The Canadian Depository for Securities Limited
85 Richmond St. W., Toronto, ON M5H 2C9
T. 416.365.3574
www.cdsltd-cdsltee.ca

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Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
email: jstevenson@osc.gov.on.ca

and

M^{e} Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec H4Z 1G3
Fax : (514) 864-6381
email: consultation-en-cours@lautorite.qc.ca

Re: Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada

Dear Sirs and Mesdames:

Further to the "Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada" issued by the Canadian Securities Administrators (CSA) Derivatives Committee on November 2nd, 2010, The Canadian Depository for Securities Limited (CDS) is pleased to provide its comments on the questions posed in the Clearing and Trade Repository sections of the paper, areas where CDS believes it can make a valuable contribution to the continuing debate on the most optimal environment for Canada vis-à-vis the processing of OTC derivative transactions.

CDS's responses are based upon the premise that there are five well understood and accepted components to a global solution for the future processing of OTC derivative transactions, namely:

1. Regulatory oversight and capital standards
2. Trade execution on organized markets
3. Standardization
4. Central counterparty (CCP) clearing
5. Central data repositories/information warehouses.

These components are articulated in recent pronouncements from the regulators in Europe (via the European Commission) and in the United States (via the *Dodd-Frank Act*) and form the basis of the consultation paper from the CSA.

It is important to recognize that these five components are inter-related and build upon each other. The regulatory oversight and capital standards component provides the foundation for the other four components which are all operational in nature. CDS believes that the order in which the four operational components are addressed is important. Determining how particular OTC derivatives will be traded has a major influence on who will lead the effort on standardization, how the clearing process will be designed and who will act as the CCP. Without standardization, both in terms of the features of the contracts that govern the relationship between the parties and in terms of the codification of the contract terms and conditions, it would not be possible to trade these derivatives on an organized market, to manage the risks within the contract by clearing through a CCP, or to efficiently input the terms and conditions into a data repository. Similarly, the scope of the work to be performed by the designated clearing organization and CCP will depend greatly on the degree to which the derivatives in question can be traded on an organized market.

CDS recommends that the first priority for the Canadian OTC derivatives initiative should be the development of an industry consensus on the likely future market structure for the products that are included within the scope of the initiative. It is CDS's opinion that developing this consensus is essential to being able to define the scope of work to be completed for the rest of the initiative. Without this consensus, it will be difficult to define, with any precision, what needs to be delivered by market participants, infrastructure providers and regulators, thereby jeopardizing Canada's ability to meet the December 2012 target date.

The definition of the market structure will identify where (i.e., geographically) the various asset classes are likely to trade in the future, whether the asset classes will trade solely on an organized market basis, solely on an OTC basis or a combination of the two depending on the nature of the product within the asset class. There is considerable evidence to suggest that the scope of the clearing/CCP process is highly influenced by the form of the trading process that precedes it. It can also be argued that the form of a central data repository will be determined by decisions that are made at the trading platform and clearing/CCP levels with, as just described, clearing/CCP being highly influenced by the type of trading process.

Ian A. Gilhooley

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President and Chief Executive Officer

About CDS

CDS Clearing and Depository Services Inc. (a subsidiary of The Canadian Depository for Securities Limited) is Canada's national securities depository, clearing and settlement hub - supporting Canada's equity, fixed income and money markets, holding over C$3 trillion on deposit and handling over 350 million domestic and cross-border security trades annually. CDS's ongoing commitment to minimise risk for market participants and its sophisticated financial risk model have earned it the top global ranking from Thomas Murray, the specialist custody rating, risk management and research firm.

Comments on Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada

Clearing Questions

Do you agree with the recommendations on the approach to implementing mandatory central clearing? What factors should be taken into consideration by regulators in identifying OTC derivatives appropriate for clearing and which are capable of being cleared?

In our response, we assume that the reference to "central clearing" means "central counterparty clearing". In Canada, there are two forms of clearing, trade-for-trade (TFT) clearing and central counterparty (CCP) clearing. In TFT clearing, the clearing organization facilitates confirmation that the contractual terms previously agreed between the parties to the transaction have been properly captured in electronic form (i.e., through the confirmation/affirmation process associated with the clearing process). In CCP clearing, the process is taken one step further, with the clearing organization netting and novating the confirmed transaction. In essence, the clearing organization becomes the counterparty to both the originating buyer and seller within a single transaction. The clearing organization, acting as the CCP, then takes on responsibility for setting margin payments and for ensuring that these margin payments are made.

