CDS Clearing and Depository Services Inc. (CDS®)

MATERIAL AMENDMENTS TO CDS PROCEDURES

AMENDMENTS TO PROCESSING A NEW YORK LINK PARTICIPANT DEFAULT

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to the CDS Participant Procedures are intended to mitigate the potentially unlimited liquidity risk[1] to which CDS and CDS Participants are exposed in using the New York Link (NYL) Service. While CDS and its participants have explicitly acknowledged and accepted this potential liquidity risk in the past, the existence of the risk is inconsistent with the requirements of the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructures (PFMIs). As part of the CPSS-IOSCO PFMI self-assessments previously submitted to its regulators, CDS identified a related gap to be remediated as part of CDS' CPSS-IOSCO Gap Remediation Project. The CPSS-IOSCO gap identified by CDS is consequential to Principle 7 (K.C. 5; E.N.3.7.10 & 11), which requires CDS to have adequate liquid resources for meeting the minimum requirement[2] when needed.

Background

CDS's CPSS-IOSCO Gap Remediation Project is intended to ensure compliance with global Financial Market Infrastructure (FMI) standards and best practices for such FMIs as established by CPSS-IOSCO.

In addition to ensuring that CDS is operating according to best practices, the PFMI Gap Remediation Project complies with CDS's Recognition Orders, which require CDS to "observe the FMI Principles as soon as possible" – as follows:

- 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

A defaulting NYL service participant's liquidity risk primarily consists of the amount of its payment obligation to National Securities Clearing Corporation (NSCC). In contrast to Depository Trust Company (DTC) settlement amounts, NSCC settlements for NYL service participants are not subject to a debit cap.[3] With no debit cap, there is no upper limit to a defaulting NYL participant's payment

[1] [1] In the context of this note, liquidity risk is the risk of loss due to the inability of CDS or its participants to meet their financial obligations in a timely manner – funding liquidity risk, more specifically, the inability of a participant to meet its payment obligations in a timely manner.

[2] The minimum requirement being to "*maintain sufficient liquid resources in all relevant currencies to effect same-day settlement, and where appropriate intraday or multiday settlement, of payment obligations with a high degree of confidence" (CPSS-IOSCP PFMI Key Consideration 7.3)*

[3] Net Debit Cap: DTC settlements in a participant's account are subject to a limit on the amount of the participant's payment obligation (the "net debit cap" assigned to the account) and are also subject to collateralization (the

obligation resulting from their NSCC settlements. CDS currently mitigates this liquidity risk by maintaining a line of credit of USD $200 million (of which the first USD $40 million must be collateralized through collateral contributions of the cross border services participants. To support draws on CDS's line of credit resulting from a default of a NYL service participant, CDS manages a collateral pool posted by NYL participants. In the last 4 quarters, the size of this collateral pool has been approximately USD $40 million. As such, the collateral posted by NYL participants is sufficient to activate CDS's line of credit.

NSCC faces similar liquidity risks to those of CDS in the event of a member default; they manage that risk primarily through a pre-arranged liquidity facility (provided by a consortium of banks). Should NSCC's pre-arranged liquidity facility be insufficient to meet NSCC's liquidity requirements in the event of a member default, credits to members (including CDS) would be haircut accordingly. CDS would credit participants due to receive a USD end-of-day payment a pro-rata amount in order to make-up the defaulting participant's deficit to the cross-border service.

CDS's proposed mitigation methodology in respect of the NYL liquidity risk was developed in collaboration and consultation with the CDS's Risk Advisory Committee (RAC) and was, thereafter, presented to the Risk Management and Audit Committee (RMAC) of the CDS Board of Directors on May 5, 2014. The RMAC recommendation to the Board of Directors to approve the proposed methodology was accepted on May 6th, 2014.

The proposed methodology, inserts the application of the defaulter's USD and CAD credits and allocation of credit reductions into the existing "waterfall" of liquidity resources (CDS's existing USD 200 million line of credit). The enhanced waterfall effectively reduces, with a high degree of confidence, the liquidity risk exposure faced by CDS and CDS Participants by transferring the residual liquidity risk from CDS Participants, and CDS generally, to those specific participants who use the NYL service.

As noted, CDS's liquidity facility alone has covered the requirements for the vast majority of the potential historical default scenarios[4].There have been, however, instances where the payment obligation of a participant would have exceeded the available liquidity facilities. In practice, the potential for unlimited NSCC payment obligations precludes establishing a pre-arranged liquidity facility that could address all default scenarios in a commercially reasonable way.

Proposed Amendments

The proposed procedure amendments are intended to align CDS's procedures with the following corresponding changes made to CDS's Financial Risk Model:

New York Link Liquidity Risk Waterfall

The liquidity risk associated with a defaulting NYL participant is the amount of its payment obligation. NSCC settlements for NYL participants are not subject to a cap as is the case for DTC settlements[5]. As a result, there is no limit to the size of a payment obligation of a defaulting NYL participant resulting from their NSCC settlements.

"collateral monitor") based on the haircut value of the securities in the participant's account. As a result, the credit risk associated with the default of a participant's DTC settlements are contained and mitigated.

[4] For the period (Sept 2006 to Sept 2014) CDS's USD $200 million line of credit would have covered all but 36 of the potential USD liquidity requirements in the event of a NYL participant default.

[5] Net Debit Cap: DTC settlements in a participant's account are subject to a limit on the amount of the participant's payment obligation (the "net debit cap" assigned to the account) and are also subject to collateralization (the "collateral monitor") based on the haircut value of the securities in the participant's account. As a result, the credit risk associated with the default of a participant's DTC settlements are contained and mitigated.

