial risks in CDS's clearing, settlement and depository services. CDS does not foresee other risks or compliance costs accruing to CDS Participants or other stakeholders.

C.3 Comparison to International Standards – (a) Committee on Payment and Settlement Systems of the Bank for International Settlements, (b) Technical Committee of the International Organization of Securities Commissions, and (c) the Group of Thirty

The PFMI are minimum international standards for enhancing the safety and efficiency of clearing, settlement and recording arrangements. The standards aim to limit systemic risk and foster transparency and financial stability. They apply to CCPs, central securities depositories (“CSDs”) and security settlement systems (“SSS”). CDS engages in all three of these market infrastructure activities. According to the terms of CDS’s recognition order requirements, CDS is required to observe PFMI as soon as possible.

Principle 4 (Credit Risk) states that CCPs “should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of a participant and its affiliates that would potentially cause the largest aggregate credit exposure for the CCP in extreme but plausible market conditions.”³ The PFMI further suggest that a CCP should cover a residual portion of its losses with non-defaulting participants’ resources through a pooling-of-resources arrangement, such as a default fund.⁴

D. DESCRIPTION OF THE RULE DRAFTING PROCESS

D.1 Development Context

CDS prepared documents describing the proposed CNS Default Fund risk mitigation strategy which were tabled at the Risk Advisory Committee (“RAC”), a CDS Participant committee that meets monthly.

D.2 Rule Drafting Process

The Amendments were drafted by CDS’s Risk Management group, and were subsequently submitted for consultation to the Legal Drafting Group (“LDG”). The LDG comments on the drafting of proposed amendments to the CDS Participant Rules, and may suggest further revisions. The LDG’s membership includes representatives from a cross-section of the CDS Participant community and meets on an ad hoc basis. On October 29th and 30th, the proposed amendments were submitted to CDS’s Risk Management and Audit Committee (“RMAC”) and CDS’s Board of Directors (“BoFD”) with a recommendation that they be approved.

D.3 Issues Considered

Consideration was given to the operational impacts that the enhancements might create for CDS Participants as outlined in section C of this Notice.

D.4 Consultation

This Amendment was initiated by CDS. CDS received input from the RAC on the concept and methodology underlying this Amendment, while the LDG commented on its legal drafting. The SDRC is expected to comment on the operational aspects of this Amendment as described in “Material Amendments to CDS Procedures. Amendments Related to the Introduction of a CNS Participant Default Fund” to be published concurrently with this Notice.

CDS’s Customer Service account managers provide continuous communication and status updates of all proposed changes to their clients, as well as soliciting input on those changes.

³ *Ibid.*, Principle 4.

⁴ *Ibid.*, “Approaches to loss allocation” p. 157.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings, which provide a forum for detailed requirement comment, and monthly meetings with service bureaus to discuss potential development impacts to them. As a courtesy, all development initiatives are also presented to the Investment Industry Regulatory Organization of Canada's ("IIROC") Financial Administrators Section ("FAS") working group.

D.5 Alternatives Considered

Alternatives with minor variations on the proposed waterfall were considered. The proposed methodology is the result of input received from the members of the RAC.

D.6 Implementation Plan

CDS is recognized as a clearing agency by the Ontario Securities Commission pursuant to section 21.2 of the Ontario Securities Act, by the British Columbia Securities Commission pursuant to Section 24(d) of the British Columbia Securities Act and by the Autorité des marchés financiers ("AMF") pursuant to section 169 of the Québec Securities Act. In addition CDS is deemed to be the clearing house for CDSX®, a clearing and settlement system designated by the Bank of Canada pursuant to section 4 of the Payment Clearing and Settlement Act. The Ontario Securities Commission, the British Columbia Securities Commission, the Autorité des marchés financiers and the Bank of Canada will hereafter be collectively referred to as the "Recognizing Regulators".

The amendments to CDS Participant Rules are expected to become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment.

E. TECHNOLOGICAL SYSTEM CHANGES

The proposed rule amendment is not expected to have an impact on technological systems, or require changes to such systems for CDS, CDS Participants, or other market participants.

F. COMPARISON TO OTHER CLEARING AGENCIES

A similar mechanism is used by the National Securities Clearing Corporation ("NSCC"), the securities CCP in the United States. Rule 4 of the "Rules & Procedures" (August 8, 2014) discusses "Clearing Fund" which is NSCC's equivalent CDS's proposed Default Fund.⁵ Further commentary is provided in the "NSCC Member Handbook" (December 2013) which confirms that where a deficiency remains, "NSCC would satisfy the deficiency by utilizing the Clearing Fund and assessing its Members as provided in its Rules. The process, in general, allocates any remaining liabilities pro rata among the non-defaulting Members based upon the Member's usage of the service to which the loss relates."⁶

Default fund is a fundamental concept in the PFMI. It is expected to be universally adopted amongst PFMI observing CCPs worldwide. Many CCPs already have such a fund in place. CDS compared the method used to determine the default fund to its global peers and found that it was consistent with the implemented practices or practices intended to be implemented of other CCPs. In fact, a default fund is a common feature of most other CCPs worldwide (e.g. Singapore's CDP "Clearing Fund" in Rule 7 and Eurex Clearing AG "Lines of Defence waterfall in Rule 6).

