

## Notice of Approval

National Instrument 24-102 *Clearing Agency Requirements*  
and  
Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements*

- and -

## Notice and Request for Comments

Proposed Amendments to Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements*

December 3, 2015

## Part I – Introduction

1. **Adoption of Instrument and Companion Policy**

The Canadian Securities Administrators (the **CSA** or **we**) are adopting National Instrument 24-102 *Clearing Agency Requirements* (**Instrument**) and Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements* (**Companion Policy**). The main objective of the Instrument is to impose new requirements on *recognized* clearing agencies that operate as a central counterparty (**CCP**), central securities depository (**CSD**) or securities settlement system (**SSS**). The requirements are based on international standards applicable to financial market infrastructures (**FMI**s) described in the April 2012 report *Principles for financial market infrastructures* (as the context requires, the “**PFMI**s” or “**PFMI Report**”) published by the Committee on Payments and Market Infrastructures (**CPMI**)<sup>1</sup> and the International Organization of Securities Commissions (**IOSCO**).<sup>2</sup> Implementation of the international standards is intended to enhance the safety and efficiency of clearing agencies, limit systemic risk, and foster financial stability.

The adopted Instrument and Companion Policy are being published in Annexes C and D, respectively, to this Notice,<sup>3</sup> and are also available on websites of CSA jurisdictions, including:

[www.lautorite.qc.ca](http://www.lautorite.qc.ca)  
[www.albertasecurities.com](http://www.albertasecurities.com)  
[www.bcsc.bc.ca](http://www.bcsc.bc.ca)  
[www.gov.ns.ca/nssc](http://www.gov.ns.ca/nssc)  
[www.fcnb.ca](http://www.fcnb.ca)  
[www.osc.gov.on.ca](http://www.osc.gov.on.ca)  
[www.fcaa.gov.sk.ca](http://www.fcaa.gov.sk.ca)  
[www.msc.gov.mb.ca](http://www.msc.gov.mb.ca)

In some jurisdictions, government ministerial approvals and, in some jurisdictions, proclamation of certain amendments to local securities legislation, are required for the implementation of the Instrument.<sup>4</sup> Subject

<sup>1</sup> Prior to September 2014, CPMI was known as the Committee on Payment and Settlement Systems (**CPSS**).

<sup>2</sup> The PFMI Report is available on the Bank for International Settlements' website ([www.bis.org](http://www.bis.org)) and the IOSCO website ([www.iosco.org](http://www.iosco.org)).

<sup>3</sup> In Ontario, the final adopted versions of the Instrument and Companion Policy are published in Chapter 5 of the Ontario Securities Commission's Bulletin (**OSCB**). More precisely, this Notice and all its Annexes are being published in (2015), 38 OSCB Supplement 5. Annex G to this Notice in relation to the Proposed CP Amendments (discussed above) is also being published as a stand-alone document in OSCB Chapter 6 *Request for Comments*, with an editor's note to refer to this Notice in the Supplement for the details of the request for comments.

to obtaining all necessary approvals, most of the provisions in the Instrument will come into force on February 17, 2016, subject to transitional provisions for certain aspects of the Instrument.

## **2. Proposed new guidance in Companion Policy**

With this Notice, we are also publishing for a 60 day comment period proposed amendments (**Proposed CP Amendments**) to the final version of the Companion Policy that is being adopted by the CSA and published concurrently with this Notice. The Proposed CP Amendments consist of new supplementary guidance jointly developed by the CSA and the Bank of Canada in interpreting and applying the international standards described in the PFMI Report. The text of the Proposed CP Amendments is contained in Annex G to this Notice. It is also available on websites of CSA jurisdictions, including those set forth above.

## **3. Structure of this Notice**

This Notice is organized into three general parts:

- Part I – Introduction
- Part II – Adoption of Instrument and Companion Policy
- Part III – Proposed CP Amendments.

It also includes the following Annexes:

- Annex A: List of commenters on proposed National Instrument 24-102 *Clearing Agency Requirements* and related Companion Policy 24-102CP (as published in the **2014 Documents**, as defined below)
- Annex B: Summary of comments on proposed National Instrument 24-102 *Clearing Agency Requirements* and related Companion Policy 24-102CP (as published in the 2014 Documents), and CSA general responses to comments
- Annex C: Final adopted National Instrument 24-102 *Clearing Agency Requirements*
- Annex D: Final adopted Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements*
- Annex E: Blackline version of final adopted National Instrument 24-102 *Clearing Agency Requirements* reflecting revisions made to proposed Instrument in the 2014 Documents
- Annex F: Blacklined version of final adopted Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements* reflecting revisions made to proposed Companion Policy in the 2014 Documents
- Annex G: Proposed amendments to final adopted Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements*

## **Part II – Adoption of Instrument and Companion Policy**

### **1. Background**

Earlier versions of the Instrument and Companion Policy were published for comment in December 2013 and again in November 2014.

#### 2013 Public Consultation

On December 18, 2013, the Autorité des marchés financiers (**AMF**), Manitoba Securities Commission (**MSC**) and Ontario Securities Commission (**OSC**) each published for comment a uniform proposed local rule 24-503 and related companion policy regarding clearing agency requirements.<sup>5</sup> The regulators collectively received nine

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<sup>4</sup> In Ontario, the OSC delivered the Instrument, Companion Policy and other relevant material to the Ontario Minister of Finance on December 2, 2015. The Minister may approve or reject the Instrument or return it for further consideration. If the Minister approves the Instrument or does not take any further action by February 2, 2016, the Instrument will come into force on February 17, 2016, subject to transitional provisions for certain aspects of the Instrument. See below “4. Summary of Amendments to 2014 Documents – (e) Parts 5, 6 and 7”.

<sup>5</sup> The proposed local rules that were published for comment are the following: AMF *Regulation 24-503 Respecting Clearing House, Central Securities Depository and Settlement System Requirements*; MSC Rule 24-503 *Clearing Agency Requirements*; and OSC Rule 24-503 *Clearing Agency Requirements* (see Notice and Request for Comment *Proposed OSC Rule 24-503 Clearing Agency Requirements and Related Companion Policy*, December 19, 2013 (2013), 36 OSCB 12209. The OSC’s local rule 24-503 and related materials are also available on the OSC’s website at: [http://www.osc.gov.on.ca/en/SecuritiesLaw\\_rule\\_20131218\\_24-503\\_rfc-clearing-agency-requirements.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20131218_24-503_rfc-clearing-agency-requirements.htm)). At the same time as these local rules were published for comment, other

comment letters.<sup>6</sup> Partially in response to comments received, the CSA agreed to take a unified approach to implementing the PFMI, and further developed the local rules as a national instrument.

### 2014 Public Consultation

The CSA published for comment on November 27, 2014 the Instrument and Companion Policy, together with a Notice and Request for Comments (the “**2014 Notice**”, and collectively with the Instrument and Companion Policy, the “**2014 Documents**”).<sup>7</sup> The 2014 Notice described a number of important policy matters on which we were seeking stakeholder input. We received five comment letters on the 2014 Documents.<sup>8</sup> A list of the commenters is attached in Annex A to this Notice. We have considered these comments and thank all the commenters. We have provided a summary of the comments, together with our responses, in Annex B to this Notice.

## **2. Substance and Purpose of Instrument and Companion Policy**

As noted in the PFMI Report,<sup>9</sup> clearing agencies that facilitate the clearing and settlement of financial transactions can strengthen the markets they serve and play a critical role in fostering financial stability. If not properly managed, they can pose significant risks to the financial system and be a potential source of contagion, particularly in periods of market stress. The PFMI Report strengthens previous international standards for clearing agencies. The main purpose of the Instrument and Companion Policy is to implement the international standards described in the PFMI as clearing agency rule requirements in Canada.

Overall, the Instrument and Companion Policy are intended to enhance the regulatory framework for recognized clearing agencies operating or seeking to operate in a jurisdiction of Canada. As discussed in the 2014 Notice, this regulatory framework will facilitate ongoing observance by a recognized clearing agency of international minimum standards applicable to FMIs. The CSA believe that the Instrument will support resilient and cost-effective clearing agency operations.

## **3. Summary of Instrument and Companion Policy**

The Instrument is divided into seven parts and includes the following attachments:

- Form 24-102F1 – *Clearing Agency Submission to Jurisdiction and Appointment of Agent for Service of Process*
- Form 24-101F2 – *Cessation of Operations Report for Clearing Agency*

The Companion Policy is divided into six parts and includes an Annex I – *Joint Supplementary Guidance Developed by the Bank of Canada and Canadian Securities Administrators*.

We highlight the key features of the Instrument and Companion Policy below.

### **(a) Part 1 – Definitions, Interpretation and Application**

Part 1 of the Instrument contains definitions and interpretive provisions, as well as application provisions that clarify the scope of certain parts of the Instrument. The Instrument uses specialized terminology related to the

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CSA jurisdictions had expressed an intention to publish similar local rules and companion policies at a later date. See Multilateral Staff Notice 24-309 at: [https://www.bcsc.bc.ca/Securities\\_Law/Policies/Policy2/24-309\\_Publication\\_of\\_Clearing\\_Agency\\_Requirements\\_in\\_Ontario\\_Quebec\\_and\\_Manitoba\\_CSA\\_Multilateral\\_Staff\\_Notice/](https://www.bcsc.bc.ca/Securities_Law/Policies/Policy2/24-309_Publication_of_Clearing_Agency_Requirements_in_Ontario_Quebec_and_Manitoba_CSA_Multilateral_Staff_Notice/)

<sup>6</sup> The regulators published a summary of the comments in CSA Notice 24-310 on July 17, 2014. See CSA Staff Notice 24-310 *Status Update on Proposed Local Rules 24-503 Clearing Agency Requirements and Related Companion Policies*, July 17, 2014, (2014), 37 OSCB 6677 (**CSA Notice 24-310**). The summary was republished, together with regulators’ responses to the comments, on November 27, 2014. See *infra* next footnote.

<sup>7</sup> See CSA Notice and Request for Comment *Proposed NI 24-102 Clearing Agency Requirements and Related Companion Policy 24-102CP*, November 27, 2014; (2014), 37 OSCB 10483. The 2014 Documents are also available on the OSC’s Website at: [http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20141127\\_24-102\\_proposed-clearing-agency.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20141127_24-102_proposed-clearing-agency.htm)

<sup>8</sup> The comment letters are available of the OSC’s Website at: <http://www.osc.gov.on.ca/en/47352.htm>

<sup>9</sup> See par. 1.1 of the PFMI Report under “Introduction”.

clearing and settlement area. Not all such terminology is defined in the Instrument, but instead may be defined or explained in the PFMI Report.<sup>10</sup>

### **(b) Part 2 – Clearing Agency Recognition and Exemption from Recognition**

Part 2 of the Instrument sets out certain requirements in connection with the application process for recognition as a clearing agency under securities legislation or for an application to be exempt from the recognition requirement. The Companion Policy describes the CSA's approach towards recognition and exemption applications.<sup>11</sup> An entity that is carrying on, or proposing to carry on, business in Canada as a clearing agency and that is systemically important to our capital markets, or that is not subject to comparable regulation by another regulatory body elsewhere, will generally be recognized by a Canadian securities regulatory authority. An application for recognition or exemption must include the applicant's most recently completed PFMI Disclosure Framework Document,<sup>12</sup> a document substantially in a form prescribed in the December 2012 CPMI-IOSCO report *Principles for financial market infrastructures: Disclosure framework and Assessment methodology*.<sup>13</sup>

Part 2 requires a recognized clearing agency to notify a securities regulatory authority in writing before implementing any *significant change*.<sup>14</sup> It also requires an exempt clearing agency to notify in writing the securities regulatory authority of any material change to the information in its PFMI Disclosure Framework Document.<sup>15</sup> However, these requirements apply only to the extent such matters are not otherwise governed by the terms and conditions of a decision of the securities regulatory authority that recognizes the clearing agency or that exempts it from a recognition requirement.<sup>16</sup> Certain recognition decisions, for example, may require prior regulatory approval before a recognized clearing agency can make a significant change or a fee change.

### **(c) Part 3 – PFMI Principles Applicable to Recognized Clearing Agencies**

Part 3 of the Instrument incorporates into securities regulatory law the principles set out in the PFMI Report, including applicable key considerations, (the **PFMI Principles**) that apply to CCPs, CSDs and SSSs. The term "PFMI Principles" is defined in the Instrument to include the principles and applicable key considerations set out in the PFMI Report. Specifically, section 3.1 of the Instrument requires a recognized clearing agency that operates as a CCP, CSD or SSS<sup>17</sup> to establish, implement and maintain rules, procedures, policies or operations designed to ensure that it meets or exceeds the PFMI Principles with respect to its clearing, settlement or depository activities. Section 3.1 excludes the application of specific PFMI Principles to certain types of recognized clearing agencies. Part 3 also excludes the application of key consideration 9 of PFMI Principle 20 for all recognized clearing agencies.

Requiring clearing agencies to implement rules, procedures, policies or operations to meet or exceed the PFMI Principles is consistent with a flexible and principles-based approach to regulation. This principles-based approach anticipates that a clearing agency's rules, procedures, policies and operations will need to evolve over time so that it can adequately respond to changes in technology, legal requirements, the needs of its participants and their customers, trading volumes, trading practices, linkages between financial markets, and the financial instruments traded in the markets that a clearing agency serves.<sup>18</sup>

Part 3 of the Companion Policy explains our views on how to interpret and apply the PFMI Principles. In interpreting and implementing the PFMI Principles, regard is to be given to the explanatory notes in the PFMI Report, as appropriate.<sup>19</sup> We have also developed, together with the Bank of Canada, supplementary guidance (**Joint Supplementary Guidance**) to provide additional clarity on certain PFMI Principles within the Canadian context. The Joint Supplementary Guidance is directed at recognized *domestic* clearing agencies that are also overseen as systemically important clearing and settlement systems by the Bank of Canada pursuant to its

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<sup>10</sup> Regard should be given to the PFMI Report in understanding such terminology, including Annex H: *Glossary*. See Section 3.1 of the Companion Policy, and discussion further below in this Notice.

<sup>11</sup> See section 2.0 of the Companion Policy.

<sup>12</sup> See par. 2.1(1)(a) of the Instrument.

<sup>13</sup> See definition "PFMI Disclosure Framework Document" in section 1.1 of the Instrument.

<sup>14</sup> See subsection 2.2(2) of the Instrument. The term "significant change" is defined in subsection 2.2(1) of the Instrument.

<sup>15</sup> See subsection 2.2(5) of the Instrument.

<sup>16</sup> See subsection 1.5 (3) and (4) of the Instrument and section 2.2 of the Companion Policy.

<sup>17</sup> See subsection 1.5(1) of the Instrument.

<sup>18</sup> See subsection 3.0(2) of the Companion Policy. See also discussion below under "4. Summary of Amendments to 2014 Documents".

<sup>19</sup> See section 3.1 of the Companion Policy.

authority under the *Payment Clearing and Settlement Act (Canada) (PCSA)*.<sup>20</sup> The Joint Supplementary Guidance is included in separate text boxes in Annex I to the Companion Policy under the relevant headings of the PFMI Principles.

#### **(d) Part 4 – Other Requirements of Recognized Clearing Agencies**

Part 4 of the Instrument sets out certain other requirements that complement, or are in addition to, the PFMI Principles. These requirements apply to a recognized clearing agency, whether or not it operates as a CCP, CSD or SSS.<sup>21</sup> They include requirements in relation to the composition of the board of directors, the designation and functions of a chief risk officer and chief compliance officer, and the formation of one or more committees on risk management, finance and audit.<sup>22</sup> Furthermore, Part 4 includes a principles-based “skin-in-the-game” requirement that applies to a recognized clearing agency that operates as a CCP.<sup>23</sup> Finally, Part 4 of the Instrument contains rules pertaining to IT systems, outsourcing arrangements, and participant access that are substantially similar to requirements found in National Instrument 21-101 *Marketplace Operations (NI 21-101)*.<sup>24</sup>

#### **(e) Part 5 – Books and Records and Legal Entity Identifier**

Part 5 of the Instrument sets out a general books and records requirement for both recognized and exempt clearing agencies.<sup>25</sup> It also requires a clearing agency to identify itself by means of a single *legal entity identifier*.<sup>26</sup>

#### **(f) Part 6 – Exemptions**

Like most CSA national instruments, Part 6 of the Instrument authorizes a regulator or securities regulatory authority, as the case may be, to grant an exemption from any provision of the Instrument. As Part 3 of the Instrument adopts a principles-based approach to incorporating the PFMI into the Instrument, we have sought to minimize any substantive duplication or material inefficiency due to cross-border regulation. However, we acknowledge that, where a recognized foreign-based clearing agency does face some conflict or inconsistency between certain requirements of Parts 2 and 4 of the Instrument and the requirements of the regulatory regime in its home jurisdiction, and such a conflict or inconsistency causes a hardship for the clearing agency, an exemption from a provision of the Instrument may be considered by a securities regulatory authority.<sup>27</sup>

#### **(g) Part 7– Effective Dates**

The Instrument will be in force by February 17, 2016, subject to ministerial approvals in certain jurisdictions, and, in some jurisdictions, proclamation of certain amendments to their local securities legislation. However, because the PFMI represent a strengthening of the previous CPMI-IOSCO standards on SSSs and CCPs, recognized clearing agencies, working together with their regulators (the CSA and Bank of Canada), need more time to implement certain PFMI Principles. Therefore, as we discuss below under “4. Summary of Amendments to 2014 Documents – (e) Parts 5, 6 and 7”, we are providing for a later coming-into-force date of December 31, 2016 for certain PFMI Principles.

### **4. Summary of Amendments to 2014 Documents**

We have revised the 2014 Documents in response to comments from stakeholders, as well as to clarify and simplify the rules in the Instrument and include certain guidance in the Companion Policy that we had expressed as our policy views in the 2014 Notice. Apart from adding new Joint Supplementary Guidance to the Companion Policy described in Part III of this Notice (which we are publishing for comment concurrently with this Notice), none of the revisions are material. Therefore, the Instrument and Companion Policy are being published with this Notice as a final approved rule and policy. Blacklined versions of the adopted Instrument and Companion Policy, reflecting the changes made to the 2014 Documents, are set forth in Annexes E and F, respectively, to this Notice. We summarize below the notable revisions made to the 2014 Documents.

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<sup>20</sup> The Joint Supplemental Guidance is included as Annex I to the Companion Policy.

<sup>21</sup> See subsection 1.5(2) of the Instrument. An example of a clearing agency that would not be considered to be operating as a CCP, CSD or SSS would be an entity that performs or offers to perform a centralized trade affirmation-confirmation (matching) and allocation service for a vast array of market participants.

<sup>22</sup> See sections 4.1, 4.3 and 4.4 of the Instrument.

<sup>23</sup> See section 4.5 of the Instrument.

<sup>24</sup> See sections 4.6 to 4.11 of the Instrument.

<sup>25</sup> See section 5.1 of the Instrument.

<sup>26</sup> See section 5.2 of the Instrument.

<sup>27</sup> See section 6.1 of the Companion Policy.

The Instrument has been amended to implement the PFMI Principles directly rather than referencing them in Appendix A of the Instrument in the 2014 Documents. This will allow the CSA to adopt future amendments to the PFMI Principles without having to go through the process of amending the Instrument. Because of this change, there are a number of consequential non-material changes throughout the Instrument and Companion Policy. None of these amendments has any impact on the substance of the Instrument or Companion Policy.

**(a) Part 1 – Definitions, Interpretation and Application**

We deleted definitions that were defined by reference to National Instrument 52-110 *Audit Committee* (NI 52-110), which were no longer needed considering the removal of subsections 4.1 (5) to (9). See our comments on Part 4 below. We have clarified the scope provisions in section 1.5 of the Instrument with respect to sections 2.2 and 2.5 of the Instrument and its potential interaction with certain terms and conditions that may be contained in clearing agency recognition or exemption decisions. See discussion below.

**(b) Part 2 – Clearing Agency Recognition and Exemption from Recognition**

The main revisions to Part 2 of the Instrument are in relation to the regulatory treatment of *significant changes* made by a clearing agency.<sup>28</sup> Pursuant to section 2.2 of the Instrument, a recognized clearing agency is not permitted to implement a significant change unless it has filed a written notice of the significant change with the securities regulatory authority at least forty-five days before implementing the change. This is a lesser regulatory requirement than the proposed requirement of the Instrument in the 2014 Documents, which would have prohibited a recognized clearing agency from implementing a material change without obtaining the prior written approval of the securities regulatory authority. However, as noted above under “3. Summary of Instrument and Companion Policy”, by virtue of the scope provisions in section 1.5 of the Instrument, the requirements of sections 2.2 and 2.5 apply only to the extent such matters are not otherwise governed by the terms and conditions of a recognition or exemption decision of the securities regulatory authority. The Companion Policy was modified to reflect this change in the Instrument, and describes our general regulatory approach to these matters more clearly.

In addition, we modified Part 2 of the Companion Policy to clarify our approach to recognition of foreign-based clearing agencies that propose to carry on business in a jurisdiction of Canada. New subsection 2.0(3) confirms that a securities regulatory authority may require a foreign-based clearing agency to be recognized if the clearing agency’s proposed business activities in the local jurisdiction are systemically important to the jurisdiction’s capital markets, even if it is already subject to comparable regulation in its home jurisdiction.<sup>29</sup> We are including this additional guidance to the final version of the Companion Policy because it is not a material change and largely reflects current regulatory practice that has previously been made public.<sup>30</sup>

**(c) Part 3 – PFMI Principles Applicable to Recognized Clearing Agencies**

As noted previously, the Instrument has been amended to implement the PFMI Principles directly rather than referencing them in Appendix A of the Instrument in the 2014 Documents. As a result, because Appendix A is no longer needed, it has been removed from the Instrument.

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<sup>28</sup> The definition “significant change” in subsection 2.2(1) of the Instrument remains unchanged from the 2014 Documents, except that the defined term “material change” in the 2014 Documents has been replaced by “significant change”.

<sup>29</sup> The Companion Policy further notes that, in such circumstances, the recognition decision would focus on key areas that pose material risks to the jurisdiction’s market and rely, where appropriate, on the current regulatory requirements and processes to which the entity is already subject in its home jurisdiction. Terms and conditions of a recognition decision that require a foreign clearing agency to report information to a Canadian securities regulatory authority may vary among foreign clearing agencies. Among other factors, they will depend on whether Canadian securities regulatory authorities have entered into an agreement or memorandum of understanding with the home regulator for sharing information and cooperation. See subsection 2.0(3) of the Companion Policy.