In addition to reducing counterparty risk, the CCP adds value to the process by being able to combine trades having the same characteristics (i.e., essentially the same terms and conditions, except for quantity and price) into a net position where participants become either a net buyer or a net seller of a particular contract "type" with the CCP being on the other side of the netted position.

A major issue with OTC derivatives is that, traditionally, they often do not have standard terms and conditions and therefore do not lend themselves to the netting process and to the benefits of a CCP. If each trade were to be unique in terms of its terms and conditions, the end result would be that the CCP would provide no real commercial value and would simply be a straight-through conduit between the original buyer and seller. From a risk management perspective, the CCP would be assuming the sum total of all bilateral risks in the marketplace, an untenable and unacceptable position to be in.

To be acceptable for CCP clearing, an OTC derivative product would need to be structured into a set of common terms and conditions, have liquidity in terms of market activity, available pricing for mark-to-market and operate within a framework of legal certainty. Only where these conditions were met would it be possible to net and novate trades in these products and apply standard risk management techniques.

For those products that do not meet the criteria just defined, central clearing is still a possibility, although only to the extent of confirming the contractual terms and conditions between the originating parties (i.e., the TFT approach). In this situation, the clearing process performs the role that has sometimes been ascribed to the trade repository in the overall design of the OTC derivatives infrastructure.

What is your view on possible solutions for accessing CCPs and allowing for the most efficient use of capital?

Although CDS is the CCP for multiple asset classes (i.e., equities and fixed income), CDS has chosen, in the risk model[1] for its CCP services, to "ring fence" the risks associated with each asset class, in effect, not co-mingling the risks associated with each asset class and therefore, not looking to offset the collateral requirements in one asset class with the collateral requirements in another asset class. The principal underlying reason for this approach has been to recognize that participants that trade in one asset class do not necessarily trade in another asset class and therefore should not bear the risk of being in a risk pool for those asset classes within which they do not trade. Conversely, participants should only be members of risk pools for asset classes within which they do trade.

CDS would recommend that the same approach be taken to risk sharing within OTC derivative asset classes. If trading in all asset classes includes the same "players", then a single risk pool could be created and offsetting collateral/capital requirements calculated. Conversely, if the trading members within asset classes are distinctly different, risk pools should be created by asset class with participants being given the option of joining particular risk pools (i.e., a continuation of the CDS risk model concept).

The ability to effectively manage risk within asset classes would appear to outweigh the benefits of being able to offset collateral/capital requirements.

Is there sufficient liquidity in each of the individual Canadian derivatives markets (e.g., equities, interest rate, commodities, foreign exchange, etc.) to support the creation of a Canadian CCP? Which derivatives markets may pose challenges to the operation of a Canadian CCP?

The characteristics of a product that can be successfully processed within a CCP environment were previously described (i.e., common terms and conditions, liquidity, available pricing for mark-to-market and a framework of legal certainty). The location of the trading environment is also an important consideration when determining the location of the CCP. The markets for the majority of OTC derivatives activity are outside of Canada and this situation will continue to exist in the future. From the statistics that have been made available, the most promising asset class for a Canadian derivatives market would be equities, although interest rate swaps involving Canadian dollars also offers some potential.

In the situation that is likely to be common to most of the assets classes under discussion, a Canadian participant will enter into a trade with a foreign participant that does not have a presence in Canada. The resultant transaction could be reported for processing to one or any of a number of different clearing organizations:

1. The clearing organization attached to the trading platform where the transaction took place (most likely)

2. The Canadian clearing organization for the asset class in question

3. The appropriate clearing organization for the foreign participant

[1] CDS Financial Risk Model v6.0. Available at <http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-CDSFinancialRiskModel-Version6.0/$File/CDS+Financial+Risk+Model_Version+6.0.pdf?OpenElement>.

