AUTORITÉ DES MARCHÉS FINANCIERS

NOTICE AND REQUEST FOR COMMENT ON

PROPOSED *REGULATION 24-503 RESPECTING CLEARING HOUSE, CENTRAL SECURITIES DEPOSITORY AND SETTLEMENT SYSTEM REQUIREMENTS*

PROPOSED *POLICY STATEMENT TO REGULATION 24-503 RESPECTING CLEARING HOUSE, CENTRAL SECURITIES DEPOSITORY AND SETTLEMENT SYSTEM REQUIREMENTS*

I. INTRODUCTION

The Autorité des marchés financiers (Authority or we) is publishing for a ninety (90) day-comment period proposed *Regulation 24-503 respecting Clearing House, Central Securities Depository and Settlement System Requirements* (Regulation) and related *Policy Statement to Regulation 24-503 respecting Clearing House, Central Securities Depository and Settlement System Requirements* (PS). The comment period will end on **March 19, 2014**.

II. BACKGROUND AND PURPOSE OF REGULATION

Section 169 of the *Securities Act* prohibits clearing houses, central securities depositories and settlement systems from carrying on activities in Québec unless they are recognized as a clearing house, a central securities depository or a settlement system or are exempt from the recognition requirement. Similarly, section 12 of the *Derivatives Act* prohibits clearing houses and settlement systems from carrying on activities in Québec unless they are recognized as a clearing house or a settlement system.

The term “clearing house” is defined in section 3 of the *Derivatives Act* only, and said definition must be read jointly with the notion of “derivatives clearing” under section 46 of this Act.

Most entities that are securities clearing houses act as, or perform the services of, one or more of the following:

- a central counterparty (CCP),
- a central securities depository (CSD), and
- a settlement system (SS).

A derivatives clearing house is typically a CCP that also acts as, or performs the services of, a settlement system. As previously mentioned, a CSD and a SS, must be recognized to carry on its activities in Québec. Where a CSD or a SS carries on activities separately from the clearing activity, it must be recognized distinctly from the clearing house.

The Regulation has several purposes. It sets out certain requirements in connection with the application process for recognition as a clearing house, central securities depository or settlement system by the Authority, or for exemption from the recognition requirement. Guidance on the regulatory approach to applications for recognition as a clearing house, central securities depository or settlement system or exemption from the recognition requirement is set out in the PS. The Regulation also sets out on-going requirements for recognized clearing houses that act as, or perform the services of, a CCP, CSD or SS and for recognized central securities depositories or recognized settlement systems. These requirements are based largely on international standards applicable to financial market infrastructures (FMIs) developed jointly by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Board of the

International Organization of Securities Commissions (IOSCO). In particular, the proposed Regulation and PS incorporate newly strengthened international standards governing FMIs set out in the CPSS-IOSCO report *Principles for financial market infrastructures*, published in April 2012 (PFMI Report).[1] The PFMI Report has been built upon the established international principles applicable to securities settlement systems and CCPs.[2]

The standards included in the PFMI Report are called "principles" (or the "PFMIs"). They are intended to enhance the safety and efficiency in clearing, depository, settlement and recording arrangements, and more broadly, to limit systemic risk and foster transparency and financial stability. The PFMI Report is viewed as containing *minimum* international standards that must be applied consistently on a global level to all systemically important FMIs, including CCPs, CSDs and securities settlement systems[3] Moreover, the new CPSS-IOSCO standards are intended to support the initiatives of the Group of Twenty Finance Ministers and Central Bank Governors (G20) and the Financial Stability Board (FSB) to strengthen core financial infrastructures and markets, including derivatives markets and critical market infrastructures. The global and uniform implementation of the new standards is considered to be crucial to meeting the G20 commitments for derivative markets regulatory reforms, including requirements for centralized clearing and data reporting.[4] Accordingly, the Authority considers the Regulation and PS to be an important component of the efforts by the Canadian Securities Administrators (CSA) to develop a comprehensive regulatory framework for the trading of derivatives in Canada intended to implement the G20 commitments.