<sup>30</sup> See, for example, LCH.Clearnet Limited – Application for Recognition – Notice of OSC Order, September 19, 2013; (2013) 36 OSCB 9267, also available at: [http://www.osc.gov.on.ca/documents/en/Marketplaces/ca\\_20130919\\_nco-lch-clearnet-app-recognition.pdf](http://www.osc.gov.on.ca/documents/en/Marketplaces/ca_20130919_nco-lch-clearnet-app-recognition.pdf); and Chicago Mercantile Exchange Inc. – Notice of OSC Order – Application for Exemptive Relief, July 4, 2013, also available at: [http://www.osc.gov.on.ca/documents/en/Marketplaces/ca\\_20130704\\_cme\\_nco-app-exemptive-relief.pdf](http://www.osc.gov.on.ca/documents/en/Marketplaces/ca_20130704_cme_nco-app-exemptive-relief.pdf)

In the 2014 Notice, we had discussed ongoing policy matters that we were assessing in relation to certain PFMI Principles.<sup>31</sup> Because we are continuing to assess aspects of PFMI Principle 14: *Segregation and portability*, PFMI Principle 19: *Tiered participation arrangements*, and PFMI Principle 3: *Framework for the comprehensive management of risks* together with PFMI Principle 15: *General business risk* as the latter two relate to a clearing agency's recovery or orderly wind-down plans (see further below in this Notice), the Instrument delays the required implementation of these PFMI Principles until December 31, 2016.

We note that, apart from moving the text of the Joint Supplementary Guidance in the Companion Policy into a new "Annex I" to the Companion Policy, we have not made any material changes to the Joint Supplementary Guidance published in the 2014 Documents.

We have made revisions to Part 3 of the Companion Policy to clarify our guidance or confirm our policy approaches described in the 2014 Notice. We discuss these revisions briefly below, as well as certain ongoing policy matters with respect to the implementation of PFMI Principle 14 in the Canadian domestic context that continue to be considered by regulators.

***(i) Principles-based approach to the PFMI Principles***

We added new subsection 3.0(2) to the final version of the Companion Policy to confirm our policy view expressed in the 2014 Notice that Part 3 of the Instrument, together with the PFMI Principles, is intended to be consistent with a flexible and principles-based approach to regulation. The text of this new subsection is substantially the same as the policy statement contained in the 2014 Notice.

***(ii) Letters of credit as acceptable collateral***

Guidance on applying PFMI Principle 5: *Collateral* to a clearing agency's particular circumstances can be found in the explanatory notes for that principle, as supplemented by the Joint Supplementary Guidance on PFMI Principle 5 in Annex I to the Companion Policy. This guidance would suggest that, in general, guarantees are not acceptable collateral. In response to concerns expressed by commenters, the CSA has clarified its view that, for the purposes of PFMI Principle 5, letters of credit may be permitted as collateral by a recognized clearing agency operating as a domestic CCP serving the derivatives markets. See our response to comment 10 in Annex B to this Notice. We express this policy guidance in new section 3.2 of the final version of the Companion Policy. However, this guidance does not apply to a recognized clearing agency that is also overseen by the Bank of Canada under the PCSA. In such cases, section 3.2 is not applicable.

***(iii) Segregation and portability***

***(A) Alternate approach for CCPs serving cash markets***

In the 2014 Notice, we had discussed our policy view that the current regulatory and customer protection regime applicable to investment dealers meets the criteria for the "alternate approach" to PFMI Principle 14 for CCPs serving certain domestic cash markets.<sup>32</sup> The comments we received on this discussion supported our view. Accordingly, we have added new section 3.3 in the final version of the Companion Policy to govern reliance on the alternate approach for domestic CCPs serving cash markets. The text of this new subsection is substantially similar to our policy view expressed in the 2014 Notice.

***(B) PFMI Principle 14 for domestic CCPs serving futures and other exchange-traded derivatives markets – ongoing policy considerations***

In the 2014 Notice, we said that CSA regulators were reviewing the implications of requiring enhanced CCP-level customer segregation and portability rules and procedures for CCPs serving the exchange-traded derivatives markets, particularly on CCPs, investment dealers, the IIROC-CIPF regime, and the pro rata distribution scheme

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<sup>31</sup> See pages 10485 to 10489 of the 2014 Notice. The policy matters were in relation to a clearing agency's recovery or orderly wind-down plans (see key consideration 4 of PFMI Principle 3: *Framework for the comprehensive management of risks* and key consideration 3 of PFMI Principle 15: *General business risk*); a clearing agency's segregation and portability arrangements for customer positions and collateral (see PFMI Principle 14: *Segregation and portability*); the resumption of operations of a clearing agency's critical information technology systems within two hours following disruptive events (see key consideration 6 of PFMI Principle 17: *Operational risks*); and tiered participation arrangements in using a clearing agency's services (see PFMI Principle 19: *Tiered participation arrangements*).

<sup>32</sup> See pages 10486 and 10487 of the 2014 Notice.

of Part XII of the BIA.<sup>33</sup> This review is ongoing and involves discussions with various stakeholders. PFMI Principle 14 will not come into force until December 31, 2016. See discussion below under “(e) Parts 5, 6 and 7”.

### ***(C) PFMI Principle 14 for CCPs serving the OTC derivatives markets***

As we had mentioned in the 2014 Notice, the CSA Derivatives Committee is separately developing a regulatory framework that will implement PFMI Principle 14 for CCPs serving the global OTC derivatives markets. We expect that a proposed revised rule governing segregation and other customer protection measures in the OTC derivatives area will require such CCPs to have detailed segregation and portability rules and arrangements.

### ***(d) Part 4 – Other Requirements of Recognized Clearing Agencies***

In addition to clarifying certain provisions and harmonizing others with recent amendments made to NI 21-101, we amended Part 4 of the Instrument generally by removing some granular rules and placing them instead as guidance only in Part 4 of the Companion Policy.

#### ***(i) Division 1 – Governance***

Subsections 4.1(5) to (9) of the Instrument in the 2014 Documents had enumerated the types of relationships that an individual can have with a clearing agency that would constitute a “material relationship” for the purposes of determining whether the individual is independent of the clearing agency. We have removed these provisions from the Instrument. Instead, we have added guidance on the types of relationships that could constitute a material relationship with a clearing agency in new subsection 4.1(4) of the Companion Policy.<sup>34</sup> In general, this new subsection in the final version of the Companion Policy mirrors the provisions in former subsections 4.1(5) to (9) of the Instrument.<sup>35</sup> The concept of independence remains consistent with NI 52-110 and other foreign regulatory regimes, without narrowing the definition to specific types of relationships which are more suited for a clearing agency that is also reporting issuer under Canadian securities legislation.

Section 4.3 of the Instrument, which governs the designation and functions of a chief risk officer and a chief compliance officer (**CCO**) of a clearing agency, is unchanged from the 2014 Documents. However, we added a clarification in subsection 4.3(3) of the Companion Policy that the role of a CCO may, in certain circumstances, be performed by the Chief Legal Officer or General Counsel of the clearing agency, where the individual has sufficient time to properly carry out his or her duties and there are appropriate safeguards in place to avoid conflicts of interest.

Section 4.4 of the Instrument in the 2014 Documents, which had required a recognized clearing agency to establish and maintain one or more committees on risk management, finance, audit and executive compensation, has been amended in several ways. The reference to an executive compensation committee has been removed. Instead, section 4.4 of the Companion Policy has been revised to outline the CSA’s view that a recognized clearing agency should consider forming a compensation committee. Moreover, section 4.4 of the Instrument has been revised to remove paragraphs (a) to (e) that would have prescribed minimum requirements for the scope of the mandates of such committees. We have included, instead, guidance on the scope of such mandates in section 4.4 of the final version of Companion Policy, which generally mirrors former paragraphs 4.4(a) to (e) of the Instrument.

#### ***(ii) Division 2 – Default management***

The CCP skin-in-the-game (**SITG**) rule in section 4.5 of the Instrument has been slightly amended to remove the reference to where in the default waterfall the CCP’s own SITG capital should be used. However, we have retained our view in section 4.5 of the Companion Policy (in the form of guidance) that a CCP’s own capital contribution should be used in the default waterfall immediately after a defaulting participant’s contributions to margin and default fund resources have been exhausted, and prior to non-defaulting participants’ contributions. As we had emphasized in the 2014 Notice, while not a requirement of the PFMIs, the SITG rule represents international best practice, particularly for CCPs that are operated on a for-profit basis. It promotes risk culture and is a positive signal to the clearing agency’s participants that the owners of a CCP have an equal stake in

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<sup>33</sup> We discuss the “IIROC-CIPF regime” and “Part XII of the BIA” in detail in the 2014 Notice.

<sup>34</sup> As a result of these revisions, former subsections 4.1(2) and (3) of the Companion Policy in the 2014 Documents were no longer needed.

<sup>35</sup> We did, however, reduce the period during which a former employee or executive officer of the clearing agency or any of its affiliates would still be considered having a material relationship with the clearing agency from three years to one year after leaving his or her position.



ensuring the robustness of the CCP's risk management. However, as there is no international consensus yet on an optimal CCP SITG approach,<sup>36</sup> we believe that it may be premature at this time to require a specific calculation for the amount of SITG. We will monitor international developments in this area, and will determine whether additional rule-making or guidance on SITG should be provided in 2016.

### **(iii) Division 3 – Operational risk**

The systems requirements of sections 4.6 to 4.9 of the Instrument have largely been modified to harmonize with recent amendments made to similar provisions in NI 21-101.<sup>37</sup> In the 2014 Notice, we had expressed our view that certain of the amendments in NI 21-101 may be equally applicable to recognized clearing agencies due to their criticality to our capital markets.<sup>38</sup>

### **(iv) Division 4 – Participation requirements**

We clarified the access and due process provisions of section 4.11 of the Instrument. In particular, subsection (2) specifies that a participant's, or potential participant's, right to be heard and make representations applies to a clearing agency's decision that terminates, suspends or restricts a participant's membership in the clearing agency or that declines entry to membership to an applicant that applies to become a participant.

### **(e) Parts 5, 6 and 7**

No key changes were made to Parts 5 and 6 of the Instrument. We have included a Part 6 to the final version of the Companion Policy to clarify the circumstances when a securities regulatory authority may consider granting an exemption from a provision of the Instrument. This guidance generally reflects the views we expressed in the 2014 Notice.

We have inserted the effective coming-into-force dates in Part 7 of the Instrument and have changed its structure to meet the legislative drafting standards applicable in some jurisdictions. As mentioned above, most of the provisions in the Instrument will come into force on February 17, 2016. However, the following provisions of the Instrument will come into force on December 31, 2016 only:

- The requirement in section 3.1 to implement rules, procedures, policies or operations designed to ensure that a recognized clearing agency meets or exceeds PFMI Principle 14: *Segregation and portability*
- The requirement in section 3.1 to implement rules, procedures, policies or operations designed to ensure that a recognized clearing agency meets or exceeds key consideration 4 of PFMI Principle 3: *Framework for the comprehensive management of risks* and key consideration 3 of PFMI Principle 15: *General business risk* with respect to a clearing agency's recovery or orderly wind-down plans
- The requirement in section 3.1 to implement rules, procedures, policies or operations designed to ensure that a recognized clearing agency meets or exceeds PFMI Principle 19: *Tiered participation arrangements*

We have already discussed above under “(c) Part 3 – PFMI Principles Applicable to Recognized Clearing Agencies – (iii) Segregation and portability” the ongoing policy work with respect to the implementation of PFMI Principle 14. Regarding the other PFMI Principles above that come in force on December 31, 2016, we are proposing new Joint Supplementary Guidance in respect of recovery and orderly wind-down planning, and are assessing policy considerations in respect of tiered participation arrangements. This new guidance is the subject of the Proposed CP Amendments discussed further below in Part III of this Notice.

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<sup>36</sup> See, for example, “A Financial System Perspective on Central Clearing of Derivatives”, remarks by Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, at “The New International Financial System: Analyzing the Cumulative Impact of Regulatory Reform”, 17th Annual International Banking Conference, sponsored by the Federal Reserve Bank of Chicago and the Bank of England, Chicago, Illinois, November 6, 2014; available at: <http://www.federalreserve.gov/newsevents/speech/powell20141106a.pdf>

<sup>37</sup> See CSA Notice of Approval – Final Amendments to National Instrument 21-101 Marketplace Operations; and National Instrument 23-101 Trading Rules; June 25, 2015, (2015) 38 OSCB (Supp-2); also available at: [http://www.osc.gov.on.ca/documents/en/Securities-Category2/ni\\_20150625\\_21-101\\_23-101\\_notice-approval-amd.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category2/ni_20150625_21-101_23-101_notice-approval-amd.pdf). In particular, see the amendments to Part 12 – *Marketplace Systems and Business Continuity Planning* of NI 21-101, as well as Annex A to the Notice of Approval – *Description of Notable Changes to the Proposed Amendments*.

<sup>38</sup> See p. 10489 of the 2014 Notice.

## 5. Authority for Instrument

In those jurisdictions in which the Instrument is adopted, the securities legislation provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the Instrument.<sup>39</sup>

## 6. Alternatives to Instrument Considered

As noted in the 2014 Notice, the CSA considered, as general alternatives, adopting the PFMI Principles in a policy, or including them on a case-by-case basis as terms and conditions to a recognition order of a clearing agency. We have decided against these alternatives because we believe the PFMI Principles should be contained in a rule to provide for greater transparency of clearing agency requirements and to promote consistency across all recognized clearing agencies that operate as a CCP, CSD or SSS in carrying on business in a jurisdiction of Canada.

## 7. Unpublished Materials

In proposing and adopting the Instrument and Companion Policy, the CSA did not rely on any significant unpublished study, report, or other material.

## 8. Anticipated Costs and Benefits

As mentioned in CSA Notice 24-310 and the 2014 Notice, the Instrument will enhance the regulatory framework for recognized clearing agencies operating or seeking to operate in a jurisdiction of Canada. This regulatory framework will facilitate ongoing observance by recognized clearing agencies of international minimum standards applicable to FMIs. We believe that the Instrument will support resilient and cost-effective clearing agency operations. It will promote transparency and support confidence among market participants in the ability of clearing agencies to provide efficient and safe clearance and settlement services, which in turn will facilitate capital formation, limit systemic risk, and foster financial stability. Also, the Instrument will further facilitate the efforts of Canadian CCPs to meet the “qualifying CCP” (**QCCP**) status under the Basel III and Canadian banking guidelines. Canadian and foreign banks that have certain counterparty exposures to Canadian CCPs would be subject to higher capital requirements if these CCPs do not meet the QCCP status.<sup>40</sup>

We also believe the clearing agency regulatory framework should enhance confidence in the market and better serve market participants. With the adoption of the Instrument, clearing agencies 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.

Finally, the adoption of the PFMI Principles is intended to support the initiatives of the Group of Twenty Finance Ministers and Central Bank Governors (**G20**) and the Financial Stability Board to strengthen core financial infrastructures and markets. To promote consistent global enforcement, the PFMI Principles are considered minimum requirements, and it is expected that members of CPMI and IOSCO apply the PFMI Principles to the fullest extent possible.<sup>41</sup> The global and uniform implementation of the PFMI Principles is considered to be crucial to meeting the G20 commitments for derivative markets regulatory reforms, including requirements for centralized clearing and data reporting.

We acknowledge that implementing the PFMI Principles will entail costs for the industry. Recognized clearing agencies in Canada are continuing to transition to the new PFMI Principles. They have conducted detailed self-

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<sup>39</sup> In Ontario, the Instrument was made under the following provisions of the *Securities Act* (Ontario) (Act): (i) paragraph 11 of subsection 143(1) of the Act allows the OSC to make rules regulating the listing or trading of publicly traded securities or the trading of derivatives, including rules relating to clearing and settling trades; and (ii) paragraph 12 of subsection 143(1) of the Act allows the OSC to make rules regulating recognized clearing agencies, including prescribing requirements in respect of the review or approval by the OSC of any by-law, rule, procedure, interpretation or practice and prescribing restrictions on its ownership, control and direction.

<sup>40</sup> See CSA Multilateral Staff Notice 24-311 Qualifying Central Counterparties, July 28, 2014, at [http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20140728\\_24-311\\_sn-qualifying-central-counterparties.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140728_24-311_sn-qualifying-central-counterparties.htm).

<sup>41</sup> CPMI and IOSCO have stated that they expect full, timely and consistent implementation of the PFMI Principles by the authorities in all member-jurisdictions. In this regard, they have established an international task force to monitor implementation of the PFMI Principles by relevant authorities. Reports on PFMI implementation by CPMI and IOSCO members, including the OSC, AMF, BCSC and Bank of Canada, 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>).

assessments against the PFMI Principles and identified their gaps in observance. They have developed plans to address these gaps, and are currently meeting many of the PFMI Principles. As noted previously, more time is needed to meet all of the PFMI Principles, and therefore we are providing for longer implementation dates for meeting the remaining PFMI Principles.

## **9. Regulations or Other Instruments to be Amended or Revoked (Ontario only)**

OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from recognition of Clearing Agencies* has been withdrawn as a result of the implementation of the Instrument and Companion Policy.

## **10. Questions**

Please refer any of your questions to the CSA staff listed below in this Notice under “Part III – Proposed CP Amendments – 3. Comment Process”.

### **Part III – Proposed CP Amendments**

#### **1. Background to, and Purpose of, Proposed CP Amendments**

As noted in the 2014 Documents, the Companion Policy consists largely of the Joint Supplementary Guidance developed by the CSA and the Bank of Canada. The Joint Supplementary Guidance is intended to provide additional clarity on certain PFMI Principles within the Canadian context. It is directed at recognized *domestic* clearing agencies that are also overseen by the Bank of Canada under the PCSA. It is included in separate text boxes in Annex I to the Companion Policy under the relevant headings of the PFMI Principles.

The adopted Companion Policy contains Joint Supplementary Guidance related to governance standards (PFMI Principle 2), collateral (PFMI Principle 5), liquidity risk (PFMI Principle 7), general business risk (PFMI Principle 15), custody and investment risk (PFMI Principles 16), and disclosure of a clearing agency’s rules, key procedures and market data (PFMI Principle 23). Such guidance was also included in the Companion Policy published for comment in the 2014 Documents. We had noted in the 2014 Documents that, over time, the CSA and Bank of Canada would propose Joint Supplementary Guidance on certain other PFMI Principles as well.

With this Notice, we are publishing, together with the Bank of Canada, the Proposed CP Amendments, which consist solely of additional Joint Supplementary Guidance. The new Joint Supplementary Guidance is intended to provide additional clarity on certain aspects of PFMI Principles 3 and 15 with respect to a clearing agency’s recovery and orderly wind-down plans. The Proposed CP Amendments will be incorporated into Annex I of the Companion Policy in a text box under relevant heading of the PFMI Principles. See Annex G to this Notice. We are seeking comment on any aspect of the Proposed CP Amendments. Please see below under “3. Comment Process” for information on how to provide comments.

#### **2. Summary of Proposed CP Amendments**

Key consideration 4 of PFMI Principle 3: *Framework for the comprehensive management of risks* requires a clearing agency to identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern, and assess the effectiveness of a full range of options for recovery or orderly wind-down. It also notes that the clearing agency should prepare appropriate plans for its recovery or orderly wind-down based on the results of that assessment. Moreover, where applicable, the clearing agency is expected to provide relevant authorities with the information needed for purposes of resolution planning. Key consideration 3 of PFMI Principle 15: *General business risk* requires a clearing agency, among other things, to maintain a viable recovery or orderly wind-down plan and hold sufficient liquid net assets funded by equity to implement the plan.

The new Joint Supplementary Guidance clarifies expectations regarding key components of recovery plans; the selection and implementation of recovery tools; additional considerations for recovery planning; implementation; review of recovery plans; orderly wind-down; and practical aspects of designing a recovery plan, such as the organization and structure of content.

#### **3. Comment Process**

Please submit your comments in writing on or before February 1, 2016. If you are not sending your comments by email, please include a CD containing the submissions. Address your submission to the following CSA member commissions:

British Columbia Securities Commission  
Alberta Securities Commission

Financial and Consumer Affairs Authority of Saskatchewan  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Nova Scotia Securities Commission  
Financial and Consumer Services Commission (New Brunswick)  
Office of the Attorney General, Prince Edward Island  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Yukon  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Nunavut

Please deliver your comments only to the addresses that follow. Your comments will be forwarded to the remaining CSA member jurisdictions.

The Secretary  
Ontario Securities Commission  
20 Queen Street West, 22nd Floor  
Toronto, Ontario M5H 3S8  
Fax: 416-593-2318  
E-mail: [comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

M<sup>e</sup> Anne-Marie Beaudoin  
Corporate Secretary  
Autorité des marchés financiers  
800, rue du Square-Victoria, 22<sup>e</sup> étage  
C.P. 246, tour de la Bourse  
Montréal (Québec) H4Z 1G3  
Fax: 514-864-6381  
E-mail: [consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)

Please note that comments received will be made publicly available and posted on the Websites of certain CSA jurisdictions. We cannot keep submissions confidential because securities legislation requires that a summary of the written comments received during the comment period be published. 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. It is important that you state on whose behalf you are making the submission.