4. A global clearing house represented by the CCPs from participating markets.

In the most comprehensive scenario (a combination of the above scenarios), a transaction would be reported to the appropriate clearing entities in both participants' markets (i.e., in Canada and in the foreign market). These clearing entities would recognize that one side of the trade was with a "foreign" participant (i.e., a participant who is not a member of that clearing entity) but would also be able to determine the CCP that acts on behalf of this foreign participant and would substitute that CCP in place of the foreign participant. The same process would take place in both clearing jurisdictions. The CCPs would need to have reconciliation processes in place to ensure that each CCP stayed in balance with its obligations to the other jurisdictions. To the extent that settlement is required, the settlement would take place between the participants and their local CCP and between the CCPs in a global clearing house. This approach is similar in concept to CLS Bank which is a global clearing facility for foreign currencies with participation from clearing entities in all member countries. The TARGET settlement system in Europe operated by the European Central Bank is another example, in this case with the central banks from the member countries playing the role of the local clearing entities.

There is, at present, a global organization that represents all CCP organizations from around the world that could assist in defining interoperability standards. This organization is called CCP12[2] and includes representatives from both cash and derivatives markets from many markets around the world (more than the original 12 members that gave CCP12 its name). CDS Clearing and Depository Services Inc. (a subsidiary of CDS) is a member of this organization as is the Canadian Derivatives Clearing Corporation (CDCC).

While the global clearing house approach is the most comprehensive and would combine clearing efficiency with the regulatory demand for information on activity involving local participants, the timeframe of December 2012 for this comprehensive approach is not realistic. The most likely scenario is that clearing will take place at the point of trading (i.e., in the same geographic location). Although this approach can be viewed as operationally expedient, it may not satisfy the regulatory requirement for transparency in the activity that regulated entities are committing to in these foreign markets.

As an intermediary step towards the global clearing house approach and as a way of addressing regulatory requirements for a complete view of all Canadian activity, CDS recommends establishing a Canadian clearing hub for all OTC derivative transactions, irrespective of asset class and trading location. All OTC derivative transactions involving a Canadian participant would be reported to this clearing hub. It would be the responsibility of the clearing hub to forward the transaction to the "official" clearing destination either in its original form or as part of the global CCP arrangement and to any trade repository that must also be made aware of the existence of the transaction. There are a number of advantages to this approach:

1. Canadian regulators would have access to a complete view of all Canadian activity.

2. Canadian participants would have a single input source for all transactions. The complexity for participants of having to deal with multiple clearing organizations and multiple trade repositories would be eliminated. The Canadian clearing hub would take responsibility for resolving these complexities. CDS has argued in its submissions on the design of capital

[2] Global Association of Central Counterparties (CCP12). <http://www.ccp12.org>.

markets infrastructure that transaction “ownership” belongs to the parties to the transaction and not to the market platform operator. Consequently, the parties to the transaction should control the clearing process and not the market platform operator that facilitated the creation of the transaction. Part of the role of the central clearing hub would be to act upon the instructions from the parties to the transaction while still maintaining a complete view of all transaction activity.

3. The transition to a global clearing house approach would be facilitated.

Given its current role in the Canadian capital markets as the recipient of all OTC trading in all asset classes, its automated interfaces to other depositories and its experience in dealing in a CCP-to-CCP environment, CDS would be ideally positioned to perform this role as the Canadian clearing hub.

Is there a willingness and an ability of Canadian market participants to use, create or participate in the creation of a Canadian CCP solution?

There is a long history of Canadian market participants’ involvement in a Canadian CCP solution through equity and fixed income clearing at CDS and futures and options clearing at the Canadian Derivatives Clearing Corporation (CDCC) and ICE Futures Canada. Consequently, there is an ability of Canadian market participants to use, create and participate in the creation of a Canadian CCP solution for OTC derivative products. A principal reason for CDS’s AA rating by global rating agency, Thomas Murray[3], is the strength of its risk model and the expertise that the organization has in its risk department. It is clearly within CDS’s capabilities to set up a CCP for OTC derivatives and to play the role of the Canadian CCP within a global context should the global CCP approach gain traction.

How should non-financial intermediary users of derivatives be able to clear their derivative trades? Should this occur through direct access and membership in a CCP or should this be done through an indirect clearing model with financial intermediary CCP members acting as agents for the non-member CCP derivative participants?

The essential element to answering this question rests with the membership standards that are applied by the clearing organization. Membership standards are a key element in any clearing organization’s risk model. CDS’s membership standards for clearing services require a participant to be regulated by one of the principal Canadian regulatory agencies or, in the case of foreign participants, by an equivalent regulatory agency in the foreign jurisdiction. If CDS were to offer services in the OTC derivatives space, the same membership standards would apply.