CPSS and IOSCO have stated that they expect full, timely and consistent implementation of the standards by the authorities in all member-jurisdictions. In this regard, they have established an international task force to monitor implementation of the standards by relevant authorities.[5]

We are publishing for a 90-day public comment period the proposed Regulation and PS. We are seeking comment on all aspects of the Regulation and PS, including on the specific issues raised in Part IV of this Notice. Readers are encouraged to read the Regulation and PS alongside the PFMI Report. We note that the Regulation and PS have been drafted to be consistent with the terminology and text used in the PFMI Report. The terminology and text used in the French version of the PFMI Report contain translation choices and differences as regards Québec securities and derivatives legislation and the derivatives consultation material published in French by the Authority. To obtain, as a first step, substantive comments about the application of the principles as set out in the PFMI Report, the translation choices and the adaptation of terminology and text to the Québec context and legislation will be reviewed as part of the publication of the final French version of the Regulation and PS.

The comment period for this Notice will end on **March 19, 2014**. Please refer to Part IX of this Notice for information on the means for providing comment.

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[1] The PFMI Report is available on the Bank for International Settlements' website (www.bis.org) and the IOSCO website (www.iosco.org).

[2] See the 2001 CPSS-IOSCO report *Recommendations for securities settlement systems* (together with the 2002 CPSS-IOSCO report *Assessment methodology for Recommendations for securities settlement systems*), and 2004 CPSS-IOSCO report *Recommendations for central counterparties*. All of these reports are available on the Bank for International Settlements' website (www.bis.org) and IOSCO website (www.iosco.org).

[3] Other FMIs are payment systems and trade repositories. Payment systems (which are not regulated by the Authority) and trade repositories are not covered by the Regulation.

4 The G-20 commitments include requirements that all standardized over-the-counter derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. Moreover, over-the-counter derivative contracts should be reported to trade repositories. Also, non-centrally cleared contracts should be subject to higher capital requirements.

[5] Reports on PFMI implementation monitoring are available on the Bank for International Settlements' website (http://www.bis.org/cpss/index.htm) and the IOSCO website (http://www.iosco.org/library/index.cfm?section=pubdocs).

III. OVERVIEW OF REGULATION AND PS

Part 1 of the Regulation sets out definitions, other interpretive provisions, and a scope provision.

Part 2 of the Regulation sets out certain requirements in connection with the application process for recognition as a clearing house, central securities depository or settlement system or exemption from the recognition requirement. The regulatory approach to such an application is set out in Part 2 of the PS.

Part 3 of the Regulation, which adopts the principles of the PFMI Report, sets out the ongoing requirements for clearing houses recognized in Québec that act as, or perform the services of, a CCP, CSD or SS and for recognized central securities depositories and recognized settlement systems. In general, the PFMI Report contains 23 headline *principles* applicable to clearing houses, central securities depositories or settlement systems each with its own set of *key considerations* and more detailed *explanatory notes*. The approach to drafting Part 3 of the Regulation was to generally incorporate all of the principles and key considerations within the Regulation, to the extent possible. Part 3 also includes a small number of additional provisions that govern matters closely related to the principles and key considerations.

The Regulation is supplemented by a PS. Part 3 of the PS incorporates, among other guidance, most of the explanatory notes contained in the PFMI Report. It also provides supplementary guidance (found in text boxes) that has been jointly developed by a working group (PFMI Coordinating Group) comprised of staff of the Ontario Securities Commission (OSC), the Authority, the British Columbia Securities Commission (BCSC) and the Bank of Canada (BoC). The purpose of the supplementary guidance is to provide additional discussion and clarity on certain aspects of these new standards in the Canadian context that are not dealt with in the PFMI Report. The PFMI Coordinating Group has been cooperating and coordinating the implementation in Canada of the new CPSS-IOSCO standards.

IV. SPECIFIC QUESTIONS

In this section, we identify and discuss certain key issues on which we are seeking specific comments. Responses to specific questions are solicited below.

