

Chapter 6

Request for Comments

6.1.1 CSA Request for Comment on Discussion Paper 24-401 on Straight-through Processing, and Proposed National Instrument 24-101 Post-trade Matching and Settlement, and Proposed Companion Policy 24-101CP to National Instrument 24-101 Post-trade Matching and Settlement

CANADIAN SECURITIES ADMINISTRATORS' REQUEST FOR COMMENT ON DISCUSSION PAPER 24-401 ON STRAIGHT-THROUGH PROCESSING, AND PROPOSED NATIONAL INSTRUMENT 24-101 POST-TRADE MATCHING AND SETTLEMENT, AND PROPOSED COMPANION POLICY 24-101CP TO NATIONAL INSTRUMENT 24-101 POST-TRADE MATCHING AND SETTLEMENT

I. Introduction

The Canadian Securities Administrators (the CSA or we) are publishing for comment the following (collectively, the Documents):

- Canadian Securities Administrators' Discussion Paper 24-401 on Straight-through Processing and Request for Comments (the Paper)
- Proposed National Instrument 24-101 — *Post-Trade Matching and Settlement* (the Instrument)
- Proposed Companion Policy 24-101CP — To National Instrument 24-101 — *Post-Trade Matching and Settlement* (the Companion Policy)

The Documents have been approved for publication in Ontario, British Columbia, Saskatchewan and Alberta and are being published at this time by the Ontario Securities Commission (OSC). All other CSA jurisdictions are expected to approve the Documents for public comment. The comment period will end on July 16, 2004,

The Paper discusses the importance of the securities clearing and settlement system and straight-through processing (STP) to the Canadian capital markets. It sets out the industry's role in achieving STP and the CSA's observations of industry efforts.

The Paper describes the industry's requests for regulatory action from the CSA, and the CSA's responses, in the context of the following key STP initiatives:

1. *Trade comparison and matching* - Improving the post-trade, pre-settlement processing of institutional trades in Canada, particularly the confirmation and affirmation process, whereby the details (including terms of settlement) of a securities trade executed on behalf of an institutional investor are agreed upon by all relevant parties on the date the trade is executed (or T).
2. *Corporate actions reporting* - Improving the process in Canada of disseminating entitlement (also known as *corporate actions*) information on publicly traded securities in a standardized or data-defined format received from issuers or offerors.
3. *Using the Large Value Transfer System for corporate entitlement payments* - Requiring issuers and offerors to make their entitlement payments (such as dividend, interest, redemption, repurchase or take-over bid payments) in funds transmitted by the *Large Value Transfer System (LVTS)*.
4. *Addressing processing issues relating to client name model for investment funds* - Improving the post-trade processing of investment fund transactions in the context of the *client name* business model as compared to the *nominee name* business model.
5. *Improving the processing of securities lending transactions* - Introducing electronic functionality for recalling loaned securities.
6. *Furthering immobilization and dematerialization of physical securities* - Reducing the physical movement of securities certificates in connection with the settlement of transactions in publicly traded securities among market participants.

The industry has identified the need for the CSA to mandate market participants to complete confirmation and affirmation, or matching, of institutional trades on T as the most important regulatory initiative to support the industry's STP milestones. The CSA agree that it is necessary to take regulatory action and propose to mandate a requirement that institutional trades be matched as soon as practicable after a trade is executed and in any event no later than the close of business on T. The CSA also propose to adopt general T+3 settlement cycle and *good delivery* rules.

Consequently, the CSA are publishing for comment, together with the Paper, the proposed Instrument and Companion Policy. A summary of the proposed Instrument is set out below.

II. Specific Request for Comments

Please refer to the Paper (under Part IV: Conclusion and Request for Comments).