Additionally, because your comments will pertain specifically to the Joint Supplementary Guidance, we request that your comments also be sent to the Bank of Canada at the following email address:

[PFMI-consultation@bankofcanada.ca](mailto:PFMI-consultation@bankofcanada.ca)

Questions with respect to this Notice, the final approved Instrument and Companion Policy, and the Proposed CP Amendments may be referred to:

Antoinette Leung  
Manager, Market Regulation  
Ontario Securities Commission  
Tel: 416-593-8901  
Email: [aleung@osc.gov.on.ca](mailto:aleung@osc.gov.on.ca)

Maxime Paré  
Senior Legal Counsel, Market Regulation  
Ontario Securities Commission  
Tel: 416-593-3650  
Email: [mpare@osc.gov.on.ca](mailto:mpare@osc.gov.on.ca)

Oren Winer  
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Tel: 416-593-8250  
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Email: mbrady@bcsc.bc.ca

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Financial and Consumer Services Commission (New Brunswick)  
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Email: ella-jane.loomis@fcnb.ca

## **ANNEX A**

### **List of commenters on proposed National Instrument 24-102 *Clearing Agency Requirements* and related Companion Policy 24-102CP (as published in the 2014 Documents)**

#### **Commenters:**

Canadian Bankers Association (CBA)  
Canadian Investor Protection Fund (CIPF)  
Investment Industry Association of Canada (IIAC)  
LCH.Clearnet Group Limited (LCH.Clearnet)  
TMX Group Limited (TMX)

## ANNEX B

### Summary of comments on proposed National Instrument 24-102 *Clearing Agency Requirements* and related Companion Policy 24-102CP (the “CP”) (as published in the 2014 Documents), and CSA general responses to comments

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
Principles-based approach	<p>1. Commenters are generally pleased that the proposed rule is now a uniform rule across Canada. Certain commenters also prefer the CSA’s more principles-based approach to incorporating the PFMI into Part 3.</p>	<p>The CSA appreciates the comments, and agrees that taking a principles-based approach to adopting the PFMI in the Instrument aligns better with the approaches taken in other foreign jurisdictions.</p>
	<p>2. A commenter argues that the Instrument does not adequately take a principles-based approach throughout the entirety of the Instrument. Rather, the commenter suggests that sections 2.2 and 2.5 and Part 4 of the Instrument impose inflexible requirements that would make it difficult for a clearing agency to evolve in a timely manner and be appropriately responsive to industry changes and participant needs. Further, the commenter asserts that such requirements are inconsistent with standards imposed in other countries.</p>	<p>We do not believe that sections 2.2 and 2.5 and Part 4 impose inflexible requirements or are inconsistent with standards imposed in other countries. However, as further discussed in this chart, we have removed or adjusted certain provisions, while maintaining others, to ensure that Canadian markets are appropriately regulated. Moreover, we note that each securities regulatory authority maintains the ability to impose additional requirements through terms and conditions of recognition or exemption to deal with specific circumstances.</p>
<p>Level playing field: exemption of foreign-based clearing agencies from recognition, and compliance by <i>recognized</i> foreign-based clearing agencies with the Instrument.</p>	<p>3. A commenter asserts that the Instrument holds domestic clearing agencies to a higher standard than foreign-based clearing agencies that may be exempted from the requirements of the Instrument that go beyond the PFMI standards. The commenter argues that subjecting foreign-based clearing agencies to different standards than their domestic counterparts would lead to a form of regulatory arbitrage, where clearing participants could choose their clearing agency based on the regime that has the most flexibility and that can more easily respond to participant needs.</p> <p>(See also comments below related to compliance by a recognized foreign-based clearing agency, and certain comments made in relation to requirements of Part 4.)</p>	<p>The decision to exempt a foreign-based clearing agency that is carrying on business in a jurisdiction of Canada from the recognition requirement is primarily based on two factors: (i) the clearing agency is subject to comparable regulation in its home jurisdiction and (ii) the nature and scope of the clearing agency’s business activities in the local jurisdiction are not systemically important to the local jurisdiction’s capital markets. With respect to (i) above, both the Parts 3 and 4 requirements would be considered. We also note that many jurisdictions do impose requirements that go beyond the PFMI, which are similar to provisions in Part 4. While some changes to Parts 2 and 4 are proposed, we do not believe that domestic clearing agencies are, or would be, at a competitive disadvantage by adhering to requirements in the Instrument that</p>

<sup>1</sup> A reference to a provision (i.e. Part, section, subsection, paragraph, etc.) is a reference to a provision of the proposed Instrument, unless otherwise indicated. Defined terms used in this summary table, which are not otherwise defined herein, have the meanings given in the Notice.

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		<p>are similarly found in comparable international regulations.</p>
	<p>4. A commenter supports the revised approach to requiring recognized foreign-based clearing agencies to comply with the Instrument. It requests that the CSA's responses to comments on the Local Rules and Local CPs (as described in the 2014 Notice) on this issue be included in the CP to the Instrument, so future regulators and recognized foreign-based clearing agencies are aware of the CSA's intended flexible application of the Instrument to recognized foreign-based clearing agencies.</p>	<p>We have included additional explanatory guidance in the CP, which generally draws on the discussion in the 2014 Notice. In particular:</p> <ul style="list-style-type: none"> <li>• In Part 3 of the CP, we added text to confirm that Part 3 is consistent with a flexible and principles-based approach to regulation.</li> <li>• With respect to a recognized foreign clearing agency that is subject to requirements in its home jurisdiction, we do not believe that compliance with Part 3 will be a burden because of the principles-based approach to incorporating the PFMLs. As such, a recognized foreign clearing agency should not experience duplication and inefficiency of cross-border regulation. However, to the extent that a recognized foreign clearing agency faces a conflict or inconsistency between the requirements of sections 2.2 and 2.5 and Part 4 and the requirements of the regulatory regime in its home jurisdiction, and such conflict or inconsistency causes a hardship for the clearing agency, we may consider granting an exemption from a provision of the Instrument, subject to appropriate conditions or restrictions. We added a Part 6 to the CP to include our views expressed above.</li> </ul>
	<p>5. A commenter argues that exempting a foreign-based clearing agency (both recognized and exempt) from certain requirements of the Instrument dilutes the meaning of "recognized clearing agency" and could confuse investors. The commenter also asserts that this may distort investor assumptions that clearing agencies recognized in Canada are subject to the Instrument and that they may rely upon regulators monitoring compliance with this Instrument.</p>	<p>There are two distinct and sequential threshold regulatory decisions that are made when a foreign-based clearing agency decides to carry on business in a local jurisdiction.</p> <p>First, we must decide whether to recognize the clearing agency or exempt it from the recognition requirement. As the CP describes (and as discussed above in our response to comments no. 3), the decision by a securities regulator to recognize or exempt a foreign clearing agency is based on whether it is systemically important to the</p>



1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		<p>jurisdiction's capital markets and whether it is subject to comparable regulation by another regulatory body. Where the entity is systemically important to a local jurisdiction's capital markets – and even though it is subject to comparable regulation in its home jurisdiction – it may nonetheless be appropriate to recognize it. The intention is that such an entity would be directly regulated in respect of matters that are <i>directly</i> relevant and important to the local jurisdiction's capital markets.</p> <p>Second, if we determine that a foreign clearing agency should be recognized, we must determine the scope of our regulatory oversight. We tailor the recognition order to focus on key areas that pose material risks to the jurisdiction's markets and to rely, where we can, on the current regulatory requirements and processes to which the entity is already subject in its home jurisdiction. A <i>recognized</i> foreign-based clearing agency will only be exempted from requirements of the Instrument if it is subject to home regulation that achieves a similar outcome. If it is determined that the entity is subject to a comparable regulatory regime in its home jurisdiction (including requirements that would result in similar outcomes to the requirements of Parts 3 and 4), its recognition order may require that it comply with the requirements of the foreign regime on an ongoing basis. Terms and conditions of a recognition decision that require the foreign clearing agency to report information to a Canadian securities regulatory authority may vary among foreign clearing agencies that are recognized. Among other factors, they will depend on whether we have entered into an agreement or memorandum of understanding for sharing information and cooperation with the home regulator.</p> <p>We have made changes to section 2.0 of the CP to reflect some of the discussion above.</p>
	<p><b>6.</b> A commenter suggests simplifying and clarifying the process for exempting foreign-based clearing agencies, through a series of jurisdiction-level comparability determinations.</p>	<p>The CP sets out a general framework for determining whether we would recognize or exempt a clearing agency under securities legislation. See section 2.0 of the CP.</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		<p>While we agree that a simple and clear exemption process is preferable, regulators require some flexibility in considering whether to exempt a foreign-based clearing agency or not. It is likely that each application by a clearing agency will be unique and require an assessment of factors or circumstances on a case by case basis, including the regulatory regime that the clearing agency is subject to in its home jurisdiction.</p>
<p>Enforcement approach to Canadian clearing agencies</p>	<p>7. A commenter notes that, given that Canadian clearing agencies may be subject to regulation by one or more provincial regulators as well as the Bank of Canada (<b>BOC</b>), the regulatory approach to enforcing applicable standards should be made clear to participants, in respect of the following:</p> <ul style="list-style-type: none"> <li>• nominating a lead regulator for Canadian clearing agencies, with the BOC as lead for systemically important infrastructures;</li> <li>• specifying the process, objectives and outcomes of regulatory oversight, as conducted by the BOC vs. CSA; and</li> <li>• requiring public or private audits of clearing agency compliance with national or international standards.</li> </ul>	<p>The CSA regularly coordinates its activities to oversee clearing agencies, including with the BOC in respect of clearing and settlement systems that have been designated as systemically important by the BOC under the <i>Payment Clearing and Settlement Act</i> (<b>designated systems</b> or FMLs). The BOC and relevant CSA recognizing provincial securities regulators in British Columbia, Ontario and Québec have entered into a <i>Memorandum of Understanding Respecting the Oversight of Certain Clearing and Settlement Systems</i> dated March 19, 2014 (BOC-CSA MOU). The purpose of the BOC-CSA MOU is to improve the efficiency and effectiveness of the oversight of designated systems. The BOC-CSA MOU provides a mechanism for mutual cooperation, coordination and assistance in carrying out their respective oversight responsibilities in respect of the designated systems, and formalizes current cooperative arrangements among the parties.</p> <p>In addition, the CSA members work cooperatively together to coordinate their oversight efforts of clearing agencies and trade repositories (TRs). The CSA is currently finalizing a memorandum of understanding (CSA MOU) among participating CSA jurisdictions that regulate clearing agencies and TRs to formalize their current cooperation arrangements using a modified lead regulator model.</p> <p>Clearing agencies that are under the jurisdiction of certain CSA members are already subject to periodic assessments against the requirements of the terms and conditions contained in their recognition or exemption decisions. CSA regulators intend to continue this practice. We will periodically assess</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		<p>compliance with the Instrument and require recognized clearing agencies to perform self-assessments against the requirements of the Instrument. Although self-assessments are generally not independently audited, securities regulatory authorities have the power to conduct on-site inspections and request any information or documentation from the clearing agency. All oversight programs will be shared and coordinated pursuant to the BOC-CSA MOU and, once finalized, the CSA MOU.</p> <p>Notwithstanding the above, while CSA regulators will make every effort to minimize regulatory burden for regulated entities, certain regulators may have different responsibilities under their governing legislation and respective regulatory mandates, and may need to deal with specific circumstances in a different manner which may necessitate additional direct oversight.</p>
PFMI Disclosure Framework Document	<p><b>8.</b> A commenter submits that the requirements in relation to the PFMI Disclosure Framework Document, which is relevant in a number of contexts in the Instrument (see sections 1.1 (definitions), 2.1 and 2.2 and PFMI Principle 23), should be delayed until discussions are finalized and regulatory expectations with respect to the format, content and level of detail required are clear.</p>	<p>The CSA continues to monitor international developments related to the PFMI Disclosure Framework Document. We note that CPMI-IOSCO published in February 2015 their final report <i>Public quantitative disclosure standards for central counterparties</i> (CPMI-IOSCO Quantitative Disclosures report). We expect most CCPs will be able to meet the disclosure standards in the CPMI-IOSCO Quantitative Disclosures report. However, while the CSA expects recognized clearing agencies to meet PFMI Principle 23, including the disclosure standards in the CPMI-IOSCO Quantitative Disclosures report, we may be prepared to grant an exemption in limited circumstances to a clearing agency that identifies a specific issue for completing its required disclosures.</p>
Section 2.2 – Material changes	<p><b>9.</b> A commenter believes that following the specified approval process for all matters included in the definition of “material change” will slow aspects of a domestic clearing agency’s business, including its ability to adapt to market conditions and respond to market participants. This may also tie up both the clearing agency’s and regulators’ resources. Further, the process may introduce an</p>	<p>The CSA does not intend section 2.2 to impose a competitive disadvantage on domestic clearing agencies, and agrees that matters that require regulatory approval should be limited to those that are important to the Canadian capital markets. Section 2.2 is generally consistent with similar requirements in NI 21-101, local rules 91-507 <i>Trade Repositories and Derivatives Data Reporting</i> (TR Rule),</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
	<p>uneven playing field as between domestic clearing agencies and foreign-based clearing agencies subject to less stringent requirements that allow them to be more flexible and timely in engaging new business activities, introducing new products and amending rules (including fees). It is proposed that the CSA implement a self-certification process for material changes and pare down the definition of material change such that it only includes changes that are material enough to warrant immediate regulatory review.</p> <p>In addition, the commenter believes the provision is overbroad, and that only those issues that truly require review and approval in order to protect the Canadian marketplace from material risks should fall under the definition.</p>	<p>and the rules of certain foreign jurisdictions. We believe that the matters referred to in the definition “significant change” (formerly “material change”) are necessarily relevant to the Canadian regulator’s oversight duties. Nonetheless, we have revised section 2.2 to replace the regulatory approval requirement with a regulatory pre-notification requirement, which we consider is a lesser regulatory burden. However, by virtue of the scope provisions in section 1.5, the requirements of section 2.2 apply only to the extent such matters are not otherwise governed by the terms and conditions of a recognition or exemption decision of the securities regulatory authority. The Companion Policy was modified to reflect this change in the Instrument.</p>
<p>PFMI Principle 5: <i>Collateral</i></p>	<p><b>10.</b> A commenter reiterates its request that letters of credit be considered permitted collateral and a qualifying liquid resource, as this would be consistent with international practice and would provide a cost effective means of meeting collateral requirements for commercial entities. The commenter argues that letters of credit are a standardized financial instrument which constitutes a committed credit facility, are widely accepted and provide substantially lower credit risk than general guarantees. In any event, any credit risk of a letter of credit can be managed.</p>	<p>Upon further consideration, we acknowledge that there are differences between a general commercial guarantee and a letter of credit (LC). Among other things, the payment obligation of an issuer of a LC is “documentary” in nature. That is, the presenter of the LC does not have to prove any underlying facts to the issuer to receive payment, and the LC is generally not subject to the same sorts of defenses that a guarantee would normally be subject to. Because a LC creates a documentary obligation, it is considered a “swift and certain payment mechanism”. Moreover, we are satisfied that certain foreign regulators permit CCPs to use LCs as acceptable collateral in certain circumstances. However, the use of LCs by systemically important CCPs raises concerns about wrong way risk in the Canadian context. We therefore agree that, in certain circumstances, LCs may be considered permitted collateral by a CCP, provided the CCP is not a designated system.</p> <p>We have added some guidance in Part 3 of the CP relating to PFMI Principle 5: <i>Collateral</i> to reflect this view. Such guidance applies only to domestic CCPs that are not also designated systems. Consequently, the CSA and BOC have not altered the Joint Supplementary Guidance (Box 3) relating to PFMI Principle 5: <i>Collateral</i> in Annex I of the CP, which applies to domestic CCPs that are</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		designated systems.
PFMI Principle 14 – <i>Segregation and portability</i>	<p><b>11.</b> Two commenters agree with the CSA position that the IIROC-CIPF regime meets criteria for the alternate approach for CCPs serving certain domestic cash markets, and will continue to monitor CSA developments in respect of the application of PFMI Principle 14 to exchange-traded and OTC derivatives markets.</p> <p><b>12.</b> A commenter notes that a move to gross margining would have a significant impact, and should not be made without a thorough assessment, including of key differences with other jurisdictions. The commenter notes that in the current Canadian futures model (a) IIROC record keeping requirements ensure customer positions can be identified timely, (b) customers are protected by CIPF, and (c) customer positions can be restored in the event of a participant default – all of which constitute a regime that is not present in other jurisdictions that have required gross margining.</p> <p>The commenter also believes the consultation process should be broadened to include participants.</p>	<p>We have included in Part 3 of the CP guidance on PFMI Principle 14 that generally draws on the discussion in the 2014 Notice on the “alternate approach” for CCPs serving cash markets. For CCPs serving the futures and other exchange-traded derivatives markets, we are continuing our review of this policy matter, including having discussions with relevant stakeholders. Similarly, for CCPs serving the global OTC derivatives markets, the CSA Derivatives Committee is continuing its work in this area.</p> <p>As mentioned in the 2014 Notice, we are continuing to review the implications of requiring enhanced CCP-level customer segregation and portability arrangements (such as gross margining) for CCPs serving the futures and other exchange-traded derivatives markets. We agree that the consultation process should be broadened to include CCP participants and other relevant stakeholders. As we explore our options on PFMI Principle 14 and continue stakeholder consultations, we may propose further amendments to the CP later in 2016 to add guidance on PFMI Principle 14 for CCPs serving the futures and other exchange-traded derivatives markets.</p>
Section 4.1 – Board of directors – independence	<p><b>13.</b> A commenter submits that the definition of independence is too narrow and granular, and is inconsistent with the existing approach taken by national and international regulators regarding director independence, and the PFMIs.</p>	<p>The Instrument’s concept of independence with respect to board membership is generally consistent with the definition of independence found in other CSA rules or policies (e.g., NI 52-110) and in the regulatory regimes of other jurisdictions. As noted in subsection 4.1(3), an individual is independent of a clearing agency if he or she has no direct or indirect material relationship with the clearing agency. Subsection 4.1(4) provides that a “material relationship” is a relationship which could, in the view of the clearing agency’s board of directors, be reasonably expected to interfere with the exercise of a member’s independent judgment. However, we acknowledge that the provisions in subsections 4.1(5) to (9) in the 2014 Documents could have had the effect of narrowly confining the concept of “material relationship.” Accordingly, we have removed</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
		<p>subsections 4.1(5) to (9) from the Instrument. Instead, we have provided guidance in the CP on certain types of relationships which we would consider to reasonably be expected to interfere with the exercise of a board member's independent judgment. With some differences, the guidance is based on the redacted subsections 4.1(5) to (9) in the Instrument.</p>
Section 4.3 – Chief compliance officer	<p><b>14.</b> A commenter asserts that the designation of Chief Compliance Officer (CCO) with the broad mandate set out in section 4.3 would create standards that are excessively high and inconsistent with the principles-based approach to compliance taken in the PFMI.</p>	<p>Section 4.3 is generally consistent with similar requirements in the TR Rule and the rules of certain foreign jurisdictions. Section 4.3 also complements key consideration 5 of PFMI Principle 2, which requires a clearing agency to have an experienced management with a mix of skills and the integrity necessary to discharge its operations and risk management responsibilities.</p>
Section 4.4 – Board or advisory committees – compensation committee	<p><b>15.</b> A commenter submits that a compensation committee should not strictly be required, as the PFMI do not strictly require their use, nor do existing recognition orders. The commenter asserts that there is no clear public interest reason for such a committee, and that flexibility would allow clearing agencies that are part of bigger organizations to use expertise and resources from the larger enterprise to optimally address compensation issues.</p>	<p>We agree that a compensation committee should not strictly be required. We have modified section 4.4 to remove the requirement to establish and maintain an executive compensation committee. Moreover, consistent with changes that we have made elsewhere in the Instrument, we have removed the detailed provisions in paragraphs (a) to (f) of section 4.4 and placed them instead in the CP, with slight differences.</p> <p>Despite the above, we strongly recommended that a clearing agency consider forming a compensation committee. We note that para. 3.2.9 of the explanatory notes in the PFMI Report suggests that “[a] board would normally be expected to have, among others, a risk committee, an audit committee, and a compensation committee, or equivalents.” The CP expressly states that regard is to be given to the explanatory notes, as appropriate, in interpreting and implementing the PFMI Principles.</p>
Section 4.5 – Use of own capital	<p><b>16.</b> Two commenters agree with the inclusion of a “skin-in-the-game” (SITG) requirement as a method to help align the incentives of the CCP's management and shareholders with those of the participants. However, one commenter raised concerns about the SITG requirement. There is general acknowledgement that there is no international consensus on the amount of SITG capital that should be used, and the order in which it should</p>	<p>In consultation with the BOC, the CSA has decided to retain part of section 4.5. There is general agreement that SITG is not a recovery tool, but instead a risk management tool. The CSA are of the view that a CCP should be required to participate in the default waterfall with its own capital contribution, to be used after a defaulting participant's contributions to margin and default fund</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
	<p>be used as part of the “waterfall”.</p> <p>One commenter believes the SITG requirement should not be calibrated based on the size of the default fund, but rather in relation to a CCP’s capital base (as is required by ESMA under EMIR). The main drawbacks of calculating the requirement based on size of default fund are: (1) it would fundamentally change the risk profile of the CCP, creating increased risk exposure to a participant default at the very time that the CCP needs to be resilient; (2) it would create an incentive for a CCP to minimize the size of the default fund, for example, by increasing initial margin requirements which could have a negative impact on end-users; and (3) it could result in the CCP needing to raise additional capital at short notice potentially at a time of market stress.</p> <p>Another commenter recommends that the SITG requirement be specific and quantifiable, tied to a clearing agency’s risk exposure; for example, a fixed percentage of the clearing agency’s tail risk. The commenter expects that this requirement will continue to be the subject of discussion, locally and internationally.</p> <p>One commenter submits that at this stage, it would be inappropriate to include the provision in the Instrument, since (i) the requirement is not a PFMI-based requirement, (ii) there is still an unresolved global debate on its rationale, structure, size, and timing, among other matters, and (iii) it would be more appropriately handled by the Bank of Canada/CSA through their guidance on resolution and recovery.</p> <p>The commenter requests that the CSA engage in further discussions with impacted parties prior to incorporating this requirement. The commenter also feels that the CSA should consider the relationship between the capital placed at risk by a clearing agency, the manner in which its fees are risk-adjusted and adjusted for the cost of that capital, the risk design of the risk model to effectively protect that capital, and the design of the participant access criteria/rules that govern who can expose the capital to loss.</p>	<p>resources have been exhausted. However, as there is no international consensus yet on an optimal CCP SITG approach, we agree that it may be premature to require at this time, from a policy perspective, a specific approach to calculate the amount of SITG. A CCP’s SITG equity should be significant enough to attract senior management’s attention. It should also be separately retained and not form part of the CCP’s equity resources for other purposes, such as to cover general business risk.</p> <p>We will monitor international developments in this area and will determine whether additional guidance on SITG should be provided later in 2016.</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
Section 4.6 – Systems requirements	<b>17.</b> A commenter submits that the distinction between the requirement to notify the regulator or, in Québec, the securities regulatory authority, is confusing and should be clarified.	We do not propose any change. In Québec, all functions and powers, including “regulator functions”, are assigned to the Autorité des marchés financiers (AMF) by the Québec securities and derivatives legislation, and therefore all notifications must be submitted to the “securities regulatory authority” in Québec. Such wording is consistent with Canadian securities legislation, including National Instrument 14-101 <i>Definitions</i> .
Section 4.8 – Clearing agency technology requirements and testing facilities	<b>18.</b> A commenter submits that there should be a materiality threshold under subsection 4.8(1), in that making the relevant information publicly available should not be required if not materially necessary, given the sensitive information involved, and the potential for malicious internet attacks.	<p>The intention of subsection 4.8(1) is to require a clearing agency to make available technology requirements that are necessary for interfacing and accessing it, and not to require disclosure of all technology and sensitive information. We understand that clearing agencies are already disclosing relevant information to participants, potential participants and service vendors, and we do not anticipate that this will create an additional burden. Therefore, subsection 4.8(1) has been amended slightly.</p> <p>We note that the provision does generally accord with requirements set out in NI 21-101, and is necessary to ensure that participants, prospective participants and indirect participants that may need to interface or access the clearing agency, as well as service vendors, have the information they need to interface with, test and access a clearing agency. To the extent that sensitive information is involved that the clearing agency does not feel is necessary to be made publicly available, the clearing agency may make an application for an exemption, in part, from the subsection.</p>
	<b>19.</b> A commenter submits that the testing facilities referred to in subsection 4.8(2) are not necessary, as participants will test the technology as appropriate for themselves, and clearing agencies provide the necessary guidance and assistance to ensure that participants can make use of the system.	We do not propose any change. The CSA currently places similar requirements on marketplaces under NI 21-101, and such requirements are appropriate for clearing agencies as well.
Sections 4.7 and 4.10 – Independent reviews	<b>20.</b> A commenter submits that the references to independent reviews in subsection 4.7(1) and paragraph 4.10(f) require clarification, including that such a review by an affiliate would suffice. It is asserted that	The CSA does not intend references to “independent systems reviews” to mean such reviews must be conducted by an arm’s length third party to a clearing agency. Rather, it references the engagement of a



