

13.1.2 Notice and Request for Comment – Material Amendments to CDS Rules – Free Payment Restrictions in CDSX

CDS CLEARING AND DEPOSITORY SERVICES INC. (CDS®)

MATERIAL AMENDMENTS TO CDS RULES

FREE PAYMENT RESTRICTIONS IN CDSX®

REQUEST FOR COMMENTS

A. DESCRIPTION OF THE PROPOSED AMENDMENTS

Specific restrictions on free payments (i.e. cash-only movements) currently in the CDS Participant Rules are proposed for deletion with the current Aggregate Collateral Value (“ACV”) risk edits and Funds risk edits acting as the more appropriate controls for collateralization and the magnitude of payment risk in CDSX.

B. NATURE AND PURPOSE OF THE PROPOSED AMENDMENTS

The original design of CDSX was based on the premise that the ACV and Funds edits provided adequate control for collateralization and the magnitude of payment risk. The Debt Clearing System (“DCS”) system (the predecessor to CDSX) included a leakage edit which compared the value of securities to the settlement amount for individual trades and rejected the input of trades where the difference was greater than 6%. CDSX does not include a leakage edit, primarily because the leakage edit was not an effective control against a defaulter being able to maximize their payment obligation within the constraints of the ACV and funds edits. Furthermore, it would have been problematic to determine an appropriate percentage difference threshold (instead of the 6% used in DCS) for equities in CDSX. Leading up to the proposed implementation of CDSX, some participants expressed concern about the removal of the leakage edit and the dependence on the ACV edit to collateralize payment obligations on an aggregate basis. Some participants also noted that the purpose of credit facilities in CDSX was for the settlement of transactions on a value-for-value basis. Concerns were also raised about the exposure faced by the Receivers’ Collateral Pool (“RCP”) without a leakage edit-like control.

During late 2003, a working group of participants and CDS representatives met to address these issues and a compromise was reached to employ a new type of cash-only transaction with a maximum value of \$500,000 for particular types of cash-only movements in CDSX (single cash-only movements exceeding \$500,000 cannot be split up in order to circumvent the rule). It was also agreed that CDS should monitor transactions for inappropriate value and follow up with those participants which consistently use these types of transactions. Inappropriate value refers to a significant difference between the value of the securities and the cash being exchanged.

Since the implementation of CDSX, considerable experience has been gained with the haircut rates applied to equity securities in CDSX. As indicated by backtesting results, the haircut rates have been effective in providing ACV for participants’ equity positions while maintaining adequate risk protection for the extender of credit granting a line of credit or for the category credit ring.

The primary risk related to cash movements and trades for inappropriate value is the potential for a participant to maximize their payment obligation within their available ACV. In order for this to happen, a participant would enter a cash movement or trade for inappropriate value between themselves and another willing participant. None of the existing controls in CDSX prevent this value transfer from a defaulter to another willing participant from occurring. Cash transfers being limited to \$500,000 and the Rule reference requiring that single cash transfers exceeding \$500,000 cannot be split into \$500,000 blocks does somewhat limit the use of cash transfers to accomplish this value transfer but does not eliminate the possibility of such occurring. Additionally, there is no mechanism to prevent inappropriate value trades. The most obvious difficulty in preventing inappropriate trades is determining what is inappropriate and what are legitimate trades where the value of the security has dropped between trade date and value date.

This difficulty has been borne out in discussions with participants with trades identified as inappropriate, particularly where the trades identified settled over a month previously. CDS believes that the identification and tracking of these inappropriate value trades provides a false sense of control.

Finally, introducing a version of the leakage edit in CDSX does not address the issue of inappropriate value transfer, it only makes more work for the defaulter and the willing participant. That is, by entering a series of trades within the leakage edit, the same effect can be accomplished.

As such, CDS is proposing to delete Rule 7.2.5. Rule 7.2.5 deals with free payments and provides that payments may be made through the Settlement Service without any corresponding delivery of Securities if the payment is made between participants and does not exceed the limit set out in the Procedures [7.2.5(a)(iii)]. This portion of the Rule alludes to the \$500,000 limit that is a part of the inappropriate value edit and should therefore be deleted. The other sub-paragraphs in Rule 7.2.5(a) are specific instances of the general Rule proposed and are unnecessary and, in any event, the language is permissive only.

Rules 7.2.5(b) and 7.2.5(c) are also proposed for deletion. They deal with restrictions on funds transfers and the monitoring of free payments.

C. IMPACT OF THE PROPOSED AMENDMENTS

As the ACV edits and Funds edits have been found to provide appropriate controls for collateralization and the magnitude of payment risk in CDSX, there is no impact in terms of risk.

D. DESCRIPTION OF THE RULE DRAFTING PROCESS

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”.

In 2007, the Canadian Dollar RCP members were presented with the proposal to eliminate the restrictions on free payments. None of the Canadian Dollar RCP members disagreed with the proposal. Furthermore, the Risk Advisory Committee (a committee comprised of Participants’ representatives, self-regulatory organizations’ representatives, CDS representatives, and Regulator observers) reviewed and approved the proposal on January 16, 2008 subject to any counterproposal of the Senior Risk Management Committee of the Extenders of Credit. As no issues were raised, the proposal was moved forward to propose Rule amendments.