(a) Systemically important clearing houses, central securities depositories and settlement systems to Québec

As discussed in subsections 2.0(4) to (7) of the PS, the Authority would generally require a clearing house, a central securities depository or a settlement system that is considered to be of "systemic importance" to the Québec capital markets to be recognized, rather than be exempted from recognition. Recognition by the Authority means that the clearing house, central securities depository or settlement system would become subject to Part 3 of the Regulation if the clearing house acts as, or performs any of the services of, a CCP, CSD or SS or if the central securities depository or the settlement system carries on its activities distinctly from a clearing house. We have considered international precedent for determining the systemic importance of an FMI. In our view, the following are guiding factors to assess the systemic importance of a clearing house, a central securities depository or a settlement system to Québec:

- value and volume of transactions processed, cleared, deposited and settled by the clearing house, central securities depository or settlement system for Québec residents;

- risk exposures of the clearing house, central securities depository or settlement system to its Québec-resident counterparties;

- complexity of the clearing house, central securities depository or settlement system; and

- centrality of the clearing house, central securities depository or settlement system to the Québec capital markets.

We briefly expand on these factors in subsections 2.0(4) and (5) of the PS, and emphasize that the factors are non-exhaustive and that no single factor will be determinative in an assessment of systemic importance in Québec. We may consider additional quantitative and qualitative factors as may be relevant and appropriate, such as the nature of a clearing house's, central securities depository's or settlement system's operations, its corporate structure, or its business model.

Question 1: ***Are there other factors that could be considered by the Authority in determining the systemic importance of a clearing house, central securities depository or settlement system to Québec capital markets? If so, please describe such factors and your reasons for including them.***

(b) Segregation and portability

Section 3.14 of the Regulation requires all CCPs to have rules and procedures to enable the segregation and portability of positions of a CCP participant's customers and related collateral upon the default or insolvency of the participant. It is a principles-based requirement that adopts Principle 14 of the PFMI Report on segregation and portability (Principle 14). We note that, as currently drafted, section 3.14 of the Regulation applies to all CCPs, serving the cash or derivatives markets, whether exchange-traded or over-the-counter-traded (OTC) products.

In February 2012, the CSA Derivatives Committee published CSA Consultation Paper 91-404 – *Derivatives: Segregation and Portability in OTC Derivatives Clearing* (Paper 91-404). In Paper 91-404, the CSA Derivatives Committee recommended, among other things, that OTC derivatives CCPs be required to maintain the Complete Legal Segregation Model, also known as the legal segregation with operational commingling or "LSOC" model.[6] Such a model protects against "fellow customer risk"[7] and has recordkeeping requirements that enhance the potential for portability in an insolvency or default situation. The CSA Derivatives Committee is developing a proposed CSA model provincial rule (CSA Model Rule) on customer clearing and protection of customer collateral and positions that would implement some of the recommendations made in Paper 91-404, in line with Principle 14 on segregation and portability. The provisions of such a provincial regulation applicable to over-the-counter derivatives would prevail over some provisions of Part 3 of the Regulation.

We believe further analysis is required to determine the appropriate application of Principle 14 to CCPs serving markets other than the OTC derivatives markets. The broader application of Principle 14 to all (particularly cash market) CCPs may have, in certain circumstances, unintended consequences for existing customer protection frameworks. In this regard, Principle 14 offers an "alternate approach" to implementation in jurisdictions that have an existing legal regime which achieves the protection of customer assets in cash markets to the same degree as the approach required by Principle 14. Features of such legal regimes are that, if a participant fails, (a) the customer positions can be identified in a

[6] This model is an omnibus account model that allows a CCP to hold all customers' collateral on an omnibus basis (i.e., commingled in an account). However, the customer positions and collateral must be recorded and attributed by both the CCP and participant to each customer based on their collateral advanced. Payments and collections of initial margin between the CCP and participant's customer accounts are made on a gross basis. The participant may post to the CCP the total required customer margin from an omnibus account, without regard to the customer to whom the collateral belongs. However, each participant would be required to report to the CCP on a daily basis, the rights and obligations attributable to each customer. Under this model, in the event of a participant default, each non-defaulting customer is protected from losses on the positions of other customers, but bears some risk of loss resulting from the investment of collateral in the customer pool (investment risk). The CCP would be permitted to access the collateral of defaulting customers, up to a value equal to the margin required to be posted by such customers, but not that of non-defaulting customers.

