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DELIVERED
Five-Year Review Committee
c/o Purdy Crawford, Chair
Osler, Hoskin & Harcourt LLP
P.O. Box 50
One First Canadian Place
Toronto, ON M5X 1B8

Dear Mr. Crawford:

We are writing in response to the Five-Year Review Committee draft report. While in general agreement with the objectives of the Committee, FundSERV is concerned with the consequences of the Committee's broad recommendation that clearing agencies be required to obtain recognition under the Securities Act. More specifically, we are concerned with:

- The ambiguity in the statute concerning the definition of "clearing agency".
- Possible misunderstanding of the role and operations of FundSERV as a service provider to its customers in the Canadian investment funds industry.
- The danger that FundSERV could be unnecessarily drawn into unwarranted and burdensome regulatory oversight.

We do not yet see how requiring recognition of FundSERV will address the public interest in any of the manners suggested by the Committee:

- Protecting investors.
- Enhancing the efficiency of capital markets.
- Safeguarding securities.
- Maintaining fair competition.

FundSERV is concerned that imposing additional regulatory burden on its customers, absent a demonstrable purpose, may be contrary to those objectives.

FundSERV was established about a decade ago with the active encouragement of the Commission, IFIC and the IDA to reduce systemic risks and operational costs of the transaction flow between the fund manufacturers and the distributors. It was funded by several large manufacturers and constituted as a cost-recovery, customer-driven enterprise. It has maintained full transparency amongst its constituents, with its Board of Directors responsible for governance and risk management, and customer chaired and staffed committees responsible for standards and functionality. Management executes within these parameters. It is now considered the channel of choice between manufacturers and distributors. Its success has been earned, rather than mandated or otherwise regulated.

FundSERV has facilitated valuable disciplines on the transaction order and settlement processes for its customers. It is positioned, by design, to avoid counterparty risks, and does not provide credit enhancement, novation nor custody services. Throughout its decade of operation, there have been no material system failures or complaints with regard to its operation. It has achieved a high degree of trust and respect and has not sought, nor been subject to, formal recognition or regulatory oversight.

FundSERV has been able to substantially reduce transaction costs for its customers. It has also succeeded in reducing systemic risk, with robust and secure processing facilities. It assisted its customers in testing their Y2K preparedness, in managing their September 11th pending orders and is active on their behalf within the CCMA with respect to Straight Through Processing and T+1 settlement.

FundSERV is concerned that formal recognition, will impose additional costs and reduced flexibility and derogate from its objectives and continued success. Additionally, formal oversight by the Commission could easily lead to recognition processes in other provinces and by other regulatory bodies. This, in turn, could further impair FundSERV's ability to respond quickly and effectively to opportunities to mitigate operational costs and systemic risks and complicate further improvement to the standards.

FundSERV is not a clearing agency in the conventional sense. It assists its clients in determining their net settlement obligations and facilitating the exchange of payments. That facility is referred to as "clearing and settlement services" because those terms are understood within the industry. Unlike the Canadian Depository for Securities Ltd., FundSERV does not function as a depository, nor settle transactions on a delivery against payment basis. There is neither novation nor assumption of a settlement obligation.

The risks associated with FundSERV's operation are mitigated by the business continuity and disaster recovery plans that are regularly tested by its customers and by using LVTS for payment exchange. Its service is not dissimilar to other back office suppliers and service bureaus. Operational risk is fundamentally different than that pertaining to continuous settlement systems or secondary markets, where the value of transactions is time-sensitive and adherence to standards is critical to investor protection and market integrity.

FundSERV is not opposed to reporting to the Commission and other regulatory self-regulatory organizations. It has welcomed and responded to numerous enquiries from such bodies and has been pro-active in sharing information about its operations and plans. FundSERV has a continuous improvement philosophy and practice to address issues that give rise to systemic risk within its customer base and operates in an open and transparent manner. It shares information with the Commission and other interested parties willingly.

