

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.3 Clearing Agencies

13.3.1 CDS – Notice and Request for Comments – Material Amendments to CDS Procedures – Enhancements to the CNS Allotment Process

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

MATERIAL AMENDMENTS TO CDS PROCEDURES

ENHANCEMENTS TO THE CNS ALLOTMENT PROCESS

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the CDS Participant Procedures will amend functionality of the allotment process in the Continuous Net Settlement Service (CNS). This change is made at the request of the Debt and Equity Subcommittee of the Strategic Development Review Committee (SDRC). The CNS allotment process refers to (i) the creation of non-exchange trades with a settlement mode of trade-for-trade (TFT) from outstanding CNS positions by assigning or allotting buyers to sellers against outstanding CNS positions, and (ii) trade conversion activities whereby exchange and non-exchange trades with a settlement mode of CNS are converted to settle TFT. This process is initiated in the case of corporate actions that would result in a participant receiving either a non-CNS eligible security or cash.

Background

CNS is a central counterparty service designed to clear and settle primarily equity trades initiated on a Canadian exchange, a quotation and trade reporting system (QTRS) or an alternative trading system (ATS). Transactions targeted to CNS may also originate as non-exchange trades with a settlement mode of CNS, manually setup in CDSX® by participants.

Novation and netting of CNS trades

When an exchange or non-exchange trade with a settlement mode of CNS reaches value date, the original buyer and seller obligations (to receive securities and deliver payment, and vice versa) are extinguished and replaced with settlement obligations between each party and CDS (i.e., novation). Each time another trade for the same security is processed, the new novated obligations are netted with the existing settlement obligations for that security. These netted obligations are the “to receive” and “to deliver” positions that are settled in the overnight batch net settlement process, and continuously in CDSX in the real-time CNS settlement process that runs from system start-up through to the start of payment exchange.

Allotment of CNS positions and trade conversion activities for corporate actions

When a corporate action is scheduled to occur on a CNS-eligible security that would result in a participant receiving either a non-CNS eligible security or cash, existing CNS positions are restricted from settling, and new trades targeted to CNS are restricted from novation and netting. This is accomplished in the following manner:

- (i) existing CNS outstanding settlement obligations are allotted from CNS and converted into TFT non-exchange trades,
- (ii) CNS non-exchange trades are converted into TFT non-exchange trades, and
- (iii) CNS exchange trades are converted into TFT exchange trades.

The allotment process removes CDS as the central counterparty by assigning buyers and sellers to the outstanding CNS obligations and replacing those obligations with non-exchange trades targeted to settle TFT. In addition, exchange and non-exchange trades that are targeted to settle CNS are converted to a TFT settlement mode. Subsequent corporate action activity is then applied to these allotted and converted trades.

The process of changing the mode of settlement on CNS exchange trades to TFT often results in participants being left with a large number of trades over which they have no control. The result is that participants are unable to effectively prioritize their settlement activity in the affected security.

Proposed Amendments

The SDRC Debt and Equity Subcommittee requested that CDS review the current trade allotment process and propose an approach whereby they would be afforded greater flexibility to manage their settlement activities. The approved proposal will amend the process such that exchange and non-exchange trades involving a security with a CNS settlement-related restriction, due to an upcoming corporate action, will be novated and netted. Once the netted obligations are determined, those outstanding CNS settlement positions will be allotted into non-exchange TFT trades, per the current process.

This change will (i) eliminate the TFT exchange trades created by the conversion process, and (ii) potentially reduce the number of TFT non-exchange trades due to additional netting activities. This amendment will result in participants having fewer trades to manage.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments are enhancements to current functionality of the allotment process which will provide greater processing efficiencies and improved trade settlement management flexibility.

CDS participants will benefit from the proposed enhancements to the trade allotment process because:

- The number of transactions that require monitoring and settlement management activities will be reduced, thereby reducing operational risk¹
- The novation and netting process will reduce the quantity to be settled.