[7] Fellow customer risk means the risk to a CCP participant's customer that another customer of the same participant will default and create a loss that exceeds both the amount of available collateral supporting the defaulting customer's positions and the available resources of the participant.

timely manner, (b) customers will be protected by an investor protection scheme designed to move customer accounts from the failed or failing participant to another participant in a timely manner, and (c) customer assets can be restored. As an example, the PFMIs suggest that domestic law may subject participants to explicit and comprehensive financial responsibility and customer protection requirements that obligate participants to make frequent determinations (for example, daily) that they maintain possession and control of all customers' fully paid and excess margin securities and to segregate their proprietary activities from those of their customers. Under these types of regimes, pending securities purchases do not belong to the customer; thus there is no customer trade or position entered into the CCP. As a result, participants who provide collateral to the CCP do not identify whether the collateral is provided on behalf of their customers regardless of whether they are acting on a principal or agent basis, and the CCP is not able to identify positions or the assets of its participants' customers.

Particularly for certain cash market CCPs (e.g. the Canadian Depository for Securities Ltd.'s (CDS) continuous net settlement services (CNS)), once netting and novation have been completed, the CCP is not able to track customer positions directly. To do otherwise would require fundamental changes to the operations, and potentially the effectiveness of, these CCPs, as well as impact the market structure more broadly. In this regard, the requirements of Principle 14 may not be appropriate for certain cash markets.

As part of our efforts to implement the PFMI Report's standards, and in light of Principle 14's requirements and the prospect of an alternate approach for the cash markets, we are seeking specific input on the proper manner of applying Principle 14. At present, section 3.14 of the proposed Regulation is drafted to require all CCPs to adhere to the minimum standards of Principle 14. However, we are of the preliminary view that the alternate approach is appropriate for some of cash market CCPs. See section 3.14 of the PS, which discusses the Authority's view that it may grant an exemption from the requirements of section 3.14 of the Regulation to a CCP that applies for such an exemption, if the alternate approach is appropriate for the CCP.

Question 2: ***Do you agree with the current drafting approach of section 3.14 of the Regulation, ie, requiring all CCPs to meet Principle 14 in its entirety (without referencing the alternate approach), and granting exemptions on a case-by-case basis to those CCPs for which the alternate approach is appropriate?***

Question 3: ***Should all CCPs serving the Canadian cash markets be able to avail themselves of the alternate approach to implementation of Principle 14? How could such CCPs demonstrate that customer assets and positions are protected to the same degree envisioned by Principle 14?***

(c) Two hour timeframe for resumption of critical information technology operations

Subparagraph 3.17(12)(c)(i) of the Regulation requires a recognized clearing house, central securities depository or settlement system to develop and maintain a reasonable business continuity plan that is designed to ensure that critical information technology systems can resume operations within two hours following a disruptive event. This provision is consistent with the CPSS-IOSCO standard in Principle 17. We note that the two hour timeframe commences from the 'disruptive event'. While a resumption-timeframe of two hours after an event seems to be an emerging industry objective for FMIs, there appears to be some views that the two-hour resumption-timeframe should commence only after the declaration by the clearing house, the central securities depository or the settlement system of a 'disaster'. We recognize that, currently, a two hour timeframe for resuming operations from a disruptive event may pose operational difficulties for certain clearing houses, central securities depositories or settlement systems. However, we believe that a recognized clearing house that performs any of the services of a CCP, CSD or SS or a recognized central securities depository or settlement system should maintain a reasonable business

continuity plan that is designed to meet the two hour resumption period, in line with the emerging industry objective.

