

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 – CDCC Interface – Phase 2

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

NOTICE AND REQUEST FOR COMMENT

MATERIAL AMENDMENTS TO CDS PROCEDURES

CDCC INTERFACE – PHASE 2

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

In December 2009, the Investment Industry Association of Canada (IIAC) received a mandate to develop a central counterparty (CCP) and netting utility for Canada's fixed income securities traded in the cash and repurchase markets. Following a request-for-proposal process, the Canadian Derivatives Clearing Corporation (CDCC) was requested by IIAC to develop this facility. CDS was asked by the IIAC Fixed Income CCP Steering Committee to modify CDS' systems and procedures to accommodate the facility.

The facility is being implemented in phases.

- Phase 1 was implemented effective February 21, 2012. This phase addressed repurchase agreements.
- Phase 1.1 was implemented effective June 25, 2012. This change gives participants the option to have their settlement control indicator updated from 'Yes' to 'No' on bilateral repo trades with a mode of settlement SNS ('SOLA Netting System') and a value date of the current business day which have been received in CDS's CDSX® system after the CDCC cutoff time.
- Phase 2 is scheduled to be implemented effective December 10, 2012. This phase includes changes to CDSX that will support the following business requirements:
 - Allow cash trades with a mode of settlement of SNS.
 - Support trade matching for direct participant (DP) cash trades with a mode of settlement of SNS.
 - Introduce security eligibility for SNS-eligible securities.
 - Support blind repo trading activity by recognizing inter-dealer broker relationships.
 - Support blind cash trading activity by introducing a zero-net matching process.
 - Support partial trade settlement for CDCC net settlement instructions.
 - Introduce a CDSX online function for participants to update their SNS profile.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments address the remaining business requirements to accommodate an effective central counterparty (CCP) and netting utility for Canada's fixed income securities traded in the cash and repurchase markets. Once implemented the following trading activity will be supported:

- Cash trade - Cash trading is a method of buying or selling securities by providing the capital needed to fund the transaction without relying on the use of margin that requires the investor to pay for securities within a specified timeframe from the time of purchase.
- Blind trade - Blind trades are submitted by Inter-Dealer Brokers (IDBs) that act as intermediaries between major dealers to facilitate inter-dealer trades. IDBs do not disclose the identities of the parties to the trade; transactions are referred to as 'blind'. This is to protect the anonymity and confidentiality of the brokers. There are two types of blind trades: blind cash trade and blind repo trade.
 - Blind cash trades – The IDB instructs the participants to submit cash trades in CDSX to be settled against the IDB's settlement bank.

- Blind repo trade – A blind repo trade is a trade submitted by an IDB. A repo is a contract in which the seller of securities agrees to buy them back at a specified time and price. There are two CDSX trades involved in a repo. The near leg is the sale of the security. The far leg is the buyback of the security by the original seller.

Support for cash trades with a mode of settlement of SNS

CDCC Interface Phase 1 addressed only repurchase agreements; Phase 2 introduces support for cash trades. Cash trades, like repo trades, will be reported to CDSX with a mode of settlement of SNS if the trade is to be targeted for novation at CDCC. Participants will identify cash trades (in contrast to repo trades) by leaving the repo tag number field blank. CDCC will recognize trades delivered by CDSX for netting as either cash trades or repo trades by examining the repo tag number and processing accordingly. The Repo tag number will no longer be a required data element for trades with a mode of settlement equal to SNS. CDSX does not consider the repo tag number for any processing.

Support Direct Participant (DP) Trade Matching for cash trades with a mode of settlement of SNS

Phase 2 will consider trades with a mode of settlement equal to SNS for the CDSX DP Trade Matching Facility. Current CDSX DP trade matching service eligibility requirements will apply. The trade matching algorithms differs only to the extent that a new mode of settlement, SNS, will now be considered. The general rule is that both trades reported by the participant must be targeted to CDCC (mode of settlement equal to SNS) for the resulting confirmed (matched trade) or residual trade to be targeted for delivery to CDCC. If only one trade is reported with a mode of settlement equal to SNS and that trade is matched with another trade targeted to settle trade for trade (TFT) or continuous net settlement (CNS), the resulting confirmed trade will be targeted to settle TFT or CNS. The residual trade will be targeted to settle TFT within CDSX.