Currently, when a CNS settlement restriction exists on a security, all new trades with a settlement mode of CNS received from an exchange or entered by participants are prevented from being picked up in the CNS novation and netting processes. The settlement mode of the trades is automatically changed to TFT, and participants must manage these transactions manually. However, participants are restricted from placing the trades that originated at an exchange on hold, which prevents settlement until such time as they are ready for the movement of securities or cash to be completed from their CDSX ledgers. This has often resulted in a large number of trades which participants have no ability to manage, and which may have used funds or securities for small value trades that participants would have preferred to first target toward larger value trades.

A change will be made to the CNS novation and netting process to disregard the CNS settlement restriction if it has been automatically created by a corporate action. This will allow all CNS trades reaching value date to be netted each day during the corporate action period. Settlement of outstanding obligations will still be restricted, and these settlement obligations will then be allotted out each day to minimal numbers of non-exchange trades over which settlement can be managed.

CNS settlement restrictions that have been placed on a security manually or automatically for reasons other than a corporate action will continue to be processed as they are today. That is, the mode of settlement on exchange and non-exchange trades will be converted from CNS to TFT.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments will provide processing efficiencies and trade settlement management flexibility. The impact of these changes will be limited to those CDS participants that utilize the CNS function within CDSX.

C.1 Competition

The proposed procedure amendments apply to all CDS participants who currently use, or may choose to use, the CNS service. Consequently, no CDS participant will be disadvantaged with the introduction of these enhancements.

C.2 Risks and Compliance Costs

CDS Risk Management has determined that the proposed amendments will improve the risk profile of its participants due to the novation and netting process. It will not change the risk profile of CDS.

¹ A participant experienced the creation of approximately 50,000 TFT exchange trades due to the allotment process, which took a three month period for completion of all settlements.

The introduction of the proposed enhancement to the CNS allotment process will not result in any changes to the existing CDSX settlement process. The method of (i) applying non-entitlement related CNS settlement restrictions to securities, (ii) placing holds on non-exchange transactions, and (iii) the settlement of exchange and non-exchange trades remain unchanged. The prioritization of settlements is also not impacted by this initiative.

There are no compliance costs to the participants associated with the proposed enhancements to the CNS allotment process.

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

As stated in Principle #21 – Efficiency and effectiveness – of the new international standards for payment, clearing and settlement systems set out in the CPSS/IOSCO report Principles for Financial Market Infrastructures², a financial market infrastructure such as CDS “should be designed to meet the needs of its participants and the markets it serves, in particular, with regard to choice of a clearing and settlement arrangement; operating structure; scope of products cleared, settled, or recorded; and use of technology and procedures”.

This development, requested by some of CDS’s participants, supports greater flexibility for managing the settlement of transactions.

No other comparisons to international standards were identified.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

The development request was tabled at the SDRC Debt and Equity Subcommittee as an opportunity to increase efficiencies in the settlement of trades systematically allotted from the CNS service. Once approved by the SDRC for further analysis, CDS developed a requirements document that was reviewed with the SDRC Debt and Equity Subcommittee. Their input was incorporated into the final design which was subsequently approved by the SDRC.

D.2 Procedure Drafting Process

The CDS procedure amendments were drafted by CDS’s Business Systems Development and Support group, and subsequently reviewed and approved by the SDRC. The SDRC determines or reviews, prioritizes and oversees CDS-related systems development and other changes proposed by participants and CDS. The SDRC’s membership includes representatives from a cross-section of the CDS participant community, and it meets on a monthly basis.

These amendments were reviewed and approved by the SDRC on July 26, 2012.

D.3 Issues Considered

During the processing of an entitlement or corporate action where the received item is a new security, the quantity amounts of any existing trades in the original security are converted to the corresponding equivalent amount of the new security. When the rate of the received item includes a fractional amount (e.g. receive 1.33 shares of a new security for each 1 share of the original security), the resulting quantity amounts on the converted trades may contain a decimalized quantity. As trade quantities must be in whole numbers, the new quantity is truncated. When a large number of trades are processed in this manner, it can result in a significant loss of shares of the new security to a participant. These fractional shares are accumulated by CDS and must be reclaimed by the participant. By allowing CNS exchange trades to remain with the CNS settlement mode and be included in the netting process, the number of trades requiring truncation will be significantly reduced.

D.4 Consultation

This development was requested by the SDRC Debt and Equity Subcommittee. CDS reviewed the requirements document with that group and received their final approval for the development of the described enhancement.