CDS would cover its liquidity exposure through a four step waterfall – as follows:

1. Apply the defaulter's USD CDSX credits to reduce the NYL payment obligation.

2. Use CDS's existing USD 200 million Line of Credit (LoC).

3. Any remaining liquidity requirement not covered by CDS's LoC would be allocated to NYL participants as follows:

   a) Allocate against surviving NYL participants as a haircut of their credits based on each NYL participant's pro-rata share of total credits.
   b) Allocate the defaulter's CAD credits to the surviving NYL participants

4. Any remaining liquidity shortfall would be managed via a same-day cash call on surviving CDS-sponsored NYL participants.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments to CDS Procedures are intended to align those procedures with the corresponding changes CDS's Risk Model:

Participating in CDS Services

Section 14.8.7: Processing a suspended NYL participant's payment obligation. These additions to CDS's procedures describe the waterfall process towards attenuating the liquidity risk associated with the NYL service. The process, and its steps, has been approved by CDS's Board of Directors.

CDSX Procedure and User Guide

Sections 9.6 and 9.7: Receiving funds for final cash positions – Canadian and US dollars. Amendments to these sections are intended to describe the synchronization of Canadian and US dollar payment exchange so that the following components of the enhanced waterfall (as described above) can be implemented:

- Apply the defaulter's USD CDSX credits against the NYL payment obligation (step 1); and

- Remaining liquidity requirement not covered by CDS's LoC will be allocated to NYL participants as follows:

  - To the extent possible, allocate the defaulting NYL participant's USD shortfall against surviving NYL participants as a haircut to their credits based on each NYL participant's pro-rata share of total credits (Step 3.a of waterfall)

  - Allocate the defaulter's CAD credits to the surviving NYL participants (Step 3.b of waterfall)

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments will provide CDS:

- Compliance with the CPSS-IOSCO PFMIs 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.

The proposed changes will require the synchronization of (i) CDSX CAD and USD payment exchanges; and (ii) cross border, DTCC, payment exchange.

Currently CDSX CAD payment exchange is automated and carried out through LVTS. CAD payments owed to participants are paid-out as soon as all CAD payments owed by CDS Participants are received.

Synchronization of payment exchange will require CDS to hold off CAD Payment Exchange by not transferring entitlement wires received to its settlement account at the start of payment exchange. Thus, the settlement account would not have sufficient CAD funding for the Bank of Canada's system to release outgoing settlement payments even after all expected settlement amounts from the Participants have been received.

The entitlement funds transfer to the settlement account would only be done after all of the expected DTCC and CDSX USD settlement payments have been received – confirming that CAD outgoing settlement payments can be released.

In similar fashion to CAD payments, USD payments would not be released until such a time as all CAD settlement payments have been received

Settlement payments in both existing currencies would thus be synchronized.

Payment exchange delays would require internal escalation by 4:45 pm with a business decision required by 5:15 pm. The Bank of Canada/Problem Management Group (PMG) would be advised if a CAD payment exchange delay is required.

C.1 Competition

The proposed procedure amendments apply to all CDS Participants who currently use, or may choose in the future to use, the NYL service. Consequently, 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 NYL 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

CDS continues to monitor the development of new international standards for payment, clearing and settlement systems set out in the CPSS/IOSCO report *Principles for Financial Market Infrastructures*[6], and will work with the financial services industry to achieve compliance with the new standards.

The proposed amendments are within the scope of Principle #7 – Liquidity Risk. Principle #7 states that financial market infrastructure such as CDS *"should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under 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 generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions."*

The proposed amendments will enhance CNS settlement effectiveness with respect to the mitigation of the liquidity risk associated with the NYL service for CDS's Participants.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

CDS prepared documents describing the proposed NYL liquidity risk mitigation strategy which were tabled at CDS's Risk Advisory Committee.

D.2 Procedure Drafting Process

The CDS procedure amendments were drafted by CDS's Risk Management and Operations groups, and subsequently reviewed by CDS's Strategic Development Review Committee (SDRC). The SDRC reviews, CDS-related systems development and may also propose system or operating changes to CDS. The SDRC's membership includes representatives from a cross-section of the CDS Participant community and it meets on a monthly basis.

The proposed amendments were reviewed and approved by the SDRC on June 26, 2014.

D.3 Issues Considered

During the analysis of the initiative, consideration was given to the operational impacts that the enhancements might create for CDS Participants as outlined in section C.

D.4 Consultation

This development is being initiated by CDS. CDS reviewed the changes with the CDS's Risk Advisory Committee.

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

[6] The report can be found at http://www.bis.org/publ/cpss101.htm

meetings with service bureaus to discuss development impacts to 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

Alternatives with minor variations on the proposed waterfall were considered. The proposed methodology is the result of input received from the members of CDS's Risk Advisory Committee. The changes are required to ensure that compliance with the CPSS-IOSCO PFMIs.

D.6 Implementation Plan

The proposed procedure amendments and the proposed implementation schedule have been communicated to CDS Participants through the SDRC and the CDS's Risk Advisory Committee. CDS Relationship Managers and the Customer Service department will provide their clients with details of the upcoming changes. Subject to regulatory approval, 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*, and by the British Columbia Securities Commission pursuant to section 24(d) of the British Columbia *Securities Act*, and as a clearing house by the *Autorité des marchés financiers* pursuant to Section 169 of the Quebec *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 participant Procedures may become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment. Subject to regulatory approval, CDS intends to implement the proposed amendments on September 30, 2014.

E. TECHNOLOGICAL SYSTEM CHANGES

E.1 CDS

There are no technological system changes required by CDS.

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 process is used by the National Securities Clearing Corporation (NSCC) as outlined in the NSCC Members Handbook (December 2013) which notes 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*".

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, the British Columbia Securities Commission Bulletin or the Autorité des marchés financiers Bulletin to:

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

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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-UserDocumentation?Open).