Introduce security service eligibility for SNS

CDSX will determine whether trades reported to CDSX should be targeted to CDCC and will do so when a trade is reported, modified, or confirmed. If the traded security is not eligible for novation at CDCC, the mode of settlement will be automatically changed from SNS to TFT. This logic will apply to both trades reported and handled directly by participants and to trades handled by the DP trade matching facility. The mode of settlement on blind repo trades will not be changed. If a security subject to a blind repo transaction is ineligible for the CDCC fixed income netting service, the trade will be rejected by CDSX.

SNS has been added to the current list of eligibility criteria in the CDSX Security Master File (SMF). CDS will receive a daily file from CDCC containing securities that are eligible for novation/netting at CDCC. Using this file, CDSX will maintain the SNS eligibility of securities in SMF. In order to be eligible at CDCC, a security must be an active ISIN that is eligible for CDSX services. SNS eligibility will be revoked when an ISIN becomes inactive.

Support Blind Repo trading activity

Blind repo trading activity is facilitated by inter-dealer brokers (IDBs). IDBs do not, themselves, currently participate in the CDCC fixed income netting service for repos. Participants will have to identify to CDS which IDB can enter blind trades on a participant's behalf. Participants will complete and submit a duly authorized Third Party Trade Reporting Request for Service Set Up form (CDS799) and the Appointment and Authorization form (CDS858). With this information, CDS will update the participant's service eligibility profile identifying the authorized reporting sources. In addition, CDSX will maintain valid source IDs for participating IDBs. The trade source will be validated against the participant's profile.

The eligible IDB will submit non-exchange trade details using existing CDS trade messaging. Both legs of the repo will be submitted against the CDCW CUID (at least four trades expected). The CDCW CUID is set up specifically to report blind repo transactions. The IDB will be required to link the multiple trade(s) making up the repo transaction by populating the same repo tag number on all related trades. The blind repo trades are set up in CDSX as confirmed trades with the participant's settlement control indicator set to No. The participant will be required to confirm the trade details by updating their settlement control indicator to Yes. When confirmed, CDSX reports the blind repo trades to CDCC for subsequent novation.

Support Blind Cash trading activity

In the current CDSX environment IDBs instruct the participants to submit blind cash trades in CDSX against the IDB's settlement bank. This practice is expected to continue in the CDCC fixed income environment as well. Alternatively, IDBs could report both sides of the cash trade as long as their settlement bank agrees by completing the authorizations required of participants for blind repos. In the second case both the participant and the settlement bank would need to confirm the trade by updating their settlement control indicator to Yes.

IDBs do not take on principal risk and therefore cannot carry a position in securities. CDS is introducing a new zero net matching process for cash trades where the mode of settlement is SNS. Trades that are successfully matched will be reported to CDCC for novation. For trades that do not match, the mode of settlement will be updated to TFT. The process will be similar to the zero-net process currently in place for FINet.

A real-time zero net matching process will run throughout the day from system CDSX start-up to system shut-down, including the overnight online period. The real-time process will match trades that net to zero on a one-to-one basis. In addition, a batch zero net matching process will run at scheduled times throughout the day. The batch process will match trades that net to zero

one-to-one, one-to-many and many-to-many. For each zero net participant, CDSX will determine whether it can net the par value of eligible cash trades to zero. When trades are matched, the trades are locked and delivered to CDCC for novation. An eligible trade must satisfy the following conditions:

- a) the trade is not yet locked,
- b) the trade is confirmed,
- c) the Settlement Control Indicator of both parties' is "Y",
- d) the trade is not a repo trade,
- e) at least one party to the trade is eligible for the zero net process, and
- f) the security is eligible for the CDCC fixed income netting service.

CDSX uses the following criteria to match trades:

- a) ISIN,
- b) value date,
- c) currency, and
- d) par value/quantity.

A process to change the mode of settlement from SNS to TFT is scheduled to run at 3:30 pm ET and 7:00 p.m. EST. The 3:30 p.m. process will update the mode of settlement from SNS to TFT on existing unlocked and unmatched cash trades which are zero net eligible and have a value date less than or equal to the current business day. The 7:00 p.m. flip process will update the mode of settlement from SNS to TFT on trades with a value date of next business day.