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.

CDS facilitates consultation through a variety of means, including regularly scheduled SDRC subcommittee meetings which provide a forum for detailed requirement review, and monthly meetings with service bureaus to discuss development impacts to

² The report can be found at <http://www.bis.org/publ/cpss101.htm>

them. 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

Initially, the SDRC Debt and Equity Subcommittee requested that CDS enable participants to manage the settlement control indicator on exchange trades converted from CNS to TFT. During the review and analysis phase, it was determined that this approach would be insufficient to achieve maximum potential efficiencies in the management of these trades as large volumes would continue to exist. Consequently, the SDRC Debt and Equity Subcommittee and the SDRC agreed that CDS's proposal to net CNS trades prior to allotment was a more complete solution.

D.6 Implementation Plan

The proposed procedure amendments and the scheduled date of implementation have been communicated regularly to CDS participants through the SDRC and its subcommittees, as well as through Customer Service relationship meetings. The Customer Service account managers will provide their clients with details of the upcoming changes, and provide customer-related training during the months of October and November 2012. CDS will distribute a bulletin to all CDS participants the week before implementation reminding them of the upcoming changes and confirming the effective date of those changes.

CDS is recognized as a clearing agency by the Ontario Securities Commission pursuant to section 21.2 of the Ontario Securities Act. The Autorité des marchés financiers has authorized CDS to carry on clearing activities in Québec pursuant to sections 169 and 170 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 Autorité des marchés financiers and the Bank of Canada will hereafter be collectively referred to as the "Recognizing Regulators".

The amendments to Participant Procedures may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment. Implementation of this initiative is planned for November 17, 2012.

E. TECHNOLOGICAL SYSTEMS CHANGES

E.1 CDS

CDSX functionality will be impacted by these changes as follows:

- a) Allow for novation and netting of CNS trades (exchange and non-exchange) when a CNS settlement restriction exists on a security. CNS positions will not be settled when this restriction is applied, per the current process.
- b) Eliminate the change to the settlement mode of existing trades from CNS to TFT during the allotment process. Trades will remain as CNS and be available for extraction.
- c) Newly entered exchange and non-exchange CNS trades will be populated with a mode of settlement as CNS when a CNS settlement restriction exists. Trades will remain as CNS and be available for novation.
- d) Automate additional allotments of CNS positions. Existing CNS trades will remain intact. New process to be triggered upon completion of CNS netting where an allotment has previously taken place on the event.

E.2 CDS Participants

There are no technological system changes required by CDS Participants.

E.3 Other Market Participants

There are no technological system changes required by CDS Participant service bureaus.

F. COMPARISON TO OTHER CLEARING AGENCIES

A similar CNS trade allotment and conversion process is provided by the National Securities Clearing Corporation (NSCC) as outlined in the NSCC Rules and Procedures dated June 28, 2012. Reference to conversion and allocation as it pertains to corporate actions is made, however CDS is not aware of any impending rule changes in this regard.

No comparable or similar procedures were available for other clearing agencies in order to conduct an analysis.

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 or the Autorité des marchés financiers Bulletin to:

Elaine Spankie
Senior Business Analyst, Business Systems Development and Support
CDS Clearing and Depository Services Inc.
85 Richmond Street West
Toronto, Ontario M5H 2C9

Phone: 416-365-3595
Email: espankie@cds.ca

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

Me Anne-Marie Beaudoin
Secrétaire générale
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Manager, Market Regulation
Capital Markets Branch
Ontario Securities Commission
Suite 1903, Box 55,
20 Queen Street West
Toronto, Ontario, M5H 3S8

Télécopieur: (514) 864-6381
Courrier électronique: consultation-en-cours@lautorite.qc.ca

Fax: 416-595-8940
email: marketregulation@osc.gov.on.ca

CDS will make available to the public, upon request, all comments received during the comment period.

I. PROPOSED CDS PROCEDURE AMENDMENTS

Access the proposed amendments to the CDS Procedures on the User documentation revisions web page (<http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-blacklined?Open>) and to the CDS Forms (if applicable) on Forms online (Click View by Form Category and in the Select a Form Category list, click External review) on the CDS Services web page (www.cdsservices.ca).