⁵ National Securities Clearing Corporation, "Rules & Procedures" (August 8, 2014), Rule 4 http://www.dtcc.com/~media/Files/Downloads/legal/rules/nscc_rules.pdf

⁶ National Securities Clearing Corporation, "NSCC Member Handbook" (December 2013), p. 24.

G. PUBLIC INTEREST ASSESSMENT

CDS has determined that the proposed amendments are not contrary to the public interest.

H. 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 to:

Legal Department
CDS Clearing and Depository Services Inc.
85 Richmond Street West
Toronto, Ontario M5H 2C9
Fax: 416-365-1984
e-mail: attention@cds.ca

Copies should also be provided to the Autorité des marchés financiers, British Columbia Securities Commission and the Ontario Securities Commission by forwarding a copy to each of the following individuals:

M^e Anne-Marie Beaudoin
Secrétaire générale
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CDS will make available to the public, upon request, all comments received during the comment period.

I. PROPOSED CDS RULE AMENDMENTS

Appendix “A” contains text of current CDS Participant Rules marked to reflect proposed amendments as well as text of these rules reflecting the adoption of the proposed amendments.

**APPENDIX “A”
PROPOSED CDS RULE AMENDMENTS**

Text of CDS Participant Rules marked to reflect proposed amendments	Text of CDS Participant Rules reflecting the adoption of proposed amendments
<p>[marked text of rules – additions are underlined and in green font; deletions are strikethrough text and in red font]</p> <p>5.7. CREDIT RINGS FOR FUNDS</p> <p>5.7.1 Establishment of Funds</p> <p>Each Participant who uses the CNS Function must become a Member of the Fund <u>Participant Fund and Default Fund</u> established for that Function.</p> <p>Each Member of a Fund is part of the Fund Credit Ring. Each Member of a Fund Credit Ring guarantees payment to CDS of certain obligations of a suspended Member pursuant to this Rule 5.7. Each Member of a Fund makes Contributions to that Fund pursuant to Rule 5.8.</p>	<p>5.7. CREDIT RINGS FOR FUNDS</p> <p>5.7.1 Establishment of Funds</p> <p>Each Participant who uses the CNS Function must become a Member of the Participant Fund and Default Fund established for that Function.</p> <p>Each Member of a Fund is part of the Fund Credit Ring. Each Member of a Fund Credit Ring guarantees payment to CDS of certain obligations of a suspended Member pursuant to this Rule 5.7. Each Member of a Fund makes Contributions to that Fund pursuant to Rule 5.8.</p>
<p>5.7.2 Payment by Fund Credit Ring</p> <p>Each Member of a Fund is also a Member of the Credit Ring for that Fund. If CDS has been unable to collect from a Defaulter who is a Member or a former Member of a Fund for a Function an obligation to CDS arising from the Defaulter's use of such Function, then each other Member of that Fund shall pay to CDS its proportionate share of that obligation forthwith upon request by CDS. If any Member fails or refuses to pay its proportionate share of an obligation pursuant to this Rule 5.7 it will be considered to be a "subsequent Defaulter". Each other Fund Member who makes payment to CDS of its proportionate share of the obligation of a Defaulter and of each subsequent Defaulter will be considered to be a "Survivor". Each other Fund Member, upon request by CDS, shall pay to CDS its proportionate share of the obligation of such subsequent Defaulter, and so on with respect to all failures or refusals of other Members to pay their respective proportionate shares, until the full amount of the obligation owing by the Defaulter to CDS has been paid. References to a Defaulter or a Survivor shall be deemed to</p>	<p>5.7.2 Payment by Fund Credit Ring</p> <p>If CDS has been unable to collect from a Defaulter who is a Member or a former Member of a Fund for a Function an obligation to CDS arising from the Defaulter's use of such Function, then each other Member of that Fund shall pay to CDS its proportionate share of that obligation forthwith upon request by CDS. If any Member fails or refuses to pay its proportionate share of an obligation pursuant to this Rule 5.7 it will be considered to be a "subsequent Defaulter". Each other Fund Member who makes payment to CDS of its proportionate share of the obligation of a Defaulter and of each subsequent Defaulter will be considered to be a "Survivor". Each other Fund Member, upon request by CDS, shall pay to CDS its proportionate share of the obligation of such subsequent Defaulter, and so on with respect to all failures or refusals of other Members to pay their respective proportionate shares, until the full amount of the obligation owing by the Defaulter to CDS has been paid. References to a Defaulter or a Survivor shall be deemed to refer to a subsequent Defaulter or to a Fund Member that makes payment to CDS of its</p>