Support partial trade settlement for CDCC net settlement instructions

If a CDCC settlement instruction trade can settle in its entirety, it will. Otherwise, the settlement function will attempt to settle the trade partially. The settlement algorithm functions similarly to the FINet partial settlement function. That is, if a trade can settle partially, it will be split into two trades. One trade will be in the amount that can settle and the other for the remaining net amount. In this case, the first trade will settle, and the residual trade will be retriggered for settlement. The split trades will carry the same details as the original trade, with the exception of the financial details (quantity and net amount). Only trades delivered to CDS by CDCC (SOLA) and those split by CDSX are eligible for partial settlement. Trades delivered to CDS will always have the CDCC CUID on either side (buyer, seller) of the trade. The trades will also always carry a mode of settlement equal to TFT.

Introduce a new online function for participants to update their SNS profile

Participants eligible for the CDCC fixed income netting service will have the ability to provide CDSX with standing instructions about how to react to trades reported by them to CDSX. Specifically, this new (online) function will enable eligible participants to:

- a) Indicate that their settlement control indicator always be set to N by CDSX for bilateral repo trades submitted after the CDCC cut off time.
- b) Indicate to CDSX whether trades reported at the CUID level or internal account level should be eligible for the mode of settlement SNS.
- c) Indicate whether their cash trades with a mode of settlement SNS should be included in the zero net process prior to being reported to CDCC.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments will allow that cash trades involving fixed income securities and that blind trading activity in fixed income securities flow through to CDCC for novation. .

C.1 Competition

The procedure amendments are being proposed to support changes to CDSX in response to an industry requirement for CDCC to develop a central counterparty (CCP) and netting utility for Canada's fixed income securities traded in the cash and repurchase markets. Once implemented, CDS's FINet service will likely be retired.

C.2 Risks and Compliance Costs

To settle in CDSX the corresponding CDCC transactions must pass all of the risk edits. Furthermore, since CDS does not act as the central counterparty (CCP) to the corresponding transactions, there is no incremental risk for CDS. Since the service being provided by CDS is a non-CCP, the risk edits mitigate the associated risk.

Increasing the suite of transactions supported by CDCC's fixed income netting service will benefit participants by reducing their bi-lateral exposure. Also, partial settlement allows greater opportunity to settle settlement instructions delivered to CDSX by CDCC by expediting settlement as soon as any settlement is possible.

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 proposed amendments are consistent with the CPSS/IOSCO principles for PFMI as described below:

The proposed amendments are within the scope of Principle #21 – Efficiency and effectiveness – which states that a financial market infrastructure such as CDS “should be designed to meet the needs of its participants and the market 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 proposed system changes and procedure amendments is intended to support the IIAC mandate to develop a central counterparty (CCP) and netting utility for Canada’s fixed income securities traded in the cash and repurchase markets.

The proposed amendments are also within the scope of Recommendation #5 - Securities lending set out in the CPSS/IOSCO report *Recommendations for securities settlement systems*¹ which states that ‘securities lending and borrowing (or repurchase agreements and other economically equivalent transactions)’ should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed. The process is intended to increase securities repurchase agreement volumes and enhance market liquidity through a more efficient use of such securities.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

The industry’s desire for an alternative CCP fixed income clearing facility, currently being developed by the CDCC on behalf of the IIAC, is the impetus for the proposed procedure amendments. The systems changes and procedure amendments are intended to minimize the impact and disruption to the current roles, practices, and systems of all affected market participants.

D.2 Procedure Drafting Process

CDS procedure amendments are reviewed and approved by CDS’s Strategic Development Review Committee (“SDRC”). The SDRC determines or reviews, prioritizes and oversees CDS-related systems development and other changes proposed by participants and CDS. The SDRC membership includes representatives from the CDS participant community and the committee meets on a monthly basis. The business requirements were also reviewed by players in the fixed income market and approved by them through the IIAC working committees.

These proposed procedure amendments were reviewed and approved by the SDRC on August 30, 2012.

D.3 Issues Considered

The primary consideration was to minimize the impact and disruption to the current roles, practices, and systems of all affected market participants. In that respect, current practice in place for IDB activity, DP trade matching, zero-net functionality and partial settlement was developed to be consistent with functionality currently in place in CDSX.

D.4 Consultation

The processes and the related procedures were developed in direct consultation with market participants under the auspices of the IIAC. Functional design was vetted through the IIAC steering committee structure and approved for development as presented.