1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
	<p>requiring a third party to conduct such an audit would increase costs significantly, particularly for smaller clearing agencies, and should not be necessary.</p>	<p>“qualified” party, which need not exclude a review by a party that is an affiliate, as long as that party was not involved in the design of the systems being tested. Subsection 4.7(1) of the CP has been slightly modified to reflect this view.</p>
<p>Section 4.11 – Access requirements and due process</p>	<p><b>21.</b> A commenter submits that section 4.11 is overbroad, a departure from the PFMI, and would impact all aspects of a clearing agency’s business. It is submitted that the requirements should only be applied to a clearing agency’s key clearing and settlement services. Specific concerns are as follows:</p> <ul style="list-style-type: none"> <li>• with respect to para. 4.11(1)(b), clearing agencies do not control or have the ability to control the extent to which a participant may discriminate among its own customers;</li> <li>• with respect to para. 4.11(1)(c), matters relating to competition should be addressed through the <i>Competition Act</i>; and</li> <li>• with respect to subsection 4.11(2), the provision is overbroad, as a clearing agency may routinely make decisions that adversely affect participants; the provision should be limited to suspension or termination of membership decisions.</li> </ul>	<p>Section 4.11 is generally consistent with similar CSA rules and policies (e.g. NI 21-101) and the rules of certain foreign jurisdictions. Nevertheless, we appreciate the concerns raised, and have made some changes as a result.</p> <p>With respect to para. 4.11(1)(b), we have replaced the words “or the customers of its participants” with “or indirect participants”. The PFMI Report recognize that FMIs may have relationships with indirect participants that affect tiered participation arrangements. See para. 3.19.1 of the explanatory notes. It is in the context of such tiered participation arrangements that clearing agencies should not unreasonably discriminate among indirect participants.</p> <p>With respect to para. 4.11(1)(c), we note that fostering competition in the Canadian financial markets is contemplated as part of certain clearing agency recognition decisions. It remains a key public interest consideration and is consistent with the general objective of securities legislation, which includes fostering fair and efficient capital markets.</p> <p>With respect to subsection 4.11(2), we agree; the provision has been revised to relate more specifically to participant access to a clearing agency.</p>
<p>Effective date and transition</p>	<p><b>22.</b> A commenter requests that the CSA provide adequate time between the finalization of the Instrument and its effective date to permit foreign-based recognized clearing agencies to request and obtain exemptions from sections 2.2 and 2.5 and Part 4 to the extent that the requirements of those provisions conflict or are inconsistent with the terms and conditions of existing recognition decisions.</p>	<p>The CSA believes it has provided adequate time.</p>
<p>Section 2.0 of the CP – Recognition and exemption</p>	<p><b>23.</b> A commenter submits that the concept of ‘carrying on business’ under subsection 2.0(1) of the CP should include a materiality threshold</p>	<p>We do not propose any change. Determining whether a clearing agency is “carrying on business” in a local jurisdiction within the meaning of</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
	<p>to allow for greater regulatory flexibility and account for commercial realities.</p>	<p>securities legislation does not require a statutory determination of whether the business activity must reach a certain materiality threshold before the “carrying on business” test is triggered (e.g. a <i>material domestic connection</i> to the jurisdiction).</p> <p>However, a materiality threshold test is implicit in determining whether to recognize or exempt a clearing agency that is carrying or proposing to carry on business in the jurisdiction. An assessment of systemic importance would consider the <i>materiality</i> of a clearing agency’s activities to a jurisdiction’s capital markets. See our responses to comments nos. 3 and 5 above.</p> <p>Where an applicant is determined by the relevant securities regulatory authority to be not systemically important, but it is not otherwise appropriately regulated in another jurisdiction, a suitable degree of oversight may be necessary. Such an oversight program would be tailored to the entity, within the terms and conditions of its recognition decision.</p>
	<p><b>24.</b> A commenter submits that the factors for assessing systemic importance should include also consideration of the size of a market served by a clearing agency relative to the overall Canadian market.</p>	<p>We have not included this factor in section 2.0 of the CP. Although this criterion may be relevant to determine which regulator should be the lead or co-lead authority under a cooperative oversight arrangement among regulators, we do not believe that this criterion should be a guiding factor to determine if the clearing agency is “systemically important” in the jurisdiction. See also our responses to comments nos. 3 and 5 above.</p>
<p>Supplementary guidance – collateral</p>	<p><b>25.</b> A commenter argues that Canadian provinces should prioritize the implementation of legislative modifications that allow Canadian entities to offer a first priority security interest in cash to their counterparties.</p>	<p>The CSA acknowledges the challenges in the area of personal property security legislation, and will continue to monitor work in this area and consult with the provincial and federal governments, as appropriate.</p>
<p>Supplementary guidance – general business risk</p>	<p><b>26.</b> A commenter supports a broad definition of clearing agency liquid assets (i.e. capital), which will ensure the clearing agency has sufficient liquid assets to carry out its recovery and resolution plan. The definition should appreciate that clearing agencies perform bank-like activities and the capital should cover a full range of credit, liquidity, operational and other risks.</p>	<p>As noted in the Joint Supplementary Guidance, once the guidance on recovery planning has been finalized, the guidance on general business risk will be updated to provide clearing agencies with additional clarity on how to calculate the costs associated with these plans and determine the amount of liquid net assets required. We expect to make further updates later in 2016.</p>

1. Theme/question <sup>1</sup>	2. Summary of comments	3. General responses
Supplementary guidance – disclosure of rules, key procedures and market data	<p><b>27.</b> A commenter notes that the CPMI-IOSCO public qualitative and quantitative disclosure frameworks (which are proposed to be the basis for clearing agency disclosures) may fall short of ISDA recommendations:</p> <ul style="list-style-type: none"> <li>• disclosures of stress test methodologies should be offered to clearing agency members;</li> <li>• the concept of CCP stress tests should be supported, but regulatory stress scenarios should not become the de-facto standard for CCPs' own risk management; rather, regulators should verify that a clearing agency covers specific risks related to the particular product classes they clear, with proper close-out period and liquidity assumptions; and</li> <li>• regulators should support greater transparency regarding clearing agencies' credit due diligence processes, with a focus also on the probability of default of the membership.</li> </ul>	<p>The CPMI-IOSCO standard setting bodies are continuing their work in developing additional guidance and standards to supplement the PFMI, including in the area of CCP stress testing methodologies and transparency. The CSA, together with the BOC, will monitor international developments and may adopt more granular requirements that are in line with international standards, if appropriate. See also our responses above to comments no. 8.</p>
Supplementary guidance (forthcoming) – resolution and recovery	<p><b>28.</b> A commenter requests that the CSA, together with the BOC, develop its guidance related to resolution and recovery with a sense of urgency, particularly where its adoption may entail significant changes to the risk profile of Canadian clearing agencies. Such guidance would assist the clearing agencies to build a holistic view of their risks.</p>	<p>We thank the commenter for these comments.</p> <p>As noted above in this Notice, we are publishing for comment (concurrently with finalizing the Instrument and CP) additional Joint Supplementary Guidance on recovery and orderly wind-down planning. Such guidance contains aspects of the comments raised. In particular, recovery plans will need to be specific about a clearing agency's default policies and procedures, including the setting out of clear, quantifiable and predictable loss allocation procedures and the use of recovery tools.</p> <p>The BOC and its federal partners have commenced developing a resolution framework specific to domestic designated FMIs. This work will include developing policy proposals for legal, governance and communications frameworks, as well as FMI-specific resolution strategies. This is expected to be a multi-year initiative.</p>

**Annex C**

**Final adopted National Instrument 24-102 *Clearing Agency Requirements***

**THE MANITOBA SECURITIES COMMISSION**  
**MSC Rule No. 2015-35**  
(Section 149.1, *The Securities Act*)

**NATIONAL INSTRUMENT 24-102**  
***CLEARING AGENCY REQUIREMENTS***

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## PART 1 – DEFINITIONS, INTERPRETATION AND APPLICATION

### Definitions

#### 1.1 In this Instrument

**"accounting principles"** means accounting principles as defined in National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

**"auditing standards"** means auditing standards as defined in National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

**"board of directors"** means, in the case of a recognized clearing agency that does not have a board of directors, a group of individuals that acts for the clearing agency in a capacity similar to a board of directors;

**"central counterparty"** means a person or company that interposes itself between the counterparties to securities or derivatives transactions in one or more financial markets, acting functionally as the buyer to every seller and the seller to every buyer or the counterparty to every party;

**"central securities depository"** means a person or company that provides centralized facilities as a depository of securities, including securities accounts, central safekeeping services and asset services, which may include the administration of corporate actions and redemptions;

**"exempt clearing agency"** means a clearing agency that has been granted a decision of the securities regulatory authority pursuant to securities legislation exempting it from the requirement in such legislation to be recognized by the securities regulatory authority as a clearing agency;

**"link"** means, in relation to a clearing agency, contractual and operational arrangements that directly or indirectly through an intermediary connect the clearing agency and one or more other systems for the clearing, settlement or recording of securities or derivatives transactions;

**"participant"** means a person or company that has entered into an agreement with a clearing agency to access the services of the clearing agency and is bound by the clearing agency's rules and procedures;

**"PFMI Disclosure Framework Document"** means a disclosure document completed substantially in the form of *Annex A: FMI disclosure template* of the December 2012 report *Principles for financial market infrastructures: Disclosure framework and Assessment methodology* published by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, as amended, supplemented or superseded from time to time, or a similar disclosure document required to be completed regularly and disclosed publicly by a clearing agency in accordance with the regulatory requirements of a foreign jurisdiction in which the clearing agency is located;

**"PFMI Principle"** means a principle, including applicable key considerations, in the April 2012 report *Principles for financial market infrastructures* published by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, as amended from time to time;

**"publicly accountable enterprise"** means a publicly accountable enterprise as defined in Part 3 of National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

**"securities settlement system"** means a system that enables securities to be transferred and settled by book entry according to a set of predetermined multilateral rules.

**Interpretation - affiliated entity, controlled entity and subsidiary entity**

**1.2(1)** In this Instrument, a person or company is considered to be an affiliated entity of another person or company if one is a subsidiary entity of the other or if both are subsidiary entities of the same person or company, or if each of them is a controlled entity of the same person or company.

**1.2(2)** In this Instrument, a person or company is considered to be controlled by a person or company if

(a) in the case of a person or company,

(i) voting securities of the first-mentioned person or company carrying more than fifty percent of the votes for the election of directors are held, otherwise than by way of security only, by or for the benefit of the other person or company, and

(ii) the votes carried by the securities are entitled, if exercised, to elect a majority of the directors of the first-mentioned person or company;

(b) in the case of a partnership that does not have directors, other than a limited partnership, the second-mentioned person or company holds more than fifty percent of the interests in the partnership; or

(c) in the case of a limited partnership, the general partner is the second-mentioned person or company.

**1.2(3)** In this Instrument, a person or company is considered to be a subsidiary entity of another person or company if

(a) it is a controlled entity of

(i) that other,

(ii) that other and one or more persons or companies, each of which is a controlled entity of that other, or

(iii) two or more persons or companies, each of which is a controlled entity of that other; or

(b) it is a subsidiary entity of a person or company that is the other's subsidiary entity.

**Interpretation – extended meaning of affiliated entity**

**1.3** For the purposes of the PFMI Principles, a person or company is considered to be an affiliate of a participant, the person or company and the participant each being described in this section as a "party", where,

(a) a party holds, otherwise than by way of security only, voting securities of the other party carrying more than 20 percent of the votes for the election of directors, or

(b) in the event paragraph (a) is not applicable,

(i) a party holds, otherwise than by way of security only, an interest in the other party that allows it to direct the management or operations of the other party; or

(ii) financial information in respect of both parties is consolidated for financial reporting purposes.

**Interpretation – clearing agency**

**1.4** For the purposes of this Instrument, in Québec, a clearing agency includes a clearing house, a central securities depository and a settlement system within the meaning of the Québec

*Securities Act* and a clearing house and a settlement system within the meaning of the *Québec Derivatives Act*.

### **Application**

**1.5(1)** Part 3 applies to a recognized clearing agency that operates as any of the following:

- (a) a central counterparty;
- (b) a central securities depository;
- (c) a securities settlement system.

**1.5(2)** Unless the context otherwise indicates, Part 4 applies to a recognized clearing agency whether or not it operates as a central counterparty, central securities depository or securities settlement system.

**1.5(3)** In Québec, if there is a conflict or an inconsistency between section 2.2 and the provisions of the *Québec Derivatives Act* governing the self-certification process with respect to a clearing agency implementing a significant change or a fee change, the provisions of the *Québec Derivatives Act* prevail.

**1.5(4)** The requirements of section 2.2 or 2.5 apply only to the extent that the subject matters of the section are not otherwise governed by the terms and conditions of a decision of the securities regulatory authority that recognizes a clearing agency or that exempts a clearing agency from a recognition requirement.

## **PART 2 – CLEARING AGENCY RECOGNITION OR EXEMPTION FROM RECOGNITION**

### **Application and initial filing of information**

**2.1(1)** An applicant for recognition as a clearing agency under securities legislation, or for exemption from the requirement to be recognized as a clearing agency under securities legislation, must include in its application all of the following:

- (a) if applicable, the applicant's most recently completed PFMI Disclosure Framework Document;
- (b) sufficient information to demonstrate that the applicant is in compliance with
  - (i) provincial and territorial securities legislation, or
  - (ii) the regulatory regime of a foreign jurisdiction in which the applicant's head office or principal place of business is located;
- (c) any additional relevant information sufficient to demonstrate that it is in the public interest for the securities regulatory authority to recognize or exempt the applicant, as the case may be.

**2.1(2)** In addition to the requirement set out in subsection (1), an applicant that has a head office or principal place of business located in a foreign jurisdiction must

- (a) certify that it will assist the securities regulatory authority in accessing the applicant's books and records and in undertaking an onsite inspection and examination at the applicant's premises, and
- (b) certify that it will provide the securities regulatory authority, if requested by such authority, with an opinion of legal counsel that the applicant has, as a matter of law, the power and authority to

- (i) provide the securities regulatory authority with prompt access to its books and records, and
- (ii) submit to onsite inspection and examination by the securities regulatory authority.

**2.1(3)** In addition to the requirements set out in subsections (1) and (2), an applicant whose head office or principal place of business is located in a foreign jurisdiction must file a completed Form 24-102F1 *Submission to Jurisdiction and Appointment of Agent for Service*.

**2.1(4)** An applicant must inform the securities regulatory authority in writing of any material change to the information provided in its application, or if any of the information becomes materially inaccurate for any reason, as soon as the change occurs or the applicant becomes aware of any inaccuracy.

**Significant changes, fee changes and other changes in information**

**2.2(1)** In this section, for greater certainty, a "significant change" includes, in relation to a clearing agency,

- (a) any change to the clearing agency's constating documents or by-laws;
- (b) any change to the clearing agency's corporate governance or corporate structure, including any change of control of the clearing agency, whether direct or indirect;
- (c) any material change to an agreement among the clearing agency and participants in connection with the clearing agency's operations and services, including those agreements to which the clearing agency is a party and those agreements among participants to which the clearing agency is not a party, but that are expressly referred to in the clearing agency's rules or procedures and are made available by participants to the clearing agency;
- (d) any material change to the clearing agency's rules, operating procedures, user guides, manuals, or other documentation governing or establishing the rights, obligations and relationships among the clearing agency and participants in connection with the clearing agency's operations and services;
- (e) any material change to the design, operation or functionality of any of the clearing agency's operations and services;
- (f) the establishment or removal of a link or any material change to an existing link;
- (g) commencing to engage in a new type of business activity or ceasing to engage in a business activity in which the clearing agency is then engaged;
- (h) any other matter identified as a significant change in the recognition terms and conditions.

**2.2(2)** Subject to subsection (4), a recognized clearing agency must not implement a significant change unless it has filed a written notice of the significant change with the securities regulatory authority at least 45 days before implementing the change.

**2.2(3)** If a proposed significant change referred to in subsection (2) would affect the information set out in its PFMI Disclosure Framework Document filed with the securities regulatory authority, a recognized clearing agency must complete and file with the securities regulatory authority, concurrently with providing the written notice referred to in subsection (2), an appropriate amendment to its PFMI Disclosure Framework Document.

**2.2(4)** If a recognized clearing agency proposes to modify a fee or introduce a new fee for any of its clearing, settlement or depository services, the clearing agency must notify in writing the securities regulatory authority of such fee change before implementing the fee change within a period



stipulated by the terms and conditions of a decision of the securities regulatory authority that recognizes the clearing agency.

**2.2(5)** An exempt clearing agency must notify in writing the securities regulatory authority of any material change to the information provided to the securities regulatory authority in its PFMI Disclosure Framework Document and related application materials, or if any of the information becomes materially inaccurate for any reason, as soon as the change occurs or the exempt clearing agency becomes aware of any inaccuracy.

#### **Ceasing to carry on business**

**2.3(1)** A recognized clearing agency or exempt clearing agency that intends to cease carrying on business in the local jurisdiction as a clearing agency must file a report on Form 24-102F2 *Cessation of Operations Report for Clearing Agency* with the securities regulatory authority

(a) at least 180 days before ceasing to carry on business if a significant reason for ceasing to carry on business relates to the clearing agency's financial viability or any other matter that is preventing, or may potentially prevent, it from being able to provide its operations and services as a going concern, or

(b) at least 90 days before ceasing to carry on business for any other reason.

**2.3(2)** A recognized clearing agency or exempt clearing agency that involuntarily ceases to carry on business in the local jurisdiction as a clearing agency must file a report on Form 24-102F2 *Cessation of Operations Report for Clearing Agency* with the securities regulatory authority as soon as practicable after it ceases to carry on that business.

#### **Filing of initial audited financial statements**

**2.4(1)** An applicant must file audited financial statements for its most recently completed financial year with the securities regulatory authority as part of its application under section 2.1.

**2.4(2)** The financial statements referred to in subsection (1) must

(a) be prepared in accordance with Canadian GAAP applicable to publicly accountable enterprises, IFRS or the generally accepted accounting principles of the foreign jurisdiction in which the person or company is incorporated, organized or located,

(b) identify in the notes to the financial statements the accounting principles used to prepare the financial statements,

(c) disclose the presentation currency, and

(d) be audited in accordance with Canadian GAAS, International Standards on Auditing or the generally accepted auditing standards of the foreign jurisdiction in which the person or company is incorporated, organized or located.

**2.4(3)** The financial statements referred to in subsection (1) must be accompanied by an auditor's report that

(a) expresses an unmodified or unqualified opinion,

(b) identifies all financial periods presented for which the auditor's report applies,

(c) identifies the auditing standards used to conduct the audit,

(d) identifies the accounting principles used to prepare the financial statements,

(e) is prepared in accordance with the same auditing standards used to conduct the audit, and

(f) is prepared and signed by a person or company that is authorized to sign an auditor's report under the laws of a jurisdiction of Canada or a foreign jurisdiction, and that meets the professional standards of that jurisdiction.

### **Filing of annual audited and interim financial statements**

**2.5(1)** A recognized clearing agency or exempt clearing agency must file annual audited financial statements that comply with the requirements set out in subsections 2.4(2) and (3) with the securities regulatory authority no later than the 90th day after the end of the recognized clearing agency or exempt clearing agency's financial year.

**2.5(2)** A recognized clearing agency or exempt clearing agency must file interim financial statements that comply with the requirements set out in paragraphs 2.4(2)(a) and (2)(b) with the securities regulatory authority no later than the 45th day after the end of each interim period.

## **PART 3 – PFMI PRINCIPLES APPLICABLE TO RECOGNIZED CLEARING AGENCIES**

### **PFMI principles**

**3.1** A recognized clearing agency must establish, implement and maintain rules, procedures, policies or operations designed to ensure that it meets or exceeds PFMI Principles 1 to 3, 10, 13, 15 to 19, 20 other than key consideration 9, 21 to 23 and the following:

- (a) if the clearing agency operates as a central counterparty, PFMI Principles 4 to 9, 12 and 14;
- (b) if the clearing agency operates as a securities settlement system, PFMI Principles 4, 5, 7 to 9 and 12; and
- (c) if the clearing agency operates as a central securities depository, PFMI Principle 11.