Each amendment to the CDS Participant Rules is reviewed by CDS’s Legal Drafting Group (“LDG”). The LDG is a committee that includes members of Participants’ legal and business groups. The LDG’s mandate is to advise CDS management and its Board of Directors on rule amendments and other legal matters relating to centralized securities depository and clearing services in order to ensure that they meet the needs of CDS, its Participants and the securities industry.

Pursuant to the unanimous shareholder agreement between The Canadian Depository for Securities Limited (“CDS Ltd.”) and CDS, effective as of November 01, 2006 whereby CDS Ltd., which acts under the supervision of its Board of Directors, assumes all rights, powers, and duties of the CDS Board of Directors, these amendments were reviewed and approved by the Board of Directors of CDS Ltd. on June 17, 2008.

The amendments to the Participant Rules will become effective upon approval of the amendments by the Recognizing Regulators following public notice and comment.

E. TECHNOLOGICAL SYSTEMS CHANGES

No system changes are required to implement these Rule amendments. There will be a consequential system amendment to eliminate the \$500,000 limit described above.

F. COMPARISON TO OTHER CLEARING AGENCIES

This Rule amendment responds to the particular conditions of the Canadian financial 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 delivered by August 3, 2008 to:

Jamie Anderson
Managing Director, Legal
CDS Clearing and Depository Services Inc.
85 Richmond Street West
Toronto, Ontario M5H 2C9

Fax: 416-365-1984
e-mail: attention@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
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22nd floor
PO box 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Fax: (514) 873-7455
e-mail: consultation-en-cours@lautorite.qc.ca

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

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

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

I. PROPOSED RULE AMENDMENTS

Appendix "A" contains text of current CDS Participant Rules marked to reflect proposed amendments as well as text of these rules reflecting the adoption of the proposed amendments.

TOOMAS MARLEY
Chief Legal Officer

APPENDIX "A"
PROPOSED RULE AMENDMENT

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
<p>7.2.4 Free Delivery</p> <p>A Participant may deliver Securities to another Participant without any corresponding payment being made.</p> <p>7.2.5 Free Payment</p> <p>(a) Methods of Making Free Payments</p> <p>In the following circumstances, a payment may be made through the Settlement Service without any corresponding delivery of Securities being made:</p> <ul style="list-style-type: none"> (i) the payment is made as part of an Entitlements Transaction between CDS and a Participant; (ii) the payment is made as part of any Transaction generated by the system, including a Transaction resulting from an ATON confirmed request for Transfer; (iii) the payment is made from a Participant to another Participant for a purpose set out in the Procedures and in an amount not exceeding the limit set out in the Procedures (provided that no Participant shall make two or more payments for the purpose of avoiding such limit); or (iv) the payment is made using a Funds Transfer. <p>(b) Restrictions on Funds Transfers</p> <p>A Funds Transfer between any two Participants is subject to the following restrictions: (i) a Funds Transfer is made only if the debit to the paying Participant's Funds Account does not exceed the credit balance in that Funds Account; and (ii) a Funds Transfer shall not draw any amount under a Line of Credit or a System Operating Cap established for the paying Participant. Such restrictions do not apply to a Fund Transfer if the following conditions are met: (i) the paying Participant is an Extender or an Active Federated Participant, (ii) the debit is denominated in US Dollars and (iii) the Funds Transfer is made for the purpose of correcting an ACV or System Operating Cap insufficiency on the part of the recipient.</p> <p>(c) Monitoring of Free Payments</p> <p>GDS monitors payments made without any corresponding delivery of securities, and may request a Participant to confirm that such a payment made or received by the Participant conformed to the requirements of this Rule 7.2.5. If CDS determines, acting reasonably, that such a payment made or received by a Participant did not conform to the</p>	<p>7.2.4 Free Delivery</p> <p>A Participant may deliver Securities to another Participant without any corresponding payment being made.</p> <p>7.2.5 Loans</p> <p>In accordance with the Procedures and User Guides, Securities may be delivered and payments made with respect to loans of Securities or of funds by one Participant to another, which may be collateralized by a Pledge of Securities or funds as agreed to by the Participants.</p> <p>7.2.6 Mode of Settlement</p> <p>Each Trade must include a mode of settlement indicator that is one of Trade-for-Trade, CNS or CBS. The mode of settlement indicator is either included in the instructions when the Trade is reported or confirmed, or is added automatically by the system in accordance with the criteria in the Procedures and user Guides. A CBS mode of settlement indicator is added by the system and cannot be included in the instructions by the Participant.</p>

Text of CDS Participant Rules marked to reflect proposed amendments	Text CDS Participant Rules reflecting the adoption of proposed amendments
<p>requirements of this Rule 7.2.5, CDS may take any steps consistent with these Rules.</p> <p>7.2.65 Loans</p> <p>In accordance with the Procedures and User Guides, Securities may be delivered and payments made with respect to loans of Securities or of funds by one Participant to another, which may be collateralized by a Pledge of Securities or funds as agreed to by the Participants.</p> <p>7.2.76 Mode of Settlement</p> <p>Each Trade must include a mode of settlement indicator that is one of Trade-for-Trade, CNS or CBS. The mode of settlement indicator is either included in the instructions when the Trade is reported or confirmed, or is added automatically by the system in accordance with the criteria in the Procedures and user Guides. A CBS mode of settlement indicator is added by the system and cannot be included in the instructions by the Participant.</p>	