Question 4: ***What are a clearing house's, central securities depository's or settlement system's current abilities and future prospects to meet the objective of recovering and resuming critical systems and processes within two hours of a disruptive event? Should recovery- and resumption-time objectives differ according to critical importance of markets?***

(d) Tiered participation

Section 3.19 of the Regulation governs so-called tiered participation arrangements. A tiered participation arrangement occurs when firms (indirect participants) rely on the services provided by other firms – who are direct participants of a clearing house, a central securities depository or a settlement system – to use the clearing house's, central securities depository's or settlement system's services. The dependencies and risk exposures (including credit, liquidity, and operational risks) inherent in these tiered arrangements can present risks to the clearing house, the central securities depository or the settlement system and its smooth functioning as well as to its participants and the broader financial markets. These risks are more likely to be material where there are indirect participants whose business through the clearing house, the central securities depository or the settlement system is a significant proportion of the clearing house's, the central securities depository's or the settlement system's overall activities or is large relative to that of the direct participant through which they access the clearing house's, the central securities depository's or the settlement system's services.

Question 5: ***To what extent can a CCP, a central securities depository or settlement system identify and gather information about a tiered (indirect) participant?***

Question 6: ***In Canada, what types of risks (such as credit, liquidity, and operational risks) arise in tiered participation arrangements between customers and direct participants or between customers and other intermediaries that provide clearing, depository or settlement services to such customers?***

Question 7: ***How can a clearing house, a central securities depository or a settlement system properly manage the risks posed by tiered participation arrangements?***

(e) Effective dates and transition

Depending on the conclusion and timing of the rule-making process, we would propose to seek approval of the final Regulation in spring of 2014. As a result, we would expect that the Regulation will be in force by June 30, 2014. However, the principles in the PFMI Report represent a substantial strengthening of the previous CPSS-IOSCO standards on CSDs, securities settlement systems and CCPs. We recognize that clearing houses, central securities depositories and settlement systems will need time to implement the new standards, from both financial and operational perspectives. Therefore, we are proposing longer transition periods for implementing certain provisions of the Regulation. Transitional effective dates are proposed for the following provisions of the Regulation:

- *Sections 3.4 (Credit Risk), 3.5 (Collateral), 3.6 (Margin) and 3.7 (Liquidity risk)*: March 31, 2015, which is 9 months from June 30, 2014;

- *Paragraphs 3.3(3)(b) to (d) (Framework for comprehensive management of risks: requirements relating to recovery, orderly wind-down or resolution plans) and subsection 3.15(3) (General business risk: maintaining and implementing a viable recovery and orderly wind-down plan)*: January 1, 2016, which is 18 months from June 30, 2014.

- *Section 3.14 (Segregation and portability)*: same effective date as a provincial regulation based on CSA Model Rule (on the assumption that the CSA Model Rule will be implemented after the implementation of the Regulation);

- *Subparagraph 3.17(12)(c)(i) (Operational risks: resumption of critical IT systems within 2 hours from a disruptive event)*: June 30, 2015, which is 12 months from June 30, 2014; and

- *Section 3.19 (Tiered participation)*: June 30, 2015, which is 12 months from June 30, 2014.

Question 8: ***Are the above transition periods appropriate? If yes, please give your reasons. If not, what alternative transition periods would balance the CPSS-IOSCO's expectation of timely implementation of the PFMIs and the practical implementation needs of our markets?***

V. PUBLICATION OF SIMILAR REGULATIONS IN OTHER JURISDICTIONS AND COORDINATION BY PFMI COORDINATING GROUP

(a) Publication of similar regulations in other jurisdictions

It is the Authority's understanding that the OSC and The Manitoba Securities Commission intend to publish concurrently a regulation substantially similar to the Regulation and PS. We have also been advised by staff of the BCSC, Alberta Securities Commission, Saskatchewan Financial Services Commission, Financial and Consumer Services Commission (New-Brunswick) and Nova Scotia Securities Commission that they intend to develop and publish a multi-lateral instrument that is materially the same as the Regulation and PS.