## **PART 4 – OTHER REQUIREMENTS OF RECOGNIZED CLEARING AGENCIES**

### ***Division 1 – Governance:***

#### **Board of directors**

**4.1(1)** A recognized clearing agency must have a board of directors.

**4.1(2)** The board of directors must include appropriate representation by individuals who are

- (a) independent of the clearing agency, and
- (b) not employees or executive officers of a participant or their immediate family members.

**4.1(3)** For the purposes of paragraph (2)(a), an individual is independent of a clearing agency if he or she has no direct or indirect material relationship with the clearing agency.

**4.1(4)** For the purposes of subsection (3), a "material relationship" is a relationship that could, in the view of the clearing agency's board of directors, be reasonably expected to interfere with the exercise of a member's independent judgment.

## **Documented procedures regarding risk spill-overs**

**4.2** The board of directors and management of a recognized clearing agency must have documented procedures to manage possible risk spill over where the clearing agency provides services with a different risk profile than its depository, clearing and settlement services.

## **Chief Risk Officer and Chief Compliance Officer**

**4.3(1)** A recognized clearing agency must designate a chief risk officer and a chief compliance officer, who must report directly to the board of directors or, if determined by the board of directors, to the chief executive officer of the clearing agency.

**4.3(2)** The chief risk officer must

- (a) have full responsibility and authority to maintain, implement and enforce the risk management framework established by the clearing agency,
- (b) make recommendations to the clearing agency's board of directors regarding the clearing agency's risk management framework,
- (c) monitor the effectiveness of the clearing agency's risk management framework, and
- (d) report to the clearing agency's board of directors on a timely basis upon becoming aware of any significant deficiency with the risk management framework.

**4.3(3)** The chief compliance officer must

- (a) establish, implement, maintain and enforce written policies and procedures to identify and resolve conflicts of interest and ensure that the clearing agency complies with securities legislation,
- (b) monitor compliance with the policies and procedures described in paragraph (a),
- (c) report to the board of directors of the clearing agency as soon as practicable upon becoming aware of any circumstance indicating that the clearing agency, or any individual acting on its behalf, is not in compliance with securities legislation and one or more of the following apply:
  - (i) the non-compliance creates a risk of harm to a participant,
  - (ii) the non-compliance creates a risk of harm to the broader financial system,
  - (iii) the non-compliance is part of a pattern of non-compliance, or
  - (iv) the non-compliance may have an impact on the ability of the clearing agency to carry on business in compliance with securities legislation,
- (d) prepare and certify an annual report assessing compliance by the clearing agency, and individuals acting on its behalf, with securities legislation and submit the report to the board of directors,
- (e) report to the clearing agency's board of directors as soon as practicable upon becoming aware of a conflict of interest that creates a risk of harm to a participant or to the capital markets, and
- (f) concurrently with submitting a report under paragraphs (c), (d) or (e), file a copy of such report with the securities regulatory authority.

## **Board or advisory committees**

**4.4(1)** The board of directors of a recognized clearing agency must, at a minimum, establish and maintain committees on risk management, finance and audit.

**4.4(2)** If a committee is a board committee, it must be chaired by a sufficiently knowledgeable individual who is independent of the clearing agency.

**4.4(3)** Subject to subsection (4), a committee must have an appropriate representation by individuals who are independent of the clearing agency.

**4.4(4)** An audit or risk committee must have an appropriate representation by individuals who are

(a) independent of the clearing agency, and

(b) not employees or executive officers of a participant or their immediate family members.

***Division 2 – Default management:***

**Use of own capital**

**4.5** A recognized clearing agency that operates as a central counterparty must dedicate and use a reasonable portion of its own capital to cover losses resulting from one or more participant defaults.

***Division 3 – Operational risk:***

**Systems requirements**

**4.6** For each system operated by or on behalf of a recognized clearing agency that supports the clearing agency's clearing, settlement and depository functions, the clearing agency must

(a) develop and maintain

(i) an adequate system of internal controls over that system, and

(ii) adequate information technology general controls, including, without limitation, controls relating to information systems operations, information security, change management, problem management, network support and system software support,

(b) in accordance with prudent business practice, on a reasonably frequent basis and, in any event, at least annually

(i) make reasonable current and future capacity estimates, and

(ii) conduct capacity stress tests to determine the ability of that system to process transactions in an accurate, timely and efficient manner, and

(c) promptly notify the regulator or, in Québec, the securities regulatory authority of any material systems failure, malfunction, delay or security breach, and provide timely updates on the status of the failure, malfunction, delay or security breach, the resumption of service, and the results of the clearing agency's internal review of the failure, malfunction, delay or security breach.

**Systems reviews**

**4.7(1)** A **recognized** clearing agency must annually engage a qualified party to conduct an independent systems review and vulnerability assessment and prepare a report in accordance with established audit standards and best industry practices to ensure that the clearing agency is in compliance with paragraph 4.6(a) and section 4.9.

**4.7(2)** The clearing agency must provide the report resulting from the review conducted under subsection (1) to

(a) its board of directors, or audit committee, promptly upon the report's completion, and

(b) the regulator or, in Québec, the securities regulatory authority, by the earlier of the 30th day after providing the report to its board of directors or the audit committee or the 60th day after the calendar year end.

#### **Clearing agency technology requirements and testing facilities**

**4.8(1)** A recognized clearing agency must make available to participants, in their final form, all technology requirements regarding interfacing with or accessing the clearing agency

(a) if operations have not begun, sufficiently in advance of operations to allow a reasonable period for testing and system modification by participants, and

(b) if operations have begun, sufficiently in advance of implementing a material change to technology requirements to allow a reasonable period for testing and system modification by participants.

**4.8(2)** After complying with subsection (1), the clearing agency must make available testing facilities for interfacing with or accessing the clearing agency

(a) if operations have not begun, sufficiently in advance of operations to allow a reasonable period for testing and system modification by participants, and

(b) if operations have begun, sufficiently in advance of implementing a material change to technology requirements to allow a reasonable period for testing and system modification by participants.

**4.8(3)** The clearing agency must not begin operations before

(a) it has complied with paragraphs (1)(a) and (2)(a), and

(b) the chief information officer of the clearing agency, or an individual performing a similar function, has certified in writing to the regulator or, in Québec, the securities regulatory authority, that all information technology systems used by the clearing agency have been tested according to prudent business practices and are operating as designed.

**4.8(4)** The clearing agency must not implement a material change to the systems referred to in section 4.6 before

(a) it has complied with paragraphs (1)(b) and (2)(b), and

(b) the chief information officer of the clearing agency, or an individual performing a similar function, has certified in writing to the regulator or, in Québec, the securities regulatory authority, that the change has been tested according to prudent business practices and is operating as designed.

**4.8(5)** Subsection (4) does not apply to the clearing agency if the change must be made immediately to address a failure, malfunction or material delay of its systems or equipment and if

(a) the clearing agency immediately notifies the regulator or, in Québec, the securities regulatory authority, of its intention to make the change, and

(b) the clearing agency discloses to its participants the changed technology requirements as soon as practicable.

#### **Testing of business continuity plans**

**4.9** A recognized clearing agency must

(a) develop and maintain reasonable business continuity plans, including disaster recovery plans, and

(b) test its business continuity plans, including its disaster recovery plans, according to prudent business practices and on a reasonably frequent basis and, in any event, at least annually.

### **Outsourcing**

**4.10** If a recognized clearing agency outsources a critical service or system to a service provider, including to an affiliated entity of the clearing agency, the clearing agency must do all of the following:

(a) establish, implement, maintain and enforce written policies and procedures to conduct suitable due diligence for selecting service providers to which a critical service and system may be outsourced and for the evaluation and approval of those outsourcing arrangements;

(b) identify any conflicts of interest between the clearing agency and the service provider to which a critical service and system is outsourced, and establish, implement, maintain and enforce written policies and procedures to mitigate and manage those conflicts of interest;

(c) enter into a written contract with the service provider to which a critical service or system is outsourced that

(i) is appropriate for the materiality and nature of the outsourced activities,

(ii) includes service level provisions, and

(iii) provides for adequate termination procedures;

(d) maintain access to the books and records of the service provider relating to the outsourced activities;

(e) ensure that the securities regulatory authority has the same access to all data, information and systems maintained by the service provider on behalf of the clearing agency that it would have absent the outsourcing arrangements;

(f) ensure that all persons conducting audits or independent reviews of the clearing agency under this Instrument have appropriate access to all data, information and systems maintained by the service provider on behalf of the clearing agency that such persons would have absent the outsourcing arrangements;

(g) take appropriate measures to determine that the service provider to which a critical service or system is outsourced establishes, maintains and periodically tests an appropriate business continuity plan, including a disaster recovery plan;

(h) take appropriate measures to ensure that the service provider protects the clearing agency's proprietary information and participants' confidential information, including taking measures to protect information from loss, thefts, vulnerabilities, threats, unauthorized access, copying, use and modification, and discloses it only in circumstances where legislation or an order of a court or tribunal of competent jurisdiction requires the disclosure of such information;

(i) establish, implement, maintain and enforce written policies and procedures to monitor the ongoing performance of the service provider's contractual obligations under the outsourcing arrangements.

***Division 4 – Participation requirements:***

**Access requirements and due process**

- 4.11(1)** A recognized clearing agency must not
- (a) unreasonably prohibit, condition or limit access by a person or company to the services offered by the clearing agency,
  - (b) unreasonably discriminate among its participants or indirect participants,
  - (c) impose any burden on competition that is not reasonably necessary and appropriate,
  - (d) unreasonably require the use or purchase of another service for a person or company to utilize the clearing agency's services offered by it, and
  - (e) impose fees or other material costs on its participants that are unfairly or inequitably allocated among the participants.

**4.11(2)** For any decision made by the clearing agency that terminates, suspends or restricts a participant's membership in the clearing agency or that declines entry to membership to an applicant that applies to become a participant, the clearing agency must ensure that

- (a) the participant or applicant is given an opportunity to be heard or make representations, and
- (b) it keeps records of, gives reasons for, and provides for reviews of its decisions, including, for each applicant, the reasons for granting access or for denying or limiting access to the applicant, as the case may be.

**4.11(3)** Nothing in subsection (2) limits or prevents the clearing agency from taking timely action in accordance with its rules and procedures to manage the default of one or more participants or in connection with the clearing agency's recovery or orderly wind-down, whether or not such action adversely affects a participant.

**PART 5 – BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER**

**Books and records**

**5.1(1)** A recognized clearing agency or exempt clearing agency must keep books, records and other documents as are necessary to account for the conduct of its clearing, settlement and depository activities, business transactions and financial affairs and must keep those other books, records and documents as may otherwise be required under securities legislation.

- 5.1(2)** The clearing agency must retain the books and records maintained under this section
- (a) for a period of seven years from the date the record was made or received, whichever is later,
  - (b) in a safe location and a durable form, and
  - (c) in a manner that permits them to be provided promptly to the securities regulatory authority.

## **Legal entity identifier**

**5.2(1)** In this section,

"**Global Legal Entity Identifier System**" means the system for unique identification of parties to financial transactions developed by the LEI Regulatory Oversight Committee, and

"**LEI Regulatory Oversight Committee**" means the international working group established by the Finance Ministers and the Central Bank Governors of the Group of Twenty nations and the Financial Stability Board, under the Charter of the Regulatory Oversight Committee for the Global Legal Entity Identifier System dated November 5, 2012.

**5.2(2)** For the purposes of any recordkeeping and reporting requirements required under securities legislation, a recognized clearing agency or exempt clearing agency must identify itself by means of a single legal entity identifier assigned to the clearing agency in accordance with the standards set by the Global Legal Entity Identifier System.

**5.2(3)** If the Global Legal Entity Identifier System is unavailable to the clearing agency, all of the following apply:

(a) the clearing agency must obtain a substitute legal entity identifier that complies with the standards established by the LEI Regulatory Oversight Committee for pre-legal entity identifiers;

(b) the clearing agency must use the substitute legal entity identifier until a legal entity identifier is assigned to the clearing agency in accordance with the standards set by the Global Legal Entity Identifier System;

(c) after the holder of a substitute legal entity identifier is assigned a legal entity identifier in accordance with the standards set by the Global Legal Entity Identifier System, the clearing agency must ensure that it is identified only by the assigned identifier.

## **PART 6 – EXEMPTIONS**

### **Exemption**

**6.1(1)** The regulator or the securities regulatory authority may grant an exemption from the provisions of this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

**6.1(2)** Despite subsection (1), in Ontario, only the regulator may grant an exemption.

**6.1(3)** Except in Ontario, an exemption referred to in subsection (1) is granted under the statute referred to in Appendix B of National Instrument 14-101 *Definitions* opposite the name of the local jurisdiction.

## **PART 7 – EFFECTIVE DATE AND TRANSITION**

### **Effective date and transition**

**7.1(1)** This Instrument comes into force on February 17, 2016.

**7.1(2)** Despite section 3.1, until December 31, 2016, a recognized clearing agency is not required to implement rules, procedures, policies or operations designed to ensure that a recognized clearing agency meets or exceeds the following:



(a) PFMI Principle 14;

(b) key consideration 4 of PFMI Principle 3 and key consideration 3 of PFMI Principle 15 with respect to a clearing agency's recovery and orderly wind-down plans; and

(c) PFMI Principle 19.

**7.1(3)** In Saskatchewan, despite subsection (1), if these regulations are filed with the Registrar of Regulations after February 17, 2016, these regulations come into force on the day on which they are filed with the Registrar of Regulations.

**7.1(4)** This Instrument may be cited as MSC Rule 2015-35.

**FORM 24-102F1**

***CLEARING AGENCY SUBMISSION TO  
JURISDICTION AND APPOINTMENT OF  
AGENT FOR SERVICE OF PROCESS***

1. Name of clearing agency (the "Clearing Agency"):  

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2. Jurisdiction of incorporation, or equivalent, of Clearing Agency:  

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3. Address of principal place of business of Clearing Agency:  

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4. Name of the agent for service of process (the "Agent") for the Clearing Agency:  

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5. Address of the Agent in \_\_\_\_\_ [name of local jurisdiction]:  

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6. The \_\_\_\_\_ [name of securities regulatory authority] ("securities regulatory authority") issued an order recognizing the Clearing Agency as a clearing agency pursuant to securities legislation, or the securities regulatory authority issued an order exempting the Clearing Agency from the requirement to be recognized as a clearing agency pursuant to such legislation, on \_\_\_\_\_.
7. The Clearing Agency designates and appoints the Agent as its agent upon whom may be served a notice, pleading, subpoena, summons or other process in any action, investigation or administrative, criminal, quasi-criminal, penal or other proceeding arising out of or relating to or concerning the activities of the Clearing Agency in \_\_\_\_\_ [province of local jurisdiction]. The Clearing Agency hereby irrevocably waives any right to challenge service upon its Agent as not binding upon the Clearing Agency.
8. The Clearing Agency agrees to unconditionally and irrevocably attorn to the non-exclusive jurisdiction of (i) the courts and administrative tribunals of \_\_\_\_\_ [name of local jurisdiction] and (ii) any proceeding in any province or territory arising out of, related to, concerning or in any other manner connected with the regulation and oversight of the activities of the Clearing Agency in \_\_\_\_\_ [name of local jurisdiction].
9. The Clearing Agency must file a new submission to jurisdiction and appointment of agent for service of process in this form at least 30 days before the Clearing Agency ceases to be recognized or exempted by the securities regulatory authority, to be in effect for six years from the date it ceases to be recognized or exempted unless otherwise amended in accordance with section 10.
10. Until six years after it has ceased to be a recognized or exempted by the securities regulatory authority, the Clearing Agency must file an amended submission to jurisdiction and appointment of agent for service of process at least 30 days before any change in the name or above address of the Agent.

11. The Clearing Agency agrees that this submission to jurisdiction and appointment of agent for service of process is to be governed by and construed in accordance with the laws of \_\_\_\_\_ [name of local jurisdiction].

Dated: \_\_\_\_\_

\_\_\_\_\_  
Signature of the Clearing Agency

\_\_\_\_\_  
Print name and title of signing officer of  
the Clearing Agency

**AGENT**

**CONSENT TO ACT AS AGENT FOR SERVICE**

I, \_\_\_\_\_ [name of Agent in full; if a corporation, full corporate name] of \_\_\_\_\_ [business address], hereby accept the appointment as agent for service of process of \_\_\_\_\_ [insert name of Clearing Agency] and hereby consent to act as agent for service pursuant to the terms of the appointment executed by \_\_\_\_\_ [insert name of Clearing Agency] on \_\_\_\_\_ [insert date].

Dated: \_\_\_\_\_

\_\_\_\_\_  
Signature of Agent

\_\_\_\_\_  
Print name of person signing and, if Agent is not an individual, the title of the person

**FORM 24-102F2**

***CESSATION OF OPERATIONS REPORT FOR CLEARING AGENCY***

1. Identification:
  - A. Full name of the recognized or exempted clearing agency:
  - B. Name(s) under which business is conducted, if different from item 1A:
2. Date clearing agency proposes to cease carrying on business as a clearing agency:
3. If cessation of business was involuntary, date clearing agency has ceased to carry on business as a clearing agency:

**Exhibits**

File all exhibits with the Cessation of Operations Report. For each exhibit, include the name of the clearing agency, the date of filing of the exhibit and the date as of which the information is accurate (if different from the date of the filing). If any exhibit required is inapplicable, a statement to that effect must be provided instead of the exhibit.

***Exhibit A***

The reasons for the clearing agency ceasing to carry on business as a clearing agency.

***Exhibit B***

A list of all participants in Canada during the last 30 days prior to ceasing business as a clearing agency.

***Exhibit C***

A description of the alternative arrangements available to participants in respect of the services offered by the clearing agency immediately before the cessation of business as a clearing agency.

***Exhibit D***

A description of all links the clearing agency had immediately before the cessation of business as a clearing agency with other clearing agencies or trade repositories.

**CERTIFICATE OF CLEARING AGENCY**

The undersigned certifies that the information given in this report is true and correct.

DATED at \_\_\_\_\_ this \_\_\_\_\_ day of \_\_\_\_\_ 20 \_\_\_\_\_

\_\_\_\_\_  
(Name of clearing agency)

\_\_\_\_\_  
(Name of director, officer or partner – please type or print)

\_\_\_\_\_  
(Signature of director, officer or partner)

\_\_\_\_\_  
(Official capacity – please type or print)

**Annex D**

**Final adopted Companion Policy 24-102CP to  
National Instrument 24-102 *Clearing Agency Requirements***

**Companion Policy 24-102CP**

**TO**

**National Instrument 24 – 102**

***CLEARING AGENCY REQUIREMENTS***

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## PART I GENERAL COMMENTS

### Introduction

**1.1 (1)** This Companion Policy (CP) sets out how the Canadian Securities Administrators (the CSA or we) interpret or apply provisions of National Instrument 24-102 *Clearing Agency Requirements* (the Instrument) and related securities legislation.

**(2)** Except for this Part 1 of the CP, section 3.2 and 3.3 of Part 3 of this CP, and the *text boxes* in Annex I to this CP, the numbering of Parts, sections and subsections in this CP generally corresponds to the numbering in the Instrument. Any general guidance or introductory comments for a Part appears immediately after the Part's name. Specific guidance on a section or subsection in the Instrument follows any general guidance. If there is no guidance for a Part, section or subsection, the numbering in this CP will skip to the next provision that does have guidance.

**(3)** Unless otherwise stated, any reference in this CP to a Part, section, subsection, paragraph or defined term is a reference to the corresponding Part, section, subsection, paragraph or defined term of the Instrument. The CP also makes references to certain paragraphs in the April 2012 report *Principles for financial market infrastructures* (the PFMI or PFMI Report, as the context requires) and the PFMI Principles set out therein. A reference to a PFMI Principle may include a reference to an applicable key consideration (see definition of "PFMI Principle" in section 1.1).

### Background and overview

**1.2 (1)** Securities legislation in certain jurisdictions of Canada requires an entity seeking to carry on business as a clearing agency in the jurisdiction to be (i) recognized by the securities regulatory authority in that jurisdiction, or (ii) exempted from the recognition requirement.<sup>1</sup> Accordingly, Part 2 sets out certain requirements in connection with the application process for recognition as a clearing agency or exemption from the recognition requirement. Guidance on the CSA's regulatory approach to such an application is set out in this CP.

**(2)** Parts 3 and 4 set out on-going requirements applicable to a recognized clearing agency. Part 3 adopts the PFMI Principles generally but does restrict their application only to a clearing agency that operates as a central counterparty (CCP), securities settlement system (SSS) or central securities depository (CSD), as relevant. Part 4 applies to a clearing agency whether or not it operates as a CCP, SSS or CSD. The PFMI Principles were developed jointly by the Committee on Payments and Market Infrastructures (CPMI)<sup>2</sup> and the International Organization of Securities Commissions (IOSCO).<sup>3</sup> The PFMI Principles harmonize and strengthen previous international standards for financial market infrastructures (FMIs).<sup>4</sup>

**(3)** Annex I to this CP includes supplementary guidance in *text boxes* that applies to recognized domestic clearing agencies that are also overseen by the Bank of Canada (BOC). The supplementary guidance (Joint Supplementary Guidance) was prepared jointly by the CSA and BOC to provide additional clarity on certain aspects of the PFMI Principles within the Canadian context.

### Definitions, interpretation and application

**1.3 (1)** Unless defined in the Instrument or this CP, defined terms used in the Instrument and this CP have the meaning given to them in the securities legislation of each jurisdiction or in National Instrument 14-101 *Definitions*.

**(2)** The terms "clearing agency" and "recognized clearing agency" are generally defined in securities legislation. For the purposes of the Instrument, a clearing agency includes, in Quebec, a clearing house, central securities depository and settlement system within the meaning of the Québec *Securities Act* and a clearing house and settlement system within the meaning of the Québec *Derivatives Act*. See section 1.4.

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<sup>1</sup> The entity is prohibited from carrying on business as a clearing agency unless recognized or exempted.

<sup>2</sup> Prior to September 1, 2014, CPMI was known as the Committee on Payment and Settlement Systems (CPSS).