III. Background to Proposed Instrument

Since the early 1970's, many initiatives have been implemented by the Canadian securities industry to enhance the efficiency of the securities clearing and settlement process and reduce risk in our capital markets. These initiatives include developing and requiring the use of a central securities depository and central counterparty (CSD/CCP) utility, encouraging the immobilization of securities and the use of *book-based* systems, and requiring that trades be settled within three days of the day of the trade (described as a T+3 settlement cycle period). These initiatives have rendered the process of clearing and settlement of securities trades in Canada one of the most efficient and safest in the world. However, some aspects of securities clearing and settlement need to be improved, particularly functions performed outside the scope of the CSD/CCP activities of a clearing agency in the Canadian capital markets. In the past decade, the volumes and dollar values of securities trades in Canada and globally have grown substantially. The increasing volumes mean existing back-office systems and procedures of market participants are challenged to meet post-trade processing demands, exacerbating the risk that a transaction may not be completed or that one of the parties to a transaction may fail.

1. What is trade matching?

A first step in settling a securities trade is to ensure that the buyer and the seller agree on the details of the transaction, a process referred to as trade confirmation and affirmation or *trade comparison and matching*. A dealer who executes trades on behalf of others is required to confirm trade details, not only with the counterparty to the trade, but also with the client for whom it acted. Agreement of trade details (sometimes referred to as *trade data elements*) must occur as soon as possible so that errors and discrepancies in the trades can be discovered early in the clearing and settlement process. Errors in recording trade details could result in inaccurate books and records, increased costs, and increased market risk and credit risk, which in turn could lead to systemic disturbances in the market. International standards and best practices suggest that speedy, accurate verification of trades and matching settlement instructions is an essential precondition for avoiding settlement failures, especially when the settlement cycle is relatively short.

Automatic trade comparison and matching systems are increasingly common in certain markets. In Canada's capital markets, different systems and processing and settlement practices have evolved over time. These include: *broker-to-broker* trades of exchange-listed securities, frequently associated with retail customer trades, which are generally matched or *locked-in* at a stock exchange or other marketplace; trades of non-exchange-traded securities between two participants of The Canadian Depository for Securities Limited (CDS), which can effectively be confirmed and affirmed through CDS' trade confirmation and affirmation system; and mutual and segregated fund transactions, where FundSERV's facilities provide a mechanism for matching, leading to the settlement of investment fund units for retail clients.

In contrast to these systems, *institutional trades* do not have the benefit of any formal mechanism or system that facilitates trade comparison and matching. Institutional investors account for a large percentage of the trading activity in our capital markets in terms of number of securities and value traded. The typical institutional trade involves at least three parties: an investment manager or portfolio adviser (institutional investor), usually acting on behalf of one or more underlying client accounts, who decides what securities to buy or sell and how the assets should be allocated among the client accounts; a dealer to execute the resulting trades; and a financial institution acting as custodian to hold the institutional investor's assets. After placing an order with, and receiving a notice of execution of a trade from, a dealer, the institutional investor must provide the dealer and custodian with certain details to facilitate the settlement of the trade. In particular, the institutional investor must provide details with respect to the underlying client accounts managed by it, and must instruct the custodian to release funds and/or securities to the clearing agency. The dealer, in turn, must issue a customer trade confirmation containing required information pertaining to the trade pursuant to securities legislation or the rules of a self-regulatory organization (SROs). A key difference between institutional and retail trade processing is that not all of the 26 trade data elements required to initiate an institutional notice of execution are required at a retail level.

According to the Canadian Capital Markets Association (CCMA),¹ the timely clearing and settlement of institutional trades is inhibited by manual processing, over-night batch runs, the undisciplined flow of information, and expensive trade data errors. Inadequate technology is the leading source of problems in the current processing environment. There is too much reliance on manual processing, a lack of real-time functionality, a lack of standard interfaces and inter-operability, and poor communication mechanisms. The current process of confirming and affirming trades is also fragmented and sequential and will not support future trade volume increases of a magnitude we have experienced during the last ten years. The current institutional trade processing model will need to be re-engineered, especially if the industry or regulators decide to move to a T+1 settlement cycle period.