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<p>refer to a subsequent Defaulter or to a Fund Member that makes payment to CDS of its proportionate share of the obligation of a subsequent Defaulter, respectively, <i>mutatis mutandis</i>. The <u>Fund Credit Ring</u> for a Fund has no obligation to CDS with respect to any obligation of a Participant arising from that Participant's use of another Function.</p>	<p>proportionate share of the obligation of a subsequent Defaulter, respectively, <i>mutatis mutandis</i>. The Fund Credit Ring has no obligation to CDS with respect to any obligation of a Participant arising from that Participant's use of another Function.</p>
<p>5.7.3 Defaulter's Obligation The obligation referred to in Rule 5.7.2 of a Defaulter who is a Member of a <u>the Fund Credit Ring</u> is the total of (a) Marks owed by the Defaulter arising from its use of the Function for which the Fund is established (including Marks calculated in respect of its Central Counterparty Obligations after the Defaulter is suspended); and (b) the net termination value of all of the Defaulter's Central Counterparty Obligations arising from its use of that Function. The obligation of a Defaulter may be denominated in Canadian dollars or in US dollars or in both and the aggregate obligation in all currencies is the Debtor's obligation.</p>	<p>5.7.3 Defaulter's Obligation The obligation referred to in Rule 5.7.2 of a Defaulter who is a Member of the Fund Credit Ring is the total of (a) Marks owed by the Defaulter arising from its use of the Function for which the Fund is established (including Marks calculated in respect of its Central Counterparty Obligations after the Defaulter is suspended); and (b) the net termination value of all of the Defaulter's Central Counterparty Obligations arising from its use of that Function. The obligation of a Defaulter may be denominated in Canadian dollars or in US dollars or in both and the aggregate obligation in all currencies is the Debtor's obligation.</p>
<p>5.8. FUNDS SECURITY INTERESTS 5.8.1 Fund Contribution As and when required by CDS each Member of a Fund shall make and maintain a contribution (the "Fund Contribution") to the Fund. The formulas and criteria for calculating the required amount of a Fund Contribution are included in the Procedures and User Guides. A Participant's Fund <u>Contribution</u> to a Fund at the time of the establishment of that Fund or at the time that a Participant first uses the Function in respect of which the Fund is established shall be determined in the discretion of CDS, acting reasonably and based upon anticipated use of the Function, and may thereafter from time to time be increased or reduced by CDS in accordance with the aforementioned formulas or criteria.</p>	<p>5.8. FUNDS SECURITY INTERESTS 5.8.1 Fund Contribution As and when required by CDS each Member of a Fund shall make and maintain a contribution (the "Fund Contribution") to the Fund. The formulas and criteria for calculating the required amount of a Fund Contribution are included in the Procedures and User Guides. A Participant's contribution to a Fund at the time of the establishment of that Fund or at the time that a Participant first uses the Function in respect of which the Fund is established shall be determined in the discretion of CDS, acting reasonably and based upon anticipated use of the Function, and may thereafter from time to time be increased or reduced by CDS in accordance with the aforementioned formulas or criteria.</p>
<p>5.8.2 Additional Fund Contribution CDS shall from time to time inform each Participant who is a Member of a Fund using a Central Counterparty Function of the amount of the Contribution it is required to make to the Participant Fund established in respect of that Function. A Participant shall deliver its required additional Fund Contribution upon being informed by CDS that</p>	<p>5.8.2 Additional Fund Contribution CDS shall from time to time inform each Participant who is a Member of a Fund of the amount of the Contribution it is required to make to the Fund. A Participant shall deliver its required additional Fund Contribution upon being informed by CDS that (a) an increase in the amount of its Fund</p>

Text of CDS Participant Rules marked to reflect proposed amendments	Text of CDS Participant Rules reflecting the adoption of proposed amendments
<p>(a) an increase in the amount of its Fund Contribution is required pursuant to Rule 5.8.1;</p> <p>(b) an additional Fund Contribution is required due to a decrease in the recognized value of Securities previously delivered by the Participant as Fund Contributions;</p> <p>(c) an additional Fund Contribution is required to reconstitute the Participant Fund pursuant to Rule 9.2.10 following the suspension of another <u>Member of that Fund</u> Participant; or,</p> <p>(d) an additional Fund Contribution is required pursuant to Rule 5.8.6.</p>	<p>Contribution is required pursuant to Rule 5.8.1;</p> <p>(b) an additional Fund Contribution is required due to a decrease in the recognized value of Securities previously delivered by the Participant as Fund Contributions;</p> <p>(c) an additional Fund Contribution is required to reconstitute the Fund pursuant to Rule 9.2.10 following the suspension of another Member of that Fund; or,</p> <p>(d) an additional Fund Contribution is required pursuant to Rule 5.8.6.</p>