D.5 Alternatives Considered

The fixed income clearing facility is an industry initiative. Alternatives to the new fixed income clearing facility process were considered at the outset of the initiative. In respect of the proposed amendments, CDS was asked to develop a solution that would support the implementation of the CDCC fixed income clearing facility with minimal development effort required by CDS’s participants and other affected market participants. CDS’s participants are familiar with the CDSX DP trade matching utility, zero-net processing and partial settlement for fixed income securities in a CCP environment. The changes introduced are extended to trade activity related specifically to the CDCC fixed income netting service.

D.6 Implementation Plan

¹ The report can be found at <http://www.bis.org/publ/cpss46.htm>

The changes documented herein are expected to be implemented December 10, 2012. These changes will be implemented at the same time that related changes to SOLA are implemented by CDCC. Prior to implementation there will be an extensive testing period including individual testing at CDS and CDCC, joint testing between CDS and CDCC, followed by industry testing. Industry readiness is managed by the IIAC.

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**. 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 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 the participant procedures may become effective on or after date of approval of the amendments by the Recognizing Regulators following public notice and comment.

E. TECHNOLOGICAL SYSTEMS CHANGES

E.1 CDS

CDSX functionality will be changed as follows:

- a) The repo tag number will be eliminated as a mandatory field on a non-exchange trade with a mode of settlement SNS. A non-exchange trade with a mode of settlement SNS submitted with a repo tag number is considered a repo trade. If the repo tag number is not provided, the trade is considered a cash trade.
- b) The DP Trade Matching process in CDSX will be enhanced to include cash trades with a mode of settlement of SNS.
- c) A new security service eligibility for SNS will be added.
- d) CDSX will support the receipt of a daily file from CDCC which will allow automatic updates of the security service eligibility for SNS or the removal of SNS eligibility on existing CDSX eligible securities.
- e) A facility for IDBs to submit confirmed blind repo trades to CDSX will be added. The IDBs will also be able to modify trades the IDBs have submitted through this facility.
- f) A new participant service eligibility at the unit level for Third Party Trade Reporting will be added.
- g) A zero net matching process for cash trades with a mode of settlement SNS will be introduced. Both a real-time zero net match process and a scheduled batch zero net match process will be available.
- h) A 'flip' process that will update the mode of settlement from SNS to TFT for unmatched, unlocked zero net eligible cash trades will be introduced. This process will be scheduled to run throughout the day.
- i) A participant CDSX online function enabling participants to manage their SNS profile will be added.

E.2 CDS Participants

CDS's participant's systems will be required to identify blind repo trades submitted on the participant's behalf by an Inter-Dealer Broker. Further, participant systems will be required to identify cash trades with a mode of settlement SNS. Finally, participant systems will be required to identify trades that have been deleted and the new trades created by CDSX according to the partial settlement process.

E.3 Other Market Participants

Where a CDS participant's systems are operated by a third-party vendor, the vendor will be required to make similar modifications to their systems as would be required by the participant (described in section E.2).

Inter-Dealer Brokers will be required to enhance their systems in order to feed pre-confirmed transactions for blind repo transactions to CDSX.

F. COMPARISON TO OTHER CLEARING AGENCIES

Netting and novation of fixed income repo trades in the U.S. market occurs through the Fixed Income Clearing Corporation (FICC); a subsidiary of the Depository Trust & Clearing Corporation (DTCC). FICC nets and novates transactions on a near real-time basis and provides counterparties with net outstanding obligations on a current and forward-dated basis. Repo transactions with a "start" or "on" leg of the current day are novated by FICC. The "end" or "off" legs are future dated and are novated and netted, with settlement taking place on the net obligation on the value date. In each case the security obligation settles through the Federal Reserve and the funds component is settled through Fedwire.

The model being developed by CDCC follows roughly that of LCH.Clearnet, an independent clearing house is based in London,

U.K. LCH.Clearnet operates RepoClear, a market utility that nets and novates bond and repo transactions between industry participants in 13 European markets. Settlement of these net obligations that have reached their value date is done at the depository in each market.

G. PUBLIC INTEREST ASSESSMENT

CDS has determined that the proposed amendments to the CDS procedures 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:

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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

The proposed procedure amendments are available for review and download on the www.cds.ca/cdsclearinghome.NSF/Pages/EN-UserDocumentation?Open page on the CDS website.