2. **What is trade settlement?**

A trade executed on the facilities of a marketplace is the entering into of a contract for the purchase or sale of securities. The marketplace is not directly involved with the exchange of property for other property or money. The rules and customs of a marketplace or SRO will generally set the terms of the contracts that are formed through the trading of securities. Settlement of trades in most equity and long-term debt securities will usually occur on T+3.²

Settlement is to be distinguished from clearance. Clearing is the process which begins immediately after the execution of a trade, and includes the comparison and trade matching process. It also includes the calculation of the mutual obligations of market participants, usually on a net basis, for the exchange of securities and money—a process which occurs within the operations of a clearing agency. The concept of *clearing* or *clearance* is therefore given a broad meaning to include the process of transmitting, reconciling and confirming payment orders or security transfer instructions prior to settlement. *Settlement* is, on the other hand, the moment when the property right or entitlement to the securities is transferred finally and irrevocably from one investor to another, usually in exchange for a corresponding transfer of money. In the context of settlement of a trade through the facilities or services of a clearing agency, settlement should be viewed as the discharge of obligations in respect of funds or securities, computed on a net basis, between and among the clearing agency and the participants of the clearing agency.

IV. Substance and Purpose of Proposed Instrument

The purpose of the proposed Instrument is to provide a framework in provincial securities legislation for ensuring more efficient post-trade processing of trades in publicly traded securities. The Instrument requires dealers and their institutional clients to complete the process of trade comparison and matching as quickly as practicable—by the close of business on T, as a general rule, or by the close of business on the day following trade date, or T+1, where exception processing is required to correct the details of a trade.

In addition, the Instrument requires trades in depository eligible securities to be settled within T+3. It also contains a *good delivery rule* that requires all delivery-versus-payment (DVP) or receive-versus-payment (RVP) trades in depository eligible securities to be settled through the facilities of a recognized clearing agency. These general requirements, which already exist to some extent in SRO and marketplace rules, will complement existing requirements and strengthen the securities clearing and settlement system in Canada.

1. **Summary of Proposed Instrument**

The Instrument mandates dealers and portfolio advisers (that is, advisers that have discretionary trading authority over client accounts) to *take all necessary steps* to match a trade as soon as practicable after the trade is executed and in any event no later than the close of business on T. To enable matching of trades executed on behalf of institutional clients on T, dealers, advisers and other parties will have to *take all necessary steps* to promptly compare the trade data elements. Dealers are required to enter into a written *trade-matching compliance agreement* with their institutional clients before they can execute trades on behalf of their clients on a DVP or RVP basis. The Instrument allows for trade comparison and matching to be undertaken through centralized facilities operated by a recognized clearing agency, a recognized exchange, a recognized quotation and trade reporting system, or a *matching service utility*. As described in the Companion Policy, a person or company subject to the Instrument or bound by a trade-matching compliance agreement will be presumed to have *taken all necessary steps* to match a trade as soon as practicable after the trade is executed if the person or company has complied with best practices and standards for institutional trade processing established and generally accepted by the industry as a whole.³ The Companion Policy describes certain key trade data elements that need to be confirmed and affirmed as soon as practicable

¹ The CCMA is an organization founded in 2000 by industry groups and participants in the financial services industries to promote and lead the STP initiatives in Canada.

² See Rule 5-103 of the Toronto Stock Exchange and Regulation 800.27 of the Investment Dealers Association of Canada.

³ The CCMA released on June 9, 2003 for public comment a document entitled *Canadian Securities Marketplace Best Practices and Standards: Institutional Trade Processing, Entitlements and Securities Lending* (CCMA Best Practices and Standards White Paper) that sets out best practices and standards for the processing for settlement of institutional trades, the processing of entitlements (corporate actions), and the processing of securities lending transactions. The final version of the CCMA Best Practices and Standards White Paper dated December 2003 can be found on the CCMA website at www.ccma-acmc.ca.

after a trade is executed. In addition, the Instrument sets out certain filing and reporting requirements for matching service utilities, which will enable the Canadian securities regulatory authorities to monitor compliance with industry best practices and standards for trade matching and progress towards industry-wide inter-operability.

