

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.3 Clearing Agencies

13.3.1 Material Amendments to CDS Procedures – Due Bill Processing in Canada – Request for Comment

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

NOTICE AND REQUEST FOR COMMENT MATERIAL AMENDMENTS TO CDS PROCEDURES

DUE BILL PROCESSING IN CANADA

A. DESCRIPTION OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed procedure amendments are available for review and download on the [User Documentation](http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-UserDocumentation?Open) page (<http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-UserDocumentation?Open>) on the CDS website.

Background

Over the last few years, the financial industry has been working on making changes to the processing of entitlement events in Canada to help improve the accuracy of the reporting of clients' holdings at the time these events occur.

Presently events such as stock splits, spin-offs, stock dividends and stock distributions reflect a post distribution price while the client's position is not adjusted until payable date thus undervaluing the client's portfolio positions, possibly creating credit issues and potential lost revenue for undervaluing fee based billing accounts for participants.

In addition, the current processing of entitlement events in Canada is different from that of the United States, which creates significant challenges in the case of interlisted securities. For example, the U.S. utilization of a "due bill" processing system, leads to a situation where inter-listed securities trade in the Canadian market at a different price than in the U.S. market during the due bill period.

Currently, due bill processing is a practice unique to the U.S. market, and applies to an entitlement event when an exchange sets the Ex-Dividend date after the Record Date. Due bills are share or cash entitlements (e.g., in the case of a stock split, the split shares) that are attached to trades that settle between the Record Date and the Due Bill Redemption Date (or, Ex-Dividend Date plus 2). The trade settles at the old price, therefore the buyer is due the entitlement. This practice was established in a certificated environment to accommodate the time it took for the shareholder to receive the physical certificates from the transfer agent. However, this process has evolved and is now accommodated in an automated electronic environment.

In Canada, where due bill trading does not currently apply, the Ex-Dividend date is set as two days prior to the Record Date, resulting in the first settlement date at the "new price" as Record Date plus 1. Also, trades that have a settlement date after Record Date are not eligible for the entitlement.

In 2010, the Canadian securities industry, as represented by the IIAC Due Bill Working Group, asked CDS to enhance and synchronize the entitlement process in CDSX, thereby adopting the due bill process in Canada.

Description of the proposed amendments

With the introduction of due bill processing in Canada, changes will be required to CDS's entitlement event management process, entitlement processing methods, including claims processing, as well as the current reporting and tracking requirements.

Updates to NCS, CDS's entitlement processing system, will include:

- The retirement of 12 existing event types, which will be replaced with four new ones (there will no longer be a requirement to differentiate events based on the listing country of the base security)

- Updates to recognize new key event processing dates (e.g. DBRD, Ex-dividend date, etc.)
- Changes to the entitlement calculations used for payments, which will now be based on whether due bill or non due bill processing is required. The due bill processing method will be used when the ex-date of an event is after record date. When the ex-date is on or before record date then the non due bill method of processing will be used.
- The generation of claims transaction on Trade-for-Trade (TFT) transactions when an outstanding TFT trade that is impacted by the entitlement has been settled. Trades will be monitored, and claims generated upon settlement, for a period of 30 calendar days after the event has been updated to a 'Paid' status.

A new web-based service – TRAX Entitlements Tracking - will be provided to allow participants to track:

- Transactions impacting their entitlement payment
- Outstanding items which, when settled, will result in claims.

Changes will also be required to some existing RMS reports to accommodate the processing changes. A new claims report will be available to participants to support the new process related to claims.

It should be noted that the French version of the procedures includes technical amendments not in the English version, to correct minor updates that occur only in the French version.

B. NATURE AND PURPOSE OF THE PROPOSED CDS PROCEDURE AMENDMENTS

The proposed amendments are considered material. These amendments will implement a new entitlement processing and calculation flow, as well as a claims process, that are expected to reduce participant costs and the risks associated with processing entitlement events using two different processes for clients located in Canada and the United States.

C. IMPACT OF THE PROPOSED CDS PROCEDURE AMENDMENTS

There are significant advantages to having a common system/solution across the industry and cross border.

Processing inefficiencies: Currently there are inconsistencies in processing entitlement events between the Canadian and U.S. marketplaces, in the case of interlisted securities. Such issues trade in the Canadian market at a different price than in the U.S. market during the due bill period causing significant effort by Canadian investment firms to track and reconcile due bills based on the different trading conventions in the two markets.

Portfolio valuation: In the case of stock splits, transfer agents typically do not issue the share entitlements on the first settlement date at the post-split price. The delay in receiving the additional shares causes an understatement in market value in clients' accounts from the first settlement date at the post-split price to the payable date.