<sup>3</sup> See the CPMI-IOSCO *Principles for Financial Market Infrastructures* Report, published in April 2012, available on the Bank for International Settlements' website ([www.bis.org](http://www.bis.org)) and the IOSCO website ([www.iosco.org](http://www.iosco.org)).

<sup>4</sup> See (i) 2001 CPMI report *Core principles for systemically important payment systems*, (ii) 2001 CPMI-IOSCO report *Recommendations for securities settlement systems* (together with the 2002 CPMI-IOSCO report *Assessment methodology for Recommendations for securities settlement systems*); and (iii) 2004 CPMI-IOSCO report *Recommendations for central counterparties*. All of these reports are available on the Bank for International Settlements' website ([www.bis.org](http://www.bis.org)). The CPMI-IOSCO reports are also available on IOSCO website ([www.iosco.org](http://www.iosco.org)).



The CSA notes that, while Part 3 applies only to a recognized clearing agency that operates as a CCP, CSD or SSS, the term “clearing agency” may incorporate certain other centralized post-trade functions that are not necessarily limited to those of a CCP, CSD or SSS, e.g., an entity that provides centralized facilities for comparing data respecting the terms of settlement of a trade or transaction may be considered a clearing agency, but would not be considered a CCP, CSD or SSS. Except in Québec, such an entity would be required to apply either for recognition as a clearing agency or an exemption from the requirement to be recognized.<sup>5</sup> The CSA considers that a recognized clearing agency, which is not a CCP, CSD or SSS, should not be subject to the application of Part 3. Such a clearing agency is, however, subject to provisions in Part 2 and all of Parts 4 and 5..

**(3)** A clearing agency may serve either or both the securities and derivatives markets. A clearing agency serving the securities markets can be a CCP, CSD or SSS. A clearing agency serving the derivatives markets is typically only a CCP.

**(4)** In this CP, FMI means a financial market infrastructure, which the PFMI Report describes as follows: payment systems, CSDs, SSSs, CCPs and trade repositories.

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<sup>5</sup> In Québec, an entity that provides such centralized facilities for comparing data would be required to apply either for recognition as a matching service utility or for an exemption from the recognition requirement, in application of the *Securities Act* or the *Derivatives Act*.

**PART 2  
CLEARING AGENCY RECOGNITION  
OR EXEMPTION FROM RECOGNITION**

**Recognition and exemption**

**2.0 (1)** An entity seeking to carry on business as a clearing agency in certain jurisdictions in Canada is required under the securities legislation of such jurisdictions to apply for recognition or an exemption from the recognition requirement. For greater clarity, a foreign-based clearing agency that provides, or will provide, its services or facilities to a person or company resident in a jurisdiction would be considered to be carrying on business in that jurisdiction.

- ***Recognition of a clearing agency***

**(2)** The CSA takes the view that a clearing agency that is systemically important to a jurisdiction's capital markets, or that is not subject to comparable regulation by another regulatory body, will generally be recognized by a securities regulatory authority.<sup>6</sup> A securities regulatory authority may consider the systemic importance of a clearing agency to its capital markets based on the following list of guiding factors: value and volume of transactions processed, cleared and settled by the clearing agency;<sup>7</sup> risk exposures (particularly credit and liquidity) of the clearing agency to its participants; complexity of the clearing agency,<sup>8</sup> and centrality of the clearing agency with respect to its role in the market, including its substitutability, relationships, interdependencies and interactions.<sup>9</sup> The list of guiding factors is non-exhaustive, and no single factor described above will be determinative in an assessment of systemic importance. A securities regulatory authority retains the ability to consider additional quantitative and qualitative factors as may be relevant and appropriate.<sup>10</sup>

**(3)** Because of the approach described in subsection 2.0(2) of this CP, a securities regulatory authority may require a foreign-based clearing agency to be recognized if the clearing agency's proposed business activities in the local jurisdiction are systemically important to the jurisdiction's capital markets, even if it is already subject to comparable regulation in its home jurisdiction. In such circumstances, the recognition decision would focus on key areas that pose material risks to the jurisdiction's market and rely, where appropriate, on the current regulatory requirements and processes to which the entity is already subject in its home jurisdiction. Terms and conditions of a recognition decision that require a foreign clearing agency to report information to a Canadian securities regulatory authority may vary among foreign clearing agencies. Among other factors, they will depend on whether Canadian securities regulatory authorities have entered into an agreement or memorandum of understanding with the home regulator for sharing information and cooperation.

- ***Exemption from recognition***

**(4)** Depending on the circumstances, a clearing agency may be granted an exemption from recognition pursuant to securities legislation and subject to appropriate terms and conditions, where it is not considered systemically important or where it does not otherwise pose significant risk to the capital markets. For example, such an approach may be considered for an entity that provides limited services or facilities, thereby not warranting full regulation, such as a clearing agency that does not perform the functions of a CCP, CSD or SSS. However, in such cases, terms and conditions may be imposed. In addition, a foreign-based clearing agency that is already subject to a comparable regulatory regime in its home jurisdiction may be granted an exemption from the recognition requirement as full regulation may be duplicative and inefficient when imposed in addition to the regulation of the home jurisdiction. The exemption may be subject to certain terms and conditions, including reporting requirements and prior notification of certain material changes to information provided to the securities regulatory authority.

**Application and initial filing of information**

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<sup>6</sup> We would consider comparable regulation by another regulatory body to be regulation that generally results in similar outcomes in substance to the requirements of Part 3 and 4.

<sup>7</sup>We would consider, for example, the current aggregate monetary values and volumes of such transactions, as well as the entity's potential for growth.

<sup>8</sup> We would look, for example, to the nature and complexity of the clearing agency, taking into account an analysis of the various products it processes, clears or settles.

<sup>9</sup> We would consider, for example, the centrality or importance of the clearing agency to the particular market or markets it serves, based on the degree to which it critically supports, or that its failure or disruption would affect, such markets or the entire Canadian financial infrastructure.

<sup>10</sup> Additional factors may be based on the characteristics of the clearing agency under review, such as the nature of its operations, its corporate structure, or its business model.

**2.1** The application process for both recognition and exemption from recognition as a clearing agency is similar. The entity that applies will typically be the entity that operates the facility or performs the functions of a clearing agency. The application for recognition or exemption will require completion of appropriate documentation. This will include the items listed in subsection 2.1(1). Together, the application materials should present a detailed description of the history, regulatory structure, and business operations of the clearing agency. A clearing agency that operates as a CCP, CSD or SSS will need to describe how it meets or will meet the requirements of Parts 3 and 4. An applicant based in a foreign jurisdiction should also provide a detailed description of the regulatory regime of its home jurisdiction and the requirements imposed on the clearing agency, including how such requirements are similar to the requirements in Parts 3 and 4.

Where specific information items of the PFMI Disclosure Framework Document are not relevant to an applicant because of the nature or scope of its clearing agency activities, its structure, the products it clears or settles, or its regulatory environment, the application should explain in reasonable detail why the information items are not relevant.

The application filed by an applicant will generally be published for public comment for a 30-day period. Other materials filed with the application, which the applicant wishes to maintain confidential, will generally be kept confidential in accordance with securities and privacy legislation. However, the clearing agency will be required to publicly disclose its PFMI Disclosure Framework Document. See PFMI Principle 23, key consideration 5.

### **Significant changes, fee changes, and other changes in information**

**2.2** Section 2.2 is subject to the application provisions of subsections 1.5(3) and (4). For example, where the terms and conditions of a recognition decision made by a securities regulatory authority require a recognized clearing agency to obtain the approval of the authority before implementing a new fee for a service, the process to seek such approval set forth in the terms and conditions will apply instead of the prior notification requirement in subsection 2.2(4).

**(2)** The written notice should provide a reasonably detailed description of the significant change (as defined in subsection 2.2(1)) and the expected date of the implementation of the change. It should enclose or attach updated relevant documentation, including clean and blacklined versions of the documentation that show how the significant change will be implemented. If the notice is being filed by a foreign-based clearing agency, the notice should also describe the approval process or other involvement by the primary or home-jurisdiction regulator for implementing the significant change. The clearing agency is required to file concurrently with the notice any changes required to be made to the clearing agency's PFMI Disclosure Framework Document as a result of implementing the significant change, in accordance with subsection 2.2(3).

### **Ceasing to carry on business**

**2.3** A recognized or exempt clearing agency that ceases to carry on business in a local jurisdiction as a clearing agency, either voluntarily or involuntarily, must file a completed Form 24-102F2 *Cessation of Operations Report for Clearing Agency* within the appropriate timelines. In certain jurisdictions, the clearing agency intending to cease carrying on business must also make an application to voluntarily surrender its recognition to the securities regulatory authority pursuant to securities legislation. The securities regulatory authority may accept the voluntary surrender subject to terms and conditions.<sup>11</sup>

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<sup>11</sup> See, for example, section 21.4 of the *Securities Act* (Ontario).

## PART 3 PFMI PRINCIPLES APPLICABLE TO RECOGNIZED CLEARING AGENCIES

### Introduction

**3.0 (1)** Section 3.1 adopts the PFMI Principles generally but excludes the application of specific PFMI Principles for certain types of clearing agencies. We have adopted only those PFMI Principles that are relevant to clearing agencies operating as a CCP, CSD or SSS.<sup>12</sup>

**(2)** Part 3, together with the PFMI Principles, is intended to be consistent with a flexible and principles-based approach to regulation. In this regard, Part 3 anticipates that a clearing agency's rules, procedures, policies and operations will need to evolve over time so that it can adequately respond to changes in technology, legal requirements, the needs of its participants and their customers, trading volumes, trading practices, linkages between financial markets, and the financial instruments traded in the markets that a clearing agency serves.

### PFMI Principles

**3.1** The definition of PFMI Principles in the Instrument includes the applicable key considerations for each principle. Annex E to the PFMI Report provides additional guidance on how each key consideration will apply to the specified types of clearing agencies. In interpreting and implementing the PFMI Principles, regard is to be given to the explanatory notes in the PFMI Report, as appropriate, unless otherwise indicated in section 3.1 or this Part 3 of the CP.<sup>13</sup> As discussed in subsection 1.2(3) of this CP, the CSA and BOC have together developed Joint Supplementary Guidance to provide additional clarity on certain aspects of some PFMI Principles within the Canadian context. The Joint Supplementary Guidance is directed at recognized domestic clearing agencies that are also overseen by the BOC. The Joint Supplementary Guidance is included in separate *text boxes* in Annex I to this CP under the relevant headings of the PFMI Principles. Except as otherwise indicated in this Part 3 of the CP, other recognized domestic clearing agencies should assess the applicability of the Joint Supplementary Guidance to their respective entity as well.

#### PFMI Principle 5: Collateral

**3.2** Notwithstanding section 3.1 of the CP and the Joint Supplementary Guidance relating to PFMI Principle 5: *Collateral* (see Box 5.1 in Annex I to this CP), we are of the view that letters of credit may be permitted as collateral by a recognized domestic clearing agency operating as a CCP serving derivatives markets that is not also overseen by the BOC, provided that the collateral and the clearing agency's collateral policies and procedures otherwise meet the requirements of PFMI Principle 5: *Collateral*. However, the recognized clearing agency must first obtain regulatory approval of its rules and procedures that govern the use of letters of credit as collateral before accepting letters of credit.

#### PFMI Principle 14: Segregation and portability for CCPs serving cash markets

**3.3** PFMI Principle 14: *Segregation and portability* requires, pursuant to section 3.1, that a CCP have rules and procedures that enable the segregation and portability<sup>14</sup> of positions and related collateral of a CCP participant's customers, particularly to protect the customers from the default or insolvency of the participant. The explanatory notes in the PFMI Report offer an "alternate approach" to meeting PFMI Principle 14. The report notes that, in certain jurisdictions, cash market CCPs operate in legal regimes that facilitate segregation and portability to achieve the protection of customer assets by alternate means that offer the same degree of protection as the approach in PFMI Principle 14.<sup>15</sup> The features of the alternate approach are described in the PFMI Report.<sup>16</sup>

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<sup>12</sup> PFMI Principles that are relevant to payment systems and trade repositories, but not CCPs, SSSs and CSDs, are not adopted in Part 3.

<sup>13</sup> For example, the Instrument uses specialized terminology related to the clearing and settlement area. Not all such terminology is defined in the Instrument, but instead may be defined or explained in the PFMI Report. Regard should be given to the PFMI Report in understanding such terminology, as appropriate, including Annex H: *Glossary*.

<sup>14</sup> Portability refers to the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party. See paragraph 3.14.3 of the PFMI Report.

<sup>15</sup> See paragraph 3.14.6 of the PFMI Report, at p. 83.

<sup>16</sup> Features of such regimes are that, if a participant fails, (a) the customer positions can be identified in a 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 PFMI's 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

- *Customers of IIROC dealer members:*

Currently, most participants of domestic cash market CCPs that clear for customers are investment dealers.<sup>17</sup> They are required to be members of the Investment Industry Regulatory Organization of Canada (IIROC)<sup>18</sup> and to contribute to the Canadian Investor Protection Fund (CIPF).<sup>19</sup> The CSA is of the view that the customer asset protection regime applicable to investment dealers (IIROC-CIPF regime) is an appropriate alternative framework for customers of investment dealers that are direct participants of a cash-market CCP. The IIROC-CIPF regime meets the criteria for the alternate approach for CCPs serving certain domestic cash markets because:

- IIROC's requirements governing, among other things, an investment dealer's books and records, capital adequacy, internal controls, client account margining, and segregation of client securities and cash help ensure that customer positions and collateral can be identified timely,
- customers of an investment dealer are protected by CIPF, and
- through a combination of IIROC's member rules and oversight powers, CIPF's role in the administration of the bankruptcy of a dealer, and the overarching policy objectives of Part XII of the federal *Bankruptcy and Insolvency Act* (BIA) (discussed below), customer accounts can be moved from a failing dealer to another dealer in a timely manner and customers' assets can be restored.

Part XII of the BIA sets out a special bankruptcy regime for administering the insolvency of a securities firm. The regime generally provides for all cash and securities of a bankrupt securities firm, whether held for its own account and for its customers, to vest in the appointed trustee in bankruptcy. The trustee, in turn, is directed to pool such assets into a "customer pool fund" for the benefit of the customers, which are entitled to a pro rata share of the customer pool fund according to their respective "net equity" claims as a priority claim before the general creditors are paid. To the extent there is a shortfall in customer recovery from the customer pool fund and any remaining assets in the insolvent estate, the assets are allocated among the customers on a pro rata basis. CIPF, which works in conjunction with IIROC and the bankruptcy trustee,<sup>20</sup> provides protection to eligible customers for losses up to \$1 million per account.<sup>21</sup>

- *Customers of other types of participants:*

A recognized clearing agency operating as a cash market CCP for participants that are not IIROC investment dealers will need to have segregation and portability arrangements at the CCP level that meet PFMI Principle 14. Where the clearing agency is proposing to rely on an alternate approach for the purposes of protecting the customers of such participants, the clearing agency will need to demonstrate how the applicable legal or regulatory framework in which it operates achieves the same degree of protection and efficiency for such customers that would otherwise be achieved by segregation and portability arrangements at the CCP level described in PFMI Principle 14. See the PFMI Report, at paragraph 3.14.6.

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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.

<sup>17</sup> Investment dealers are firms registered in the category of "investment dealer" under provincial securities legislation. Investment dealers are required to be members of IIROC. See section 9.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

<sup>18</sup> IIROC is the national self-regulatory organization (SRO) which oversees all investment dealers and trading activity on debt and equity marketplaces in Canada. It is a recognized SRO in all 10 provinces in Canada and is subject to regulation and oversight by the CSA.

<sup>19</sup> CIPF is an investor compensation protection fund that is sponsored by IIROC and approved by the CSA.

<sup>20</sup> CIPF is a "customer compensation body" for the purposes of Part XII of the BIA. Where the accounts of a securities firm are protected (in whole or in part) by CIPF, the trustee in bankruptcy is required to consult with CIPF on the administration of the bankruptcy, and CIPF may designate an inspector to act on its behalf. See section 264 of the BIA.

<sup>21</sup> The losses must be in respect of a claim for the failure of the dealer to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property received, acquired or held by the dealer in an account for the customer.

**PART 4  
OTHER REQUIREMENTS OF  
RECOGNIZED CLEARING AGENCIES**

**Introduction**

**4.0** As discussed in section 1.2(2) of this CP, the provisions of Part 4 are in addition to the requirements of Part 3, and apply to a clearing agency whether or not it operates as a CCP, SSS or CSD.

***Division 1 – Governance:***

**Board of directors**

**4.1 (4)** Consistent with the explanatory notes in the PFMI Report (see paragraph 3.2.10), we are of the view that the following individuals have a relationship with a clearing agency that would reasonably be expected to interfere with the exercise of the individual's independent judgment:

- (a) an individual who is, or has been within the last year, an employee or executive officer of the clearing agency or any of its affiliated entities;
- (b) an individual whose immediate family member is, or has been within the last year, an executive officer of the clearing agency or any of its affiliated entities;
- (c) an individual who beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding;
- (d) an individual whose immediate family member beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding;
- (e) an individual who is, or has been within the last year, an executive officer of a person or company that beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding; and
- (f) an individual who accepts or who received within the last year, directly or indirectly, any audit, consulting, advisory or other compensatory fee from the clearing agency or any of its affiliated entities, other than as remuneration for acting in his or her capacity as a member of the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee.

For the purposes of paragraph (f) above, compensatory fees would not normally include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the clearing agency if the compensation is not contingent in any way on continued service. Also, the indirect acceptance by an individual of any audit, consulting, advisory or other compensatory fee includes acceptance of a fee by (a) an individual's immediate family member; or (b) an entity in which such individual is a partner, a member, an officer such as a managing director occupying a comparable position or an executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the clearing agency or any of its affiliated entities.

In addition, an individual appointed to the board of directors or board committee of the clearing agency or any of its affiliated entities or of a person or company referred to in paragraph (e) above would not be considered to have a material relationship with the clearing agency solely because the individual acts, or has previously acted, as a chair or vice-chair of the board of directors or a board committee.

**Documented procedures regarding risk spill-overs**

**4.2** For guidance on this provision, see the Joint Supplementary Guidance in Box 2.2 in Annex I of this CP.

**Chief Risk Officer (CRO) and Chief Compliance Officer (CCO)**

**4.3** Section 4.3 is consistent with PFMI Principle 2, key consideration 5, which requires a clearing agency to have an experienced management with a mix of skills and the integrity necessary to discharge its operations and risk management responsibilities.

**(3)** The reference to “harm to the broader financial system” in subparagraph 4.3(3)(c)(ii) may be in relation to the domestic or international financial system. The CSA is of the view that the role of a CCO may, in certain circumstances, be performed by the Chief Legal Officer or General Counsel of the clearing agency, where the individual has sufficient time to properly carry out his or her duties and, provided that there are appropriate safeguards in place to avoid conflicts of interest.

#### **Board or advisory committees**

**4.4** Section 4.4 is intended to reinforce the clearing agency’s obligations to meet the PFMI Principles, particularly PFMI Principles 2 and 3. The CSA is of the view that the mandates of the committees should, at a minimum, include the following:

- (a) providing advice and recommendations to the board of directors to assist it in fulfilling its risk management responsibilities, including reviewing and assessing the clearing agency’s risk management policies and procedures, the adequacy of the implementation of appropriate procedures to mitigate and manage such risks, and the clearing agency’s participation standards and collateral requirements;
- (b) ensuring adequate processes and controls are in place over the models used to quantify, aggregate, and manage the clearing agency’s risks;
- (c) monitoring the financial performance of the clearing agency and providing financial management oversight and direction to the business and affairs of the clearing agency;
- (d) implementing policies and processes to identify, address, and manage potential conflicts of interest of board members; and
- (e) regularly reviewing the board of directors’ and senior management’s performance and the performance of each individual member.

Section 4.4 is a minimum requirement. Consistent with the explanatory notes in the PFMI Principles (see paragraph 3.2.9), a recognized clearing agency should also consider forming other types of board committees, such as a compensation committee. All committees should have clearly assigned responsibilities and procedures. The clearing agency’s internal audit function should have sufficient resources and independence from management to provide, among other activities, a rigorous and independent assessment of the effectiveness of its risk-management and control processes. See section 4.1 for the concept of independence. A board will typically establish an audit committee to oversee the internal audit function. In addition to reporting to senior management, the audit function should have regular access to the board through an additional reporting line.

#### ***Division 2 – Default management:***

##### **Use of own capital**

**4.5** The CSA is of the view that a CCP’s own capital contribution should be used in the default waterfall, immediately after a defaulting participant’s contributions to margin and default fund resources have been exhausted, and prior to non-defaulting participants’ contributions. Such equity should be significant enough to attract senior management’s attention, and separately retained and not form part of the CCP’s resources for other purposes, such as to cover general business risk.

#### ***Division 3 – Operational risk:***

**4.6 to 4.10** Sections 4.6 to 4.10 complement PFMI Principle 17, which requires a clearing agency to identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. PFMI Principle 17 further requires that systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity, and business continuity management should aim for timely recovery of operations and fulfilment of the FMI’s obligations, including in the event of a wide-scale or major disruption.

## **Systems requirements**

**4.6 (a)** The intent of these provisions is to ensure that controls are implemented to support information technology planning, acquisition, development and maintenance, computer operations, information systems support, and security. Recognized guides as to what constitutes adequate information technology controls include 'Information Technology Control Guidelines' from the Canadian Institute of Chartered Accountants (CICA) and 'COBIT' from the IT Governance Institute.

(b) Capacity management requires that the clearing agency monitor, review, and test (including stress test) the actual capacity and performance of the system on an ongoing basis. Accordingly, under subsection 4.6(b), the clearing agency is required to meet certain standards for its estimates and for testing. These standards are consistent with prudent business practice. The activities and tests required in this subsection are to be carried out at least once a year. In practice, continuing changes in technology, risk management requirements and competitive pressures will often result in these activities being carried out or tested more frequently.