Finally, the Instrument requires dealers to take all necessary steps to settle trades in depository eligible securities no later than the end of T+3. It also prohibits dealers from executing a trade in a depository eligible security on behalf of a client pursuant to a DVP or RVP arrangement, unless settlement of the trade is effected through the facilities of a recognized clearing agency.

V. Authority for Proposed Instrument in Ontario

In Ontario, the proposed Instrument is being made under the following provisions of the *Securities Act* (Ontario) (the Act):

- Paragraph 11 of subsection 143(1) of the Act allows the Commission to make rules *regulating the listing or trading of publicly traded securities*, including requiring reporting of trades and quotations.
- Paragraph 2(i) of subsection 143(1) of the Act allows the Commission to make rules in respect of *standards of practice and business conduct of registrants in dealing with their customers and clients and prospective customers and clients*.
- Paragraph 12 of subsection 143(1) of the Act allows the Commission to make rules regulating recognized stock exchanges, recognized self-regulatory organizations, recognized quotation and trade reporting systems, and recognized clearing agencies.

VI. Alternatives to Proposed Instrument Considered

In proposing the Instrument, the CSA had considered as an alternative not implementing any regulatory requirement, relying instead on the SROs to impose trade comparison and matching by the end of T. We believe that market participants are looking for assurances that, before they invest in the necessary financial and technical resources to improve post-trade processing, a requirement to complete trade comparison and matching by the end of T will become a rule subject to compliance and enforcement by the securities regulatory authorities. We seek comment on this specific point. See, in particular, Question 4 and the related discussion in the Paper (under Part III: Mandating Requirements - CSA Response to Industry — B. Institutional trade matching on trade date — 3. CSA response: proposed National Instrument).

VII. Unpublished Materials

In proposing the Instrument and publishing the Paper, the CSA have not relied on any significant unpublished study, report, or other material.

VIII. Anticipated Costs and Benefits

Please refer to the Paper (under Part I: The Canadian Securities Clearing and Settlement System and Straight-through Processing — C. Why is STP important to the Canadian capital markets?)

In summary, the CSA are of the view that the Instrument offers several benefits to the Canadian capital markets, including but not limited to the following:

- Reduction of processing costs due to development of STP systems;
- Reduction of operational risk due to development of STP systems;
- Protection of Canadian market liquidity;
- Reduction of settlement risk;
- Overall mitigation of systemic risk in, and support for the global competitiveness of, the Canadian capital markets.

The CSA recognize, however, that implementing the Instrument may entail costs, which will be borne by market participants. In the CSA's view, the benefits of the Instrument justify its costs. General securities law requirements to match trades before the end of T and settle trades before the end of T+3 will augment the efficiency and enhance the integrity of capital markets. It promises to reduce both risk and costs, generally benefit the investor, and improve the global competitiveness of our capital markets. In addition, in assessing the anticipated costs and benefits of the Instrument to the industry, we carefully considered the industry's express desire for CSA regulatory action in this area.

IX. Regulations to be Amended or Revoked (Ontario)

None.

X. Comments and Questions

You are invited to comment on any aspect of the Documents. In particular, you are asked to respond or otherwise comment on the specific questions set out in the Paper. Please refer to the Paper (under Part IV: Conclusion and Request for Comments). Please submit your comments in writing before July 16, 2004.

Submissions should be sent to all securities regulatory authorities listed below in care of the Ontario Securities Commission in duplicate, as indicated below:

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Securities Administration Branch, New Brunswick
Securities Office, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario
M5H 3S8
jstevenson@osc.gov.on.ca

Submissions should also be addressed to the *Autorité des marchés financiers (Québec)* as follows:

Madame Anne-Marie Beaudoin
Directrice du secrétariat de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3
Telephone: 514-940-2199 ext 2511
Fax: 514-864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

A diskette containing the submissions should also be submitted. As securities legislation in certain provinces requires a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to:

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Request for Comments

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April 16, 2004.