FundSERV is aware of regulatory initiatives in place or under consideration in other jurisdictions to ensure the effective oversight of agencies providing "clearing and settlement-related functions". A partial overview is attached. In most such jurisdictions, there is a careful focus on the functions being performed by the entities in question, rather than on the identity or name of the entity performing them.

We would urge the Five-Year Review Committee to recommend such a functional approach to regulation. This might start with a re-examination and more precise focusing of the definition of "clearing agency" under the Securities Act. For example, depending upon one's view of the meaning of the word "intermediary" in the definition, it is arguable as to whether FundSERV falls within the definition in the current, permissive, statutory framework to the extent that securities do not pass through it.

Equally importantly, to the extent the Committee feels it appropriate to recommend regulatory oversight of clearing agencies, it should be based on an analysis and identification of specific concerns regarding operating standards or other issues directly relating to investor protection, capital market efficiency, the safeguarding of securities or maintaining fair competition. In turn, consideration should be given to "least cost/most effective" regulatory instruments that specifically address such identified concerns.

Such an approach is consistent with the thoughtful views expressed by Federal Reserve Chairman Alan Greenspan in an address prior to the passage of the Commodity Futures Modernization Act of 2000:

> "To be sure, clearing houses concentrate and mutualize risks in ways that make regulation of clearing houses desirable from a systemic stability perspective. But here again, we need to recognize the potential effectiveness of private market regulation. Any government regulation of clearing houses must be carefully designed to avoid impairing private regulation. This may not be possible if a one-size-fits-all regulatory approach is adopted."[1]

These remarks were given in the context of legislative reform to the Federal Deposit Insurance Corporation Act and the Commodity Exchange Act, each of which defined clearing organizations in terms of "a system utilized by more than two participants in which the bilateral credit exposures of market participants arising from the transactions cleared are effectively eliminated and replaced by a system of guarantees, insurance, or mutualized risk of loss." We do not believe that FundSERV would fall within the ambit of such a definition.

As noted above, FundSERV would willingly provide the Commission and other regulatory bodies, on a voluntary basis, whatever information could be useful to them, as it currently does with its direct constituents. FundSERV would value input from Commission staff and would welcome opportunities for its Board of Directors, advisory committees and management to interact directly with the Commission.

By way of example, FundSERV would have no objection to providing the Commission and other interested regulatory bodies with annual reports, notice of material changes, performance statistics, on-site inspections, copies of service agreements and assurances as to record-keeping, system integrity and fair access. Interested parties could also be included in FundSERV's escalation procedures such as activating its disaster recovery backup plans.

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[1] Available at http://www.federalreserve.gov/boarddocs/speeches/1997/19970221.htm

As is the case with the Canadian Investor Protection Fund, FundSERV would welcome the opportunity to meet, on an annual basis, with the Chairs of the Canadian Securities Administrators and other interested regulatory authorities.

If further consideration is to be given to subjecting FundSERV to more formal regulation, consideration of the following would be appreciated:

a) Identifying more precisely the risks, if any, within FundSERV's operations, that require such direct regulation and amending the definition of "clearing agency" under the Act to specifically encompass those risks;

b) Analysing the costs and benefits of direct and multiple regulation – both in absolute terms and relative to other less formal, oversight frameworks;

c) Assessing whether and if so, the manner and extent to which such costs might materially impair the original objectives and current and prospective value proposition of FundSERV; and

d) If particular risks are identified which merit consideration of direct regulation, performing a more rigorous analysis to ensure that the proposed regulatory instruments specifically address such legitimate concerns.

FundSERV respects and supports the work of the Committee. As is often the case, the devil in broad policy recommendations is in the details. In this instance, FundSERV recommends that the details be analyzed more carefully before imposing regulatory burdens where they may not be warranted.

FundSERV would welcome the opportunity to provide the Committee with additional information or input that would be of assistance in finalizing its recommendations.