(c) A failure, malfunction or delay or other incident is considered to be "material" if the clearing agency would, in the normal course of operations, escalate the matter to or inform its senior management ultimately accountable for technology. It is also expected that, as part of this notification, the clearing agency will provide updates on the status of the failure and the resumption of service. Further, the clearing agency should have comprehensive and well-documented procedures in place to record, report, analyze, and resolve all operational incidents. In this regard, the clearing agency should undertake a "post-incident" review to identify the causes and any required improvement to the normal operations or business continuity arrangements. Such reviews should, where relevant, include the clearing agency's participants. The results of such internal reviews are required to be communicated to the securities regulatory authority as soon as practicable. Subsection 4.6(c) also refers to a material security breach. A material security breach or systems intrusion is considered to be any unauthorized entry into any of the systems that support the functions of the clearing agency or any system that shares resources with one or more of these systems. Virtually any security breach would be considered material and thus reportable to the securities regulatory authority. The onus would be on the clearing agency to document the reasons for any security breach it did not consider material.

## **Systems reviews**

**4.7 (1)** A qualified party is a person or company or a group of persons or companies with relevant experience in both information technology and in the evaluation of related internal systems or controls in a complex information technology environment. Qualified persons may include external auditors or third party information system consultants, as well as employees of the clearing agency or an affiliated entity of the clearing agency, but may not be persons responsible for the development or operation of the systems or capabilities being tested. Before engaging a qualified party, a clearing agency should discuss its choice with the regulator or, in Québec, the securities regulatory authority.

## **Clearing agency technology requirements and testing facilities**

**4.8 (1)** The technology requirements required to be disclosed under subsection 4.8(1) do not include detailed proprietary information.

(5) We expect the amended technology requirements to be disclosed as soon as practicable, either while the changes are being made or immediately after.

## **Testing of business continuity plans**

**4.9** Business continuity management is a key component of a clearing agency's operational risk-management framework. A recognized clearing agency's business continuity plan and its associated arrangements should be subject to frequent review and testing. At a minimum, under section 4.9, such tests must be conducted annually. Tests should address various scenarios that simulate wide-scale disasters and inter-site switchovers. The clearing agency's employees should be thoroughly trained to execute the business continuity plan and participants, critical service providers, and linked clearing agencies should be regularly involved in the testing and be provided with a general summary of the testing results. The CSA expects that the clearing agency will also facilitate and participate in industry-wide testing of the business continuity plan (domestically-based recognized clearing agencies are required to participate in all industry-wide business continuity tests, as determined by a regulation services provider, regulator, or in Québec, the securities regulatory authority, pursuant to National Instrument 21-101 *Marketplace Operation*). The clearing agency should make appropriate adjustments to its business continuity plan and associated arrangements based on the results of the testing exercises.



## **Outsourcing**

**4.10** Where a recognized clearing agency relies upon or outsources some of its operations to a service provider, it should generally ensure that those operations meet the same requirements they would need to meet if they were provided internally. Under section 4.10, the clearing agency must meet various requirements in respect of the outsourcing of critical services or systems to a service provider. These requirements apply regardless of whether the outsourcing arrangements are with third-party service providers, or with affiliated entities of the clearing agency.

Generally, the clearing agency is required to establish, implement, maintain and enforce policies and procedures to evaluate and approve outsourcing agreements to critical service providers. Such policies and procedures should include assessing the suitability of potential service providers and the ability of the clearing agency to continue to comply with securities legislation in the event of the service provider's bankruptcy, insolvency or termination of business. The clearing agency is also required to monitor and evaluate the on-going performance and compliance of the service provider to which they outsourced critical services, systems or facilities. Accordingly, the clearing agency should define key performance indicators that will measure the service level. Further, the clearing agency should have robust arrangements for the substitution of such providers, timely access to all necessary information, and the proper controls and monitoring tools.

Under section 4.10, a contractual relationship should be in place between the clearing agency and the critical service provider allowing it and relevant authorities to have full access to necessary information. The contract should ensure that the clearing agency's approval is mandatory before the critical service provider can itself outsource material elements of the service provided to the clearing agency, and that in the event of such an arrangement, full access to the necessary information is preserved. Clear lines of communication should be established between the outsourcing clearing agency and the critical service provider to facilitate the flow of functions and information between parties in both ordinary and exceptional circumstances.

Where the clearing agency outsources operations to critical service providers, it should disclose the nature and scope of this dependency to its participants. It should also identify the risks from its outsourcing and take appropriate actions to manage these dependencies through appropriate contractual and organisational arrangements. The clearing agency should inform the securities regulatory authority about any such dependencies and the performance of these critical service providers. To that end, the clearing agency can contractually provide for direct contacts between the critical service provider and the securities regulatory authority, contractually ensure that the securities regulatory authority can obtain specific reports from the critical service provider, or the clearing agency may provide full information to the securities regulatory authority.

### ***Division 4 – Participation requirements:***

#### **Access requirements and due process**

**4.11** Section 4.11 complements PFMI Principle 18, which requires a clearing agency to have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

**(1)(b)** We consider an indirect participant to be an entity that relies on the services provided by other entities (participants) to use a clearing agency's clearing and settlement facilities. As defined in the Instrument, a participant (sometimes also referred to as a "direct participant") is an entity that has entered into an agreement with a clearing agency to access the services of the clearing agency and is bound by the clearing agency's rules and procedures. While indirect participants are generally not bound by the rules of the clearing agency, their transactions are cleared and settled through the clearing agency in accordance with the clearing agency's rules and procedures. The concept of indirect participant is discussed in the PFMI Report, at paragraph 3.19.1.

**(1)(d)** We are of the view that a requirement on participants of a clearing agency serving the derivatives markets to use a trade repository that is an affiliated entity to report derivatives trades would be unreasonable.

**PART 5**  
**BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER**

**Legal Entity Identifiers**

**5.2 (1)** The Global Legal Entity Identifier System defined in subsection 5.2(1) and referred to in subsections 5.2(2) and 5.2(3) is a G20 endorsed system<sup>22</sup> that will serve as a public-good utility responsible for overseeing the issuance of legal entity identifiers (LEIs) globally to counterparties that enter into transactions in order to uniquely identify parties to transactions. It is currently being designed and implemented under the direction of the LEI Regulatory Oversight Committee (ROC), a governance body endorsed by the G20.

**(3)** If the Global LEI System is not available at the time a clearing agency is required to fulfill their recordkeeping or reporting requirements under securities legislation, they must use a substitute LEI. The substitute LEI must be in accordance with the standards established by the LEI ROC for pre-LEI identifiers. At the time the Global LEI System is operational, a clearing agency or its affiliated entities must cease using their substitute LEI and commence using their LEI. It is conceivable that the two identifiers could be identical.

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<sup>22</sup> See [http://www.financialstabilityboard.org/list/fsb\\_publications/tid\\_156/index.htm](http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm) for more information.

## **PART 6 EXEMPTIONS**

### **Exemptions**

**6.1** As Part 3 adopts a principles-based approach to incorporating the PFMI Principles into the Instrument, the CSA has sought to minimize any substantive duplication or material inefficiency due to cross-border regulation. Where a recognized foreign-based clearing agency does face some conflict or inconsistency between the requirements of sections 2.2 and 2.5 and Part 4 and the requirements of the regulatory regime in its home jurisdiction, the clearing agency is expected to comply with the Instrument. However, where such a conflict or inconsistency causes a hardship for the clearing agency, and provided that the entity is subject to requirements in its home jurisdiction resulting in similar outcomes in substance to the requirements of sections 2.2 and 2.5 and Part 4, an exemption from a provision of the Instrument may be considered by a securities regulatory authority. The exemption may be subject to appropriate terms or conditions.

## Annex I

### to Companion Policy 24-102CP

#### Joint Supplementary Guidance

Developed by the Bank of Canada and Canadian Securities Administrators

#### - **PFMI Principle 2: Governance**

##### **Box 2.1: Joint Supplementary Guidance – Financial Stability and Other Public Interest Considerations**

###### **Context**

The PFMI's define governance as the set of relationships between an FMI's owners, board of directors (or equivalent), management, and other relevant parties, including participants, authorities, and other stakeholders (such as participants' customers, other interdependent FMIs, and the broader market). Governance provides the processes through which an organization sets its objectives, determines the means for achieving those objectives, and monitors performance against those objectives. This note provides supplementary regulatory guidance for Canadian FMIs on their governance arrangements as it relates to supporting relevant public interest considerations.

###### **Public interest considerations in the context of the PFMI's**

The PFMI's indicate that FMIs should "explicitly support financial stability and other relevant public interests." However, there may be circumstances where providing explicit support of relevant public interests conflict with other FMI objectives and therefore require appropriate prioritization and balancing. For example, addressing the potential trade-offs between protecting the participants and the FMI while ensuring the financial stability interests are upheld.

###### **Guidance within the PFMI's**

The following text has been extracted directly from the PFMI's. The pertinent information is in bold italics.

PFMI paragraph 3.2.2:

***Given the importance of FMIs and the fact that their decisions can have widespread impact, affecting multiple financial institutions, markets, and jurisdictions, it is essential for each FMI to place a high priority on the safety and efficiency of its operations and explicitly support financial stability and other relevant public interests. Supporting the public interest is a broad concept that includes, for example, fostering fair and efficient markets. For example, in certain over the counter derivatives markets, industry standards and market protocols have been developed to increase certainty, transparency, and stability in the market. If a CCP in such markets were to diverge from these practices, it could, in some cases, undermine the market's efforts to develop common processes to help reduce uncertainty. An FMI's governance arrangements should also include appropriate consideration of the interests of participants, participants' customers, relevant authorities, and other stakeholders. (...) For all types of FMIs, governance arrangements should provide for fair and open access (see Principle 18 on access and participation requirements) and for effective implementation of recovery or wind-down plans, or resolution.***

PFMI paragraph 3.2.8:

***An FMI's board has multiple roles and responsibilities that should be clearly specified. These roles and responsibilities should include (a) establishing clear strategic aims for the entity; (b) ensuring effective monitoring of senior management (including selecting its senior managers, setting their objectives, evaluating their performance, and, where appropriate, removing them); (c) establishing appropriate compensation policies (which should be consistent with best practices and based on long-term achievements, in particular, the safety and efficiency of the FMI); (d) establishing and overseeing the risk-management function and material risk decisions; (e) overseeing internal control functions (including ensuring independence and adequate resources); (f) ensuring compliance with all supervisory and oversight requirements; (g) ensuring consideration of financial stability and other relevant***

*public interests; and (h) providing accountability to the owners, participants, and other relevant stakeholders.*

The CPMI-IOSCO PFMI Disclosure framework and Assessment methodology provides questions to guide the assessment of the FMI against the PFMI. Questions related to public interest considerations are focused on ensuring that the FMI's objectives are clearly defined, giving a high priority to safety, financial stability and efficiency while also ensuring all other public interest considerations are identified and reflected in the FMI's objectives.

### **Supplementary Guidance for designated Canadian FMIs**

By definition the PFMI apply to systemically important FMIs, so safety and financial stability objectives should be given a high priority.

Efficiency is also a high priority that should contribute to (but not supersede) the safety and financial stability objectives.

Other public interest considerations such as competition and fair and open access should also be considered in the broader safety and financial stability context.

A framework (objectives, policies and procedures) should be in place for default and other emergency situations. The framework should articulate explicit principles to ensure financial stability and other relevant public interests are considered as part of the decision making process. For example, it should provide guidance on discretionary management decisions, consider the trade-offs between protecting the participants and the FMI while also ensuring the financial stability interests are upheld, and articulate a communication protocol with the board and regulators.

Practical questions/approaches to assessing the appropriateness of the framework include:

- Does the enabling legislation, articles of incorporation, corporate by-laws, corporate mission, vision statements, corporate risk statements/frameworks/methodology clearly articulate the objectives and are they appropriately aligned and communicated (transparent)?
- Do the objectives give appropriate priority to safety, financial stability, efficiency and other public interest considerations?
- Does the Board structure ensure the right mix of skills/experience and interests are in place to ensure the objectives are clear, appropriately prioritized, achieved and measured?
- What is the training provided to the Board and management to support the objectives?
- Do the service offerings and business plans support the objectives?
- Do the system design, rules, procedures support the objectives?
- Are the inter-dependencies and key dependencies considered and managed in the context of the broader financial stability objectives? For instance, do problem and default management policies and procedures appropriately provide for consideration of the broader financial stability interests and do they engage the key stakeholders and regulators?
- Are there procedures in place to get timely engagement of the Board to discuss emerging/current issues, consider scenarios, provide guidance and make decision?
- Does the framework ensure that the broader financial stability issues are considered in any actions relating to a participant suspension?

### **Box 2.2: Joint Supplementary Guidance— Vertically and Horizontally Integrated FMIs**

#### **Context**

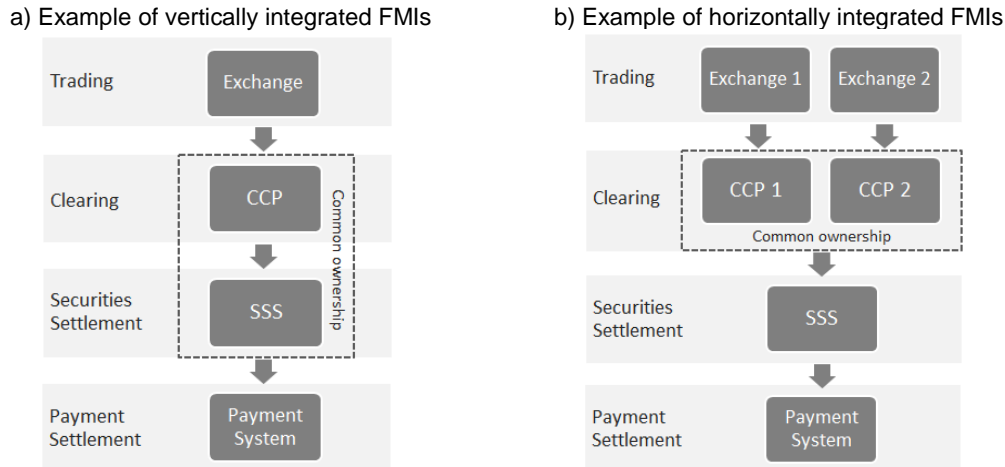
Consolidation, or integration, of FMI services may bring about benefits for merging FMIs; however it may also create new governance challenges. The PFMI contain some general guidance regarding how FMIs should manage governance issues that arise in integrated entities. This note provides supplementary regulatory guidance for Canadian FMIs that either belong to an integrated entity or are considering consolidating with another entity to form one. The guidance applies to both vertically and horizontally integrated entities.

#### **Vertical and horizontal integration in the context of FMIs**

The PFMI define a vertically integrated FMI group as one that brings together post-trade infrastructure providers under common ownership with providers of other parts of the value chain (for example, one entity owning and operating an exchange, CCP and SSS) and a horizontally integrated group as one that provides the same post-trade service offerings across a number of different products (for example, one entity offering

CCP services for derivatives and cash markets).<sup>23</sup> Examples are shown in Figure 1.

**Figure 1: Examples of FMI integration in the value chain**



### Guidance within the PFMI

The following text has been extracted directly from the PFMI. The pertinent information is in bold italics.

PFMI paragraph 3.2.5:

*Depending on its ownership structure and organisational form, an FMI may need to focus particular attention on certain aspects of its governance arrangements. **An FMI that is part of a larger organisation, for example, should place particular emphasis on the clarity of its governance arrangements, including in relation to any conflicts of interests and outsourcing issues that may arise because of the parent or other affiliated organisation’s structure. The FMI’s governance arrangements should also be adequate to ensure that decisions of affiliated organisations are not detrimental to the FMI.**<sup>24</sup> An FMI that is, or is part of, a for-profit entity may need to place particular emphasis on managing any conflicts between income generation and safety.*

PFMI paragraph 3.2.6:

*An FMI may also need to focus particular attention on certain aspects of its risk-management arrangements as a result of its ownership structure or organisational form. **If an FMI provides services that present a distinct risk profile from, and potentially pose significant additional risks to, its payment, clearing, settlement, or recording function, the FMI needs to manage those additional risks adequately. This may include separating the additional services that the FMI provides from its payment, clearing, settlement, and recording function legally, or taking equivalent action.** The ownership structure and organisational form may also need to be considered in the preparation and implementation of the FMI’s recovery or wind-down plans or in assessments of the FMI’s resolvability.*

### Supplementary guidance for designated Canadian FMIs

An FMI that is part of a larger entity faces additional risk considerations compared to stand-alone FMIs. While there are potential benefits from integrating services into one large entity, including potential risk reduction benefits, integrated entities could face additional risks such as a greater degree of general business risk. Examples of how this could occur include the following:

- losses in one function may spill-over to the entity’s other functions;
- the consolidated entity may face high combined exposures across its functions; and

<sup>23</sup> CPMI-IOSCO 2010. “Market structure developments in the clearing industry: implications for financial stability.” CPMI-IOSCO Paper No 92. Available at: <http://www.bis.org/publ/cpss92.htm>.

<sup>24</sup> If an FMI is wholly owned or controlled by another entity, authorities should also review the governance arrangements of that entity to see that they do not have adverse effects on the FMI’s observance of this principle.

- the consolidated entity may face exposures to the same participants across its functions.

For a more extensive discussion of potentially heightened risks that integrated FMIs may face, see CPMI, “Market structure developments in the clearing industry: implications for financial stability” (2010).<sup>25</sup>

If an FMI belongs to a larger entity, or is considering consolidating with another entity, it should consider how its risk profile differs as part of the consolidated entity, and take appropriate measures to mitigate these risks.

In addition, FMIs that either belong to an integrated entity or are considering merging to form one should meet the following conditions.

### 1) Measures to protect critical FMI functions

- FMIs may be part of a larger consolidated entity. These FMIs must either:
  - legally separate FMI-related functions<sup>26</sup> from non-FMI-related functions performed by the consolidated entity in order to maximize bankruptcy remoteness of the FMI-related functions; or
  - have satisfactory policies and procedures in place to manage additional risks resulting from the non-FMI-related functions appropriately to ensure the FMI’s financial and operational viability.
- If an FMI performs multiple FMI-related functions with distinct risk profiles within the same entity, the operator should effectively manage the additional risks that may result. The FMI should hold sufficient financial resources to manage the risks in all services it offers, including the combined or compounded risks that would be associated with offering the services through a single legal entity. If the FMI provides multiple services, it should disclose information about the risks of the combined services to existing and prospective participants to give an accurate understanding of the risks they incur by participating in the FMI. The FMI should carefully consider the benefits of offering critical services with distinct risk profiles through separate legal entities.
- If an FMI offers CCP services as part of its FMI-related functions, further conditions apply. CCPs take on more risk than other FMIs, and are inherently at higher risk of failure. Therefore, the FMI must either legally separate its CCP functions from other critical (non-CCP) FMI-related functions, or have satisfactory policies and procedures in place to manage additional risks appropriately to ensure the FMI’s financial and operational viability.
- Legal separation of critical functions is intended to maximize their bankruptcy remoteness and would not necessarily preclude integration of common organizational management activities such as IT and legal services across functions as long as any related risks are appropriately identified and mitigated.

### 2) Independence of governance and risk management

- FMIs and non-FMIs may have different corporate objectives and risk management appetites which could conflict at the parent level. For example, non-FMI-related functions, such as trading venues, are generally more focused on profit generation than risk management and do not have the same risk profile as FMI-related functions. A trading venue in a vertically integrated entity may benefit from increased participation in its service if its associated clearing function lessens its participation requirements.
- To mitigate potential conflicts, in particular the ability of other functions to negatively influence the FMI’s risk controls, each FMI subsidiary should have a governance structure and risk management decision-making process that is separate and independent from the other functions and should maintain an appropriate level of autonomy from the parent and other functions to ensure efficient decision making and effective management of any potential conflicts of interest. In addition, the consolidated entity’s broad governance arrangements should be reviewed to ensure they do not impede the FMI-related function’s observance of the CPMI-IOSCO principle on governance.

### 3) Comprehensive management of risks

- Although risk management governance and decision-making should remain independent, it is

<sup>25</sup> Available at <http://www.bis.org/cpmi/publ/d92.pdf>.

<sup>26</sup> FMI-related functions are CCP, SSS, and CSD functions, including other core aspects of clearing and settlement necessary to perform the CCP, SSS, and CDS functions (see the CPMI-IOSCO glossary definitions of “clearing” and “settlement”, available at <http://www.bis.org/cpmi/publ/d00b.pdf>).

nonetheless necessary that the consolidated entity is able to manage risk appropriately across the entity. At a consolidated level, the entity should have an appropriate risk management framework that considers the risks of each subsidiary and the additional risks related to their interdependencies.

- An FMI should identify and manage the risks it bears from and poses to other entities as a result of interdependencies. Consolidated FMIs should also identify and manage the risks they pose to one another as a result of their interdependencies. Consolidated FMIs may have exposures to the same participants, liquidity providers, and other critical service providers across products, markets and/or functions. This may increase the entity's dependence on these providers and may heighten the systemic risk associated with the consolidated entity compared to a stand-alone FMI. Where possible, the consolidated entity and its FMIs should consider ways to mitigate risks arising from shared dependencies. The consolidated entity and its FMIs should also consider conducting entity-wide operational risk testing related to identifying and mitigating these risks.

#### 4) Sufficient capital to cover potential losses

- Consolidated entities face the risk that a single participant defaults in more than one subsidiary simultaneously. This could result in substantial losses for the consolidated entity which will then also need to replenish resources for the FMIs to continue to operate. FMIs should consider such risks in developing their resource replenishment plan.
- Consolidated entities may face higher or lower business risk than individual FMIs depending on size, complexity and diversification across affiliates. Consolidated entities should consider these impacts in their general business risk profiles and in determining the appropriate level of liquid assets needed to cover their potential general business losses.<sup>27</sup>

#### - PFMI Principle 5: Collateral

##### Box 5.1: Joint Supplementary Guidance – Collateral

#### Context

The PFMI establish the form and attributes of collateral that an FMI holds to manage its own credit exposures or those of its participants. This note provides additional guidance for Canadian FMIs to meet the components of the collateral principle related to: (i) acceptance of collateral with low credit, liquidity and market risk; (ii) concentrated holdings of certain assets; and (iii) calculating haircuts. In certain circumstances, regulators may allow exceptions to the collateral policy on a case-by-case basis if the FMI demonstrates that the risks can be adequately managed.