(b) PFMI Coordinating Group

The PFMI Report notes that relevant authorities (including central banks and market regulators) are expected to incorporate the PFMIs in their legal and regulatory framework and oversight activities as soon as possible. Such authorities are also expected to cooperate in order to support each other in fulfilling their respective regulatory, supervisory, or oversight mandates with respect to FMIs. Consistent with these expectations, we have been cooperating and coordinating the implementation of the new CPSS-IOSCO standards in Canada with staff of the OSC, BCSC and BoC through the PFMI Coordinating Group.

The BoC has adopted the PFMIs as minimum requirements for clearing and settlement systems that it has designated as systemically important pursuant to the federal *Payment Clearing and Settlement Act*. In addition, the Authority, BCSC, BoC and OSC intend to coordinate a public consultation process regarding the joint supplementary guidance which is presented in the PS, including respecting the timing of the consultation and the resolution of public comments received.

We will continue to work with the other Canadian authorities through the PFMI Coordinating Group to consider any additional guidance that may be necessary as a result of implementing the PFMIs in Canada. We expect additional guidance will be necessary in areas that are still being considered internationally (e.g. recovery and resolution planning; quantitative disclosure) or areas that are prone to different interpretation (e.g. liquidity risk).

VI. ALTERNATIVES TO INSTRUMENT CONSIDERED

Many of the provisions in the Regulation are closely modeled on the CPSS-IOSCO standards set out in the PFMI Report. The Authority considered, as general alternatives, adopting the CPSS-IOSCO standards set out in the PFMI Report in a policy, or including them on a case-by-case basis as terms and conditions to a recognition decision of a clearing

house, a central securities depository or a settlement system. The Authority decided against these alternatives because it believes the PFMI standards should be contained in a regulation to provide for greater transparency of clearing house, central securities depository and settlement system requirements and to promote consistency across all recognized clearing houses that act as a CCP, CSD or SS, recognized central securities depositories and recognized settlement systems carrying on activities in Québec.

VII. UNPUBLISHED MATERIALS

In proposing the Regulation and PS, the Authority did not rely on any significant unpublished study, report, or other material.

VIII. ANTICIPATED COSTS AND BENEFITS

The purpose of the proposed Regulation is to enhance the regulatory framework for recognized clearing houses, central securities depositories and settlement systems. This regulatory framework will facilitate ongoing compliance with the requirements of Québec securities legislation. The Regulation also enhances harmonization with and observance of international minimum standards applicable to clearing houses, central securities depositories and settlement systems. The Authority believes that these requirements will support resilient and cost-effective operations, as well as promote transparency that would consequently support confidence among market participants in clearing houses', central securities depositories' and settlement systems' ability to serve as efficient and financially stable mechanisms for clearance, depository and settlement and to facilitate capital formation.

The Authority believes the proposed clearing house, central securities depository and settlement system regulatory framework should enhance confidence in the market and better serve market participants. With the adoption of the Regulation, clearing houses, central securities depositories and settlement systems may be better positioned to withstand market volatility and evolve with market developments and technological advancements. Establishing rules that are consistent with current practice and international standards provides a good starting point for promoting appropriate risk management practices.

IX. COMMENT PROCESS

Please provide your comments in writing by **March 19, 2014**. If you are not sending your comments by email, an electronic file containing the submissions should also be provided (Windows format, Word). **Please deliver your comments to the following address**:

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Please note that comments received will be made publicly available and posted at www.lautorite.qc.ca, and www.osc.gov.on.ca. In this context, you should be aware that some information which is personal to you, such as your e-mail and address, may appear in the websites. Therefore, you should not include any information of a personal nature directly in the comments to be published. It is important that you state on whose behalf you are making the submission.

Additionally, **where comments pertain specifically to the supplementary guidance** developed jointly by the Canadian authorities (as presented in text boxes within the PS), it is requested that these particular **comments *also* be sent to the PFMI Coordinating Group as follows**:

Bank of Canada:
Email: PFMI-consultation@bankofcanada.ca

British Columbia Securities Commission:
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Please refer your questions to any of:

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