Respectfully,

Alan Hutton
President and Chief Executive Officer

Attachment

cc: Randee Pavalow
Cindy Petlock
Howard Wetston

OVERVIEW OF REGULATORY REGIMES WITH RESPECT TO CLEARING AGENCIES

PART I - INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS ("IOSCO")

In September 1998 IOSCO issued a Technical Committee report, "Objectives and Principles of Securities Regulation". Of the 30 principles outlined therein, none specifically relate to clearing and settlement in the investment funds section of the report. One of the principles, under the general heading referring to secondary markets, refers to regulatory oversight of systems for clearing and settlement of securities transactions. As noted in our submission, FundSERV does not provide secondary market facilities.

More recently (November 2001) IOSCO and the Bank for International Settlements ("BIS") issued a report, "Recommendations for Securities Settlement Systems". The report notes at the outset that because of the diversity of institutional arrangements internationally, the recommendations must focus on the functions to be performed, not on the institutions that may perform them. While it defines "securities settlement systems" broadly, most of the specific oversight recommendations relate only to "central securities depositories" and "central counterparties". FundSERV would not fit either of these definitions.

PART II - EUROPE

The Committee of European Securities Regulators is currently considering how to respond to the joint IOSCO/BIS report noted above. The focus appears to be on the clearing activities of central counterparties and on reducing barriers to the further integration of the European securities clearing and settlement infrastructure.

PART III - UNITED KINGDOM

The *Financial Services and Markets Act* 2000 ("FSMA"), which came into force (for the most part) on December 1, 2001, established a comprehensive regulatory regime for financial services under a single regulator (the Financial Services Authority). It also introduced a universal registration/authorization/exemption regime.

EMX Company Limited is an electronic message exchange service for the investment funds industry launched in 2000 which, in many respects, is comparable to FundSERV. Its status under the FSMA is that of an "authorized person". Such authorization is intended for companies that provide services such as information and order routing services.

In contrast, CRESTco is a recognized clearinghouse under the FSMA (as are the London Clearing House and European Central Counterparty Limited – both of which are central counterparties).

CRESTco provides international multi-currency real time electronic securities settlement services, including trade input, matching and delivery versus payment.

PART IV - UNITED STATES

Section 3(a)(23)(A) of the U.S. *Exchange Act* defines "clearing agency" extremely broadly. As subsequent interpretive releases have noted, it did so in furtherance of the goal articulated in Section 17(A)(a) of the *Exchange Act*, namely the creation of a national clearance and settlement system.

The namesake of FundSERV in the U.S. (Fund/SERV) is, in fact, a small element of that national system. Fund/SERV is a service offering of National Securities Clearing Corporation ("NSCC"), the nation's leading provider of centralized clearance, settlement and information services. NSCC is, in turn, a subsidiary of The Depository Trust & Clearing Corporation ("DTCC"), which is registered as a "clearing agency". It should also be noted that the Fund/SERV offering includes 29 processing cycles over 24 hours in contrast to FundSERV's single daily settlement cycle and is fully integrated with a range of other NSCC and DTCC clearing and settlement services.

The SEC noted in Interpretive Release No. 34-39829 (April 6, 1998) that, while matching services come within the definition of "clearing agency," an entity that limits its clearing agency functions to providing a matching service "need not be subject to the full panoply of clearing agency regulation". The SEC has affirmed this approach in Release No. 34-44188, "SRO Rule-Making: Global Joint Venture Matching Services," an order granting exemption from registration as a clearing agency.

In contrast, the definition of "derivatives clearing organization" under the *Commodity Exchange Act* is more specific and excludes facilities that would be caught by the definition solely because they arrange for settlement, netting or novation of obligations (i) resulting from agreements on a bilateral basis and without a central counterparty, (ii) through an interbank payment system, or (iii) resulting from a sale of a commodity in a transaction in the spot market for the commodity.

The *Federal Deposit Insurance Corporation Improvement Act* of 1991, as amended by the *Commodity Futures Modernization Act* of 2000, contains a definition of "multi-lateral clearing organization" which provides that the term means "a system utilized by more than two participants in which the bilateral credit exposures of participants arising from the transactions cleared are effectively eliminated and replaced by a system of guarantees, insurance, or mutualized risk of loss".