C.1 Competition

The procedure amendments are being proposed to support CDS system changes that will assist in the standardization of entitlement processing in Canada and the U.S.

C.2 Risks and Compliance Costs

The proposed amendments are not expected to change the risk profile of CDS or its participants.

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

Currently, due bill processing is a practice unique to the U.S. market, and is not used internationally.

D. DESCRIPTION OF THE PROCEDURE DRAFTING PROCESS

D.1 Development Context

The proposed amendments and the CDS system changes required to implement the proposed amendments are the result of the financial industry's desire for a standard processing method for entitlement events that are subject to due bills. The changes will help improve the accuracy of the reporting of client's holdings at the time an entitlement event occurs in Canada.

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's membership includes representatives from the CDS participant community and it meets on a monthly basis.

These proposed procedure amendments were reviewed and approved by the SDRC on July 28, 2011.

D.3 Issues Considered

None.

D.4 Consultation

The amended processes, as well as the procedures changes, were developed with direct consultation with market participants through the SDRC Entitlement subcommittee and IIAC meetings.

D.5 Alternatives Considered

In November 2008, the SDRC asked CDS to prepare a gap analysis and work effort estimate to implement due bill processing in CDSX, similar to that used in the U.S. In January 2009, CDS presented its findings to the Investment Industry Regulatory Organization of Canada (IIROC) FAS operations committee and the SDRC. Two options were presented, one that included claims processing similar to DTCC and one that did not. In 2010, the Canadian securities industry, as represented by the IIAC Due Bill Working Group, reached consensus to enhance and synchronize the entitlement process by adopting the due bill process with claims in Canada.

D.6 Implementation Plan

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.

E. TECHNOLOGICAL SYSTEMS CHANGES

E.1 CDS

CDS's systems will be modified to accommodate the changes required to process entitlement events subject to due bills, and provide tracking and reporting of outstanding Trade-for-Trade transactions and associated claims.

Enhanced trade tracking and reporting will be available for subscription through a new web-based service – TRAX Entitlements Tracking – on the CDS website, www.cds.ca.

E.2 CDS Participants

CDS participants will be impacted as follows:

- New process allows for more efficient tracking of trades executed in the U.S. marketplace for inter-listed securities
- Reduced reliance on in-house pricing adjustments/processes to deal with existing timing differences
- Must become familiar with and be able to process the new event types of SDV (stock dividend), SPN (spin off), SSP (stock split) and SDS (stock distribution)
- Will be able to process a DBRD date on their internal systems from incoming files and messages
- Enhanced information dissemination through bulletins: Notification on cash dividend events when the event involves due bill processing. Due bill redemption date will be provided on the existing rights & warrants and cash distribution events when the event involves due bill processing.
- Claims will only be settled once the underlying trade has been settled to ensure only valid TFT trades trigger claims
- Claims will be generated for stock split events instead of having the current trade conversion activity occur
- May refer to the new 'Claims for Settled Trades and O/S CNS Positions' RMS report for information on claims generated using the new method of processing

If a participant subscribes to the new TRAX Entitlement Tracking service, they will be further impacted as follows:

- Able to view the projected payment sooner allowing for earlier reconciliation of their client's accounts to the amounts being received
- Due Bills Only: Able to quickly identify the transactions included in the entitlement payment which will facilitate the reconciliation of settled transactions to the entitlement payment
- Due Bills Only – Prior to Payable Date: Able to easily identify and follow up on outstanding transactions to be settled and included in the entitlement payment resulting in fewer claims generated
- Post Payable Date: Able to view, in one location, outstanding TFT transactions, CNS positions and pledge loan items that will generate a claim once settled. They will also be able to view all claims that have settled (or pledge modifications for existing pledges). This will facilitate the reconciliation of amounts receivable/payable to their internal records

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 systems modifications to:

- process the new event types of SDV (stock dividend), SPN (spin off), SSP (stock split) and SDS (stock distribution)
- process a DBRD date on their internal systems from incoming files and messages

Additionally, CDS will use the dates provided by the TMX (for Canadian listed securities) or DTCC (for U.S. listed or interlisted securities) when establishing the Ex-Dividend and Due Bill Redemption dates applicable to an event.

F. COMPARISON TO OTHER CLEARING AGENCIES

These changes will synchronize the due bill entitlement process in Canada with that used in the U.S. Currently, due bill processing is unique to the U.S. market.

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 to:

Laura Ellick
Manager, Business Systems
CDS Clearing and Depository Services Inc.
85 Richmond Street West
Toronto, Ontario M5H 2C9

Telephone: 416-365-3872
Fax: 416-367-2755
Email: lelick@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:

M^e Anne-Marie Beaudoin
Secrétaire del'Autorité
Autorité des marchés financiers
800, square Victoria, 22^e 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.