Indirect clearing is commonly used within the Canadian clearing environment. Both non-financial intermediaries and financial institutions may clear indirectly through CCP members. Financial institutions may choose to clear indirectly because they do not meet the standards for membership in the CCP or because they do not wish to accept the risk and loss allocation mechanisms inherent in CCP risk models. The direct members of the CCP accept the risks of dealing with their customers, the indirect clearers, and are liable for their transactions processed through the CCP. The direct members of the CCP determine the terms of their clearing and custody agreements with their clients and the means by which they protect themselves against

[3] Thomas Murray. 2011. Public CSD Rating Report: CDS Clearing and Depository Services Inc. Available at: <http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-ThomasMurrayRatingJanuary2011/$File/Thomas+Murray+CSD+Public+Rating+2011.pdf?OpenElement>.

the default of their customers. Generally, the CCP has no legal or other relationship with the indirect clearers.

Trade Repository Questions

Do you agree with a mandatory reporting requirement for all OTC derivatives trades? If not, should there be a threshold below which reporting would not be required?

Data repositories are viewed as a key piece of the future infrastructure for OTC derivative products. The concept of swap data repositories is a feature of the legislation recently adopted in the U.S., and is also included in the proposed European Market Infrastructure Regulation (EMIR) now under discussion in the EU. The *Dodd-Frank Act* specifies that all OTC derivatives, standardized or not, centrally cleared or not, should be recorded in central data registries called "swap data repositories", to provide transparency to regulators and the public on these markets. The information collected in such repositories would include the number of transactions and size of outstanding positions.

The mandatory reporting requirement to a data repository being imposed by U.S. and European regulators will clearly apply to Canadian participants that trade in OTC derivative products. Reporting will likely be at the point of trading for each asset class with regulators and participants having appropriate levels of access to relevant entries within the repository. It can be assumed that the primary data repository for a number of asset classes will be outside of Canada. The central clearing hub concept for OTC derivative transactions being proposed by CDS and previously described would address any concerns that Canadian regulators may have on a reliance on obtaining the required levels of access to data repositories in foreign jurisdictions. The central clearing hub would either, in and of itself, be the Canadian data repository or would populate a separate Canadian trade repository providing a consolidated view of all trades involving a Canadian participant irrespective of asset class and geographic trading location.

With mandatory reporting of derivatives trades, should dealers have to report noncleared trades to a global trade repository or to a Canadian trade repository?

As discussed previously, a clearing organization can clear trades in one of two ways (i.e., on a TFT basis or on a CCP basis). Reporting all trades to the central clearing hub for OTC derivative transactions has the advantage of standardizing the processing of all trades in OTC derivative products. It should also be possible to optimize the efficiency of capturing all trades in a trade repository if all trades are first reported to a central clearing hub (i.e., through an automated interface between the clearing organization and the trade repository organizations). It may even be possible for the central clearing hub to provide trade repository services where all trades in a particular asset class are being reported to a single clearing organization.

What impediments currently stand in the way of implementing real-time reporting of data to trade repositories?

The logical sequence of events should be: i) reporting to the clearing organization; ii) confirmation of the trade details as part of the clearing process; and iii) reporting of the trade by the clearing organization to the trade repository organization. Until such time as the overall structure of the OTC derivatives markets is determined, the relationships and the interfaces will not be able to be designed, developed and put in place.

As described earlier in this document, CDS believes that the first priority for the Canadian OTC derivatives initiative should be the development of an industry consensus on the likely future market structure for the products that are included within the scope of the initiative. Having this template in place will allow the design and development work to proceed with a definitive end goal in mind.

What information, if any, should be made publicly available? Should this information be available on a real-time, same day or historical basis?

Data confidentiality will be a major determinant in what information can be made publicly available. It is also likely that only aggregated information can be made available without reference to particular market participants. On the assumption that the technology is supportive and the costs involved are justified, real-time availability is the preferred means of information dissemination.

Should a trade repository be able to publish its non-confidential data for fees?

Whether the trade repository is run as a component of an industry utility on a cost-recovery basis, such as is the case with CDS, or as part of a for-profit organization, it should be possible for the trade repository to be able to publish its non-confidential data for fees in order to defray the costs of operating the trade repository on behalf of the industry. If the trade repository is part of a for-profit organization, it may be necessary for the regulators to oversee pricing to ensure that monopoly pricing does not occur.