#### (i) Acceptable collateral

An FMI should conduct its own assessment of risks when determining collateral eligibility. In general, collateral held to manage the credit exposures of the FMI or those of its participants should have minimal credit, liquidity and market risk, even in stressed market conditions. However, asset categories with additional risk may be accepted when subject to conservative haircuts and adequate concentration limits.<sup>28</sup>

The following clarifies regulators' expectations on what is acceptable collateral by specifying:

- 1) minimum requirements for all assets that are acceptable as collateral;
- 2) the asset categories that are judged to have minimal credit, liquidity and market risk; and
- 3) additional asset categories that could be acceptable as collateral if subject to conservative haircuts and concentration limits.

- 1) An FMI should conduct its own internal assessment of the credit, liquidity and market risk of the assets eligible as collateral. The FMI should review its collateral policy at least annually, and whenever market factors justify a more frequent review. At a minimum, acceptable assets should:**

- i) be freely transferable without legal, regulatory, contractual or any other**

<sup>27</sup> Liquid assets held for general business losses must be funded by equity (such as common stock, disclosed reserves, or retained earnings) rather than debt.

<sup>28</sup> See PFMI Principle 5, key considerations 1 and 4.



- ii) **constraints that would impair liquidation in a default; be marketable securities that have an active outright sale market even in stressed market conditions;**
- iii) **have reliable price data published on a regular basis;**
- iv) **be settled over a securities settlement system compliant with the Principles; and**
- v) **be denominated in the same currency as the credit exposures being managed, or in a currency that the FMI can demonstrate it has the ability to manage.**

An FMI should not rely only on external opinions to determine what acceptable collateral is. The FMI should conduct its own assessment of the riskiness of assets, including differences within a particular asset category, to determine whether the risks are acceptable. Since the primary purpose of accepting collateral is to manage the credit exposures of the FMI and its participants, it is paramount that assets eligible as collateral can be liquidated for fair value within a reasonable time frame to cover credit losses following a default. The annual review of the FMI's collateral policy provides an opportunity to assess whether risks continue to be adequately managed. Owing to the dynamic nature of capital markets, the FMI should monitor changes in the underlying risk of the specific assets accepted as collateral, and should adjust its collateral policy in the interim period between annual reviews, when required.

At a minimum, an asset should have certain characteristics in order to provide sufficient assurance that it can be liquidated for fair value within a reasonable time frame. These characteristics relate primarily to the FMI's ability to reliably sell the asset as required to manage its credit exposures. The asset should be unencumbered, that is, it must be free of legal, regulatory, contractual or other restrictions that would impede the FMI's ability to sell it. The challenges associated with selling or transferring non-marketable assets, or those without an active secondary market, preclude their acceptance as collateral.

**2) Assets generally judged to have minimal credit, liquidity and market risk are the following:**

- i) **cash;**
- ii) **securities issued or guaranteed by the Government of Canada;<sup>29</sup>**
- iii) **securities issued or guaranteed by a provincial government; and**
- iv) **securities issued by the U.S. Treasury.**

In general, the assets judged to have minimal risk are cash and debt securities issued by government entities with unique powers, such as the ability to raise taxes and set laws, and that have a low probability of default. Total Canadian debt outstanding is currently dominated by securities issued or guaranteed by the Government of Canada and by provincial governments. The relatively large supply of securities issued by these entities and their generally high creditworthiness contribute to the liquidity of these assets in the domestic capital market. Securities issued by the U.S. Treasury are also deemed to be of high quality for the same reasons. The overall riskiness of securities issued by the Government of Canada and the U.S. Treasury is further reduced by their previous record of maintaining value in stressed market conditions, when they tend to benefit from a "flight to safety."

It is essential that an FMI regularly assesses the riskiness of even the specific high-quality assets identified in this section to determine their adequacy as eligible collateral. In some cases, only certain assets within the more general asset category may be deemed acceptable.

**3) An FMI should consider its own distinct arrangements for allocating credit losses and managing credit exposures when accepting a broader range of assets as collateral. The following asset classes may be acceptable as collateral if they are subject to conservative haircuts and concentration limits:**

- i) **securities issued by a municipal government;**
- ii) **bankers' acceptances;**
- iii) **commercial paper;**
- iv) **corporate bonds;**
- v) **asset-backed securities that meet the following criteria: (1) sponsored by**

<sup>29</sup> Guarantees include securities issued by federal and provincial Crown corporations or other entities with an explicit statement that debt issued by the entity represents the general obligations of the sovereign.

- vi) **a deposit-taking financial institution that is prudentially regulated at either the federal or provincial level, (2) part of a securitization program supported by a liquidity facility , and (3) backed by assets of an acceptable credit quality;**
- vii) **equity securities traded on marketplaces regulated by a member of the CSA and the Investment Industry Regulatory Organization of Canada; and other securities issued or guaranteed by a government, central bank or supranational institution classified as Level 1 high-quality assets by the Basel Committee on Banking Supervision.**

An FMI should take into account its specific risk profile when assessing whether accepting certain assets as collateral would be appropriate. The decision to broaden the range of acceptable collateral should also consider the size of collateral holdings to cover the credit exposures of the FMI relative to the size of asset markets. In cases where the total collateral required to cover credit exposures is small compared with the market for high-quality assets, there is less potential strain on participants to meet collateral requirements.

Accepting a broader range of collateral has certain advantages. Most importantly, it provides participants with more flexibility to meet the FMI's collateral requirements, which may be especially important in stressed market conditions. A broader range of collateral diversifies the risk exposures faced by the FMI, since it may be easier to liquidate diversified collateral holdings when liquidity unexpectedly dries up for a particular asset class. It also diversifies market risk by reducing potential exposure to idiosyncratic shocks. Accepting a broader range of assets recognizes the increased cost to market participants of posting only the highest-quality assets, as well as the increasing encumbrance of these assets in order to meet new regulatory standards.<sup>30</sup>

## **(ii) Concentration Limits**

An FMI should avoid concentrated holding of assets where this could potentially introduce credit, market and liquidity risk beyond acceptable levels. In addition, the FMI should mitigate specific wrong-way risk by limiting the acceptance of collateral that would likely lose value in the event of a participant default, and prevent participants from posting assets they or their affiliates have issued. The FMI should measure and monitor the collateral posted by participants on a regular basis, with more frequent analysis required when more flexible collateral policies have been implemented.<sup>31</sup>

The following points clarify regulators' expectations regarding the composition of collateral accepted by an FMI by specifying:

- 1) broad limits for riskier asset classes to mitigate concentration risk;
  - 2) targeted limits for securities issued by financial sector entities to mitigate specific wrong-way risk; and
  - 3) the level of monitoring required for collateral posted by participants.
- 1) An FMI should limit assets from the broader range of acceptable assets identified in section (i)3 to a maximum of 40 per cent of the total collateral posted from each participant. Within the broader range of acceptable assets, the FMI should consider implementing more specific concentration limits for different asset categories.**

**An FMI should limit securities issued by a single issuer from the broader range of acceptable assets to a maximum of 5 per cent of total collateral from each participant.**

The guidance limits the acceptance of collateral from the broader range of assets to a maximum of 40 per cent because a higher proportion could potentially create unacceptable risks to FMIs and their participants. This limit is currently applied to the Bank's Standing Liquidity Facility and the Liquidity Coverage Ratio under Basel III. The benefits of expanding collateral—namely, providing participants with more flexibility and achieving greater diversification—are achieved within the limit of 40 per cent, with collateral in excess of this limit increasing the overall risk exposures with less benefit. In some circumstances, regulators may permit an FMI to accept more than 40 per cent of total collateral from the broader range of assets if the risk from a particular participant is low. Employing a limit of 5 per cent of total collateral for securities issued by a single issuer is a prudent measure to limit exposures from idiosyncratic shocks. It also reduces the need for procyclical

<sup>30</sup> The encumbrance of high-quality assets is expected to increase through a number of regulatory reforms, including Basel III, over-the-counter derivatives reform and the Principles.

<sup>31</sup> See Principle 5, key considerations 1 and 4.

adjustments to collateral requirements following a decline in value.

An FMI should consider implementing more stringent concentration limits, as well as imposing limits on certain asset categories, depending on the FMI's specific arrangements for managing credit exposures. The considerations described in section (i) 3) for accepting a broader range of assets as collateral apply equally to the decision over whether more stringent concentration limits should be implemented.

**2) An FMI should limit the collateral from financial sector issuers to a maximum of 10 per cent of total collateral pledged from each participant. The FMI should not allow participants to post their own securities or those of their affiliates as collateral.**

An FMI is exposed to specific wrong-way risk when the collateral posted is highly likely to decrease in value following a participant default. It is highly likely that the value of debt and equity securities issued by companies in the financial sector would be adversely affected by the default of an FMI participant, introducing wrong-way risk. This is especially the case for interconnected FMI participants with activities that are concentrated in domestic financial markets. Implementing a limit on financial sector issuers mitigates potential risk exposures from specific wrong-way risk. More stringent limits should be implemented where appropriate.

**3) In cases where only the highest-quality assets are accepted, an FMI is required to measure and monitor the collateral posted by participants during periodic evaluations of participant creditworthiness. The FMI should measure and monitor the correlation between a participant's creditworthiness and the collateral posted more frequently when a broader range of collateral is accepted. The FMI should have the ability to adjust the composition and to increase the collateral required from participants experiencing a reduction in creditworthiness.**

When only the highest-quality assets are accepted as collateral, there is less risk associated with the composition of collateral posted by a participant; hence, such risk does not need to be monitored as closely. The FMI should monitor the composition of collateral pledged by participants more frequently when riskier assets are eligible, since such assets are more likely to be correlated with the participant's creditworthiness. FMIs should also consider the general credit risk of their participants when deciding how frequently monitoring should be conducted. In all circumstances, the FMI should have the contractual and legal ability to unilaterally require more collateral and to request higher-quality collateral from a participant that is judged to present a greater risk.

**(iii) Haircuts**

An FMI should establish stable and conservative haircuts that consider all aspects of the risks associated with the collateral. An FMI should evaluate the performance of haircuts by conducting backtesting and stress testing on a regular basis.<sup>32</sup>

The following points clarify regulators' expectations regarding the calculation and testing of haircuts by outlining:

- 1) requirements for calculating haircuts; and
  - 2) requirements for testing the adequacy of haircuts and overall collateral accepted.
- 1) An FMI should apply stable and conservative haircuts that are calibrated against stressed market conditions. When the same haircut is applied to a group of securities, it should be sufficient to cover the riskiest security within the group. Haircuts should reflect both the specific risks of the collateral accepted and the general risks of an FMI's collateral policy.**

Including periods of stressed market conditions in the calibration of haircuts should increase the haircut rate. In addition to representing a conservative approach, this helps to mitigate the risk of a procyclical increase in haircuts during a period of high volatility. Typically, FMIs group similar securities by shared characteristics for the purposes of calculating haircuts (e.g., Government of Canada bonds with similar maturities). An FMI should recognize the different risks associated with each individual security by ensuring that the haircut is sufficient to cover the security with the most risk within each group. Haircuts should always account for all of the specific risks associated with each asset accepted as collateral. However, the FMI should also consider the portfolio risk of the

<sup>32</sup> See PFMI Principle 5, key considerations 2 and 3.

total collateral posted by a participant; the FMI may consider employing deeper haircuts for concentration and wrong-way risk above certain thresholds.

- 2) An FMI should perform backtesting of its collateral haircuts on at least a monthly basis, and conduct a more thorough review of haircuts quarterly. The FMI's stress tests should take into account the collateral posted by participants.**

FMI's are expected to calculate stable and conservative haircuts by considering stressed market conditions. In general, including stressed market conditions in the calibration of haircuts should provide a high level of coverage that does not require continuous testing and verification. Nonetheless, backtesting on a monthly basis allow the adequacy of haircuts to be evaluated against observed outcomes. A quarterly review of haircuts balances the objective of stable haircuts with the need to adjust haircuts as required. Including changes to collateral values as part of stress testing provides a more accurate assessment of potential losses in a default scenario.

- **PFMI Principle 7: Liquidity risk**

**Box 7.1:  
Joint Supplementary Guidance –  
Liquidity Risk**

**Context**

The PFMI's define liquidity risk as risk that arises when the FMI, its participants or other entities cannot settle their payment obligations when due as part of the clearing or settlement process. This note provides additional guidance for Canadian FMI's to meet the components of the liquidity-risk principle related to: (i) maintaining sufficient liquid resources and (ii) qualifying liquid resources.

**(i) Maintaining sufficient liquid resources**

An FMI should maintain sufficient qualifying liquid resources to cover its liquidity exposures to participants with a high degree of confidence. An FMI should maintain additional liquid resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible conditions. Liquidity stress testing should be performed on a daily basis. An FMI should verify that its liquid resources are sufficient through comprehensive stress testing conducted at least monthly.<sup>33</sup>

The information provided in this section clarifies regulators' expectations of sufficient qualifying liquid resources by specifying:

- 1) the degree of confidence required to cover liquidity exposures;
- 2) the total liquid resources that should be maintained; and
- 3) how the FMI should verify that its liquid resources are sufficient and adjust liquid resources when necessary.

- 1) Qualifying liquid resources should meet an established single-tailed confidence level of at least 97 per cent with respect to the estimated distribution of potential liquidity exposures.<sup>34</sup> The FMI should have an appropriate method for estimating potential exposures that accounts for the design of the FMI and other relevant risk factors.**

The guidance requires a high threshold for covering liquidity exposures with qualifying liquid resources, while also considering the expense associated with obtaining these resources. A 97 per cent degree of confidence is equivalent to less than one observation per month (on average) in which a liquidity exposure is greater than the FMI's qualifying liquid resources. However, if it is to meet the required threshold, the FMI should estimate its potential liquidity exposures accurately. The FMI should account for all relevant predictive factors when estimating potential exposures. While historical exposures are expected to form the basis of estimated potential exposures, the FMI should account for the impact of new products, additional participants,

<sup>33</sup> See PFMI Principle 7, key considerations 3, 5, 6 and 9.

<sup>34</sup> A "potential liquidity exposure" is defined as the estimated maximum daily liquidity needs resulting from the market value of the FMI's payment obligations under normal business conditions. FMI's should consider potential liquidity exposures over a rolling one-year time frame.

changes in the way transactions settle or other relevant market- risk factors.

**2a) An FMI should maintain additional liquid resources that are sufficient to cover a wide range of potential**

**stress scenarios. Total liquid resources should cover the FMI's largest potential exposure under a variety of extreme but plausible conditions. The FMI should have a liquidity plan that justifies the use of other liquid resources and provides the supporting rationale for the total liquid resources that it maintains.**

The guidance requires that total liquid resources be determined by the largest potential exposure in extreme but plausible conditions. This implies maintaining total liquid resources sufficient to cover at least the FMI's largest observed liquidity exposures, but the liquidity resources would likely be larger, based on an assessment of potential liquidity exposures in extreme but plausible conditions. The FMI's liquidity plan should explain why the FMI's estimated largest potential exposure is an accurate assessment of the FMI's liquidity needs in extreme but plausible conditions, thereby demonstrating the adequacy of the FMI's total liquid resources.

It is permissible for an FMI to manage this risk in part with other liquid resources because it may be prohibitively expensive, or even impossible, for the FMI to obtain sufficient qualifying liquid resources. FMIs face increased risk from liquid resources that do not meet the strict definition of "qualifying," and thus an FMI should include in its liquidity plan a clear explanation of how these resources could be used to satisfy a liquidity obligation. This additional explanation is warranted in all cases, even when the FMI's dependence on other liquid resources is minimal.

**2b) When applicable, the possibility that a defaulting participant is also a liquidity provider should be taken into account.**

Generally, the liquidity providers for Canadian FMIs are also participants in the FMI. When a defaulting participant is also a liquidity provider, it is important that the FMI's liquidity facilities are arranged in such a way that it has sufficient liquidity. To do so, the FMI should either have additional liquid resources or negotiate a backup liquidity provider, so that the FMI has sufficient liquidity (as specified in this guidance) in the event that one of its liquidity providers defaults.

**3) FMIs should perform liquidity stress testing on a daily basis to assess their liquidity needs. At least**

**monthly, FMIs should conduct comprehensive stress tests to verify the adequacy of their total liquid resources and to serve as a tool for informing risk management. Stress-testing results should be reviewed by the FMI's risk-management committee and reported to regulators on a regular basis.**

**FMIs should have clear procedures to determine whether their liquid resources are sufficient and to adjust their available liquid resources when necessary. A full review and potential resizing of liquid resources should be completed at least annually.**

**The annual validation of an FMI's model for managing liquidity risk should determine whether its stress testing follows best practices and captures the potential risks faced by the FMI.**

FMIs should assess their liquidity needs through stress testing that includes the measurement of the largest daily liquidity exposure that they face. FMIs should also conduct stress testing to verify whether their liquid resources are sufficient to cover potential liquidity exposures under a wide range of stress scenarios. An annual full review and potential resizing of liquid resources provides adequate time to negotiate with liquidity providers. While it may be impractical for FMIs to frequently obtain additional liquid resources, it is important that FMIs clearly define the circumstances requiring prompt adjustment of their available liquid resources, and have a reliable plan for doing so. Establishing clear procedures provides transparency regarding an FMI's decision-making process and prevents the FMI from delaying required increases in liquid resources beyond what is reasonably acceptable. The review of stress- testing results by the FMI's risk-management committee provides additional assurance that liquid resources are sufficient, and whether an interim resizing is necessary. Reporting results to regulators on a monthly basis allows for timely intervention if liquid resources have been deemed inadequate.

Comprehensive stress testing should also encompass a broad range of stress scenarios, not just to verify whether the FMI's liquid resources are sufficient, but also to identify potential risk factors. Reverse stress testing, more extreme stress scenarios, valuation of liquid assets and focusing on

individual risk factors (e.g., available collateral) all help to inform the FMI of potential risks. The annual validation of the FMI's risk-management model enables it to fully assess the appropriateness of the stress scenarios conducted and the procedures for adjusting liquid resources.

## **(ii) Qualifying liquid resources**

Qualifying liquid resources should be highly reliable and have same-day availability. Liquid resources are reliable when the FMI has near certainty that the resources it expects will be available when required. Qualifying liquid resources should be available on the same day that they are needed by the FMI to meet any immediate liquidity obligation (e.g., a participant's default). Qualifying liquid resources that are denominated in the same currency as the FMI's exposures count toward its minimum liquid-resource requirement.<sup>35</sup>

The following section clarifies regulators' expectations as to what is considered a qualifying liquid resource by:

- 1) identifying the assets in the possession, custody or control of the FMI that are considered qualifying liquid resources; and
- 2) setting clear standards for liquidity facilities to be considered qualifying liquid resources, including more-stringent standards for uncommitted liquidity facilities.

### **1) Cash and treasury bills<sup>36</sup> in the possession, custody or control of an FMI are qualifying liquid resources for liquidity exposures denominated in the same currency.<sup>37</sup>**

Cash held by an FMI does not fluctuate in value and can be used immediately to meet a liquidity obligation, thereby satisfying the criteria for liquid resources to be highly reliable and available on the same day.<sup>38</sup> Treasury bills issued by the Government of Canada or the U.S. Treasury also meet the definition of a qualifying liquid resource. By market convention, sales of treasury bills settle on the same day, allowing funds to be obtained immediately, whereas other bonds can settle as late as three days after the date of the trade. Treasury bills can also be transacted in larger sizes with less market impact than most other bonds. In addition, the shorter-term nature of treasury bills makes them more liquid than other securities during a crisis (i.e., they benefit from a "flight to liquidity"). Thus, there is a high degree of certainty that the FMI would obtain liquid resources in the amount expected following the sale of treasury bills.

### **2a) Committed liquidity facilities are qualifying liquid resources for liquidity exposures denominated in the same currency if the following criteria are met:**

- i) **facilities are pre-arranged and fully collateralized;**
- ii) **there is a minimum of three independent liquidity providers;<sup>39</sup> and**
- iii) **the FMI conducts a level of due diligence that is as stringent as the risk assessment completed for FMI participants.**

For liquidity facilities to be considered reliable, an FMI should have near certainty that the liquidity provider will honour its obligation. Pre-arranged liquidity facilities provide clarity on terms and conditions, allowing greater certainty regarding the obligations and risks of the liquidity providers. Pre-arranged facilities also reduce complications associated with obtaining liquidity, when required. Furthermore, a liquidity provider is most likely to honour its obligations when lending is fully collateralized. Therefore, only the amount that is collateralized will be considered a qualifying liquid resource. A liquidity facility is more reliable when the risk of non-performance is not concentrated in a single institution. By having at least three independent liquidity providers, the FMI would continue to diversify its risks should even a single provider default. To monitor the continued reliability of a liquidity facility, the FMI should assess its liquidity providers on an

<sup>35</sup> See PFMI Principle 7, key considerations 4, 5 and 6

<sup>36</sup> "Treasury bills" refers to bonds issued by the Government of Canada and the U.S. Treasury with a maturity of one year or less.

<sup>37</sup> This section refers to unencumbered assets free of legal, regulatory, contractual or other restrictions on the ability of the FMI to liquidate, sell, transfer or assign the asset.

<sup>38</sup> "Cash" refers to currency deposits held at the issuing central bank and at creditworthy commercial banks.

"Value" in this context refers to the nominal value of the currency.

<sup>39</sup> The Liquidity providers should not be affiliates to be considered independent.

ongoing basis. In this respect, an FMI's risk exposures to its liquidity providers are similar to the risks posed to it by its participants. Therefore, it is appropriate for the FMI to conduct comparable evaluations of the financial health of its liquidity providers to ensure that the providers have the capacity to perform as expected.

**2b) Uncommitted liquidity facilities are considered qualifying liquid resources for liquidity exposures in**

**Canadian dollars if they meet the following additional criteria:**

- i) the liquidity provider has access to the Bank of Canada's Standing Liquidity Facility (SLF);**
- ii) the facility is fully collateralized with SLF-eligible collateral; and**
- iii) the facility is denominated in Canadian dollars.**

More-stringent standards are warranted for uncommitted facilities because a liquidity provider's incentives to honour its obligations are weaker. However, the risk that the liquidity provider will be unwilling or unable to provide liquidity is reduced by the requirement that it needs to be a direct participant in the Large Value Transfer System and that the collateral be eligible for the Standing Liquidity Facility (SLF). This is because the collateral obtained from the FMI in exchange for liquidity can be pledged to the Bank of Canada under the SLF. This option significantly reduces the liquidity pressures faced by the liquidity provider that could interfere with its ability to perform on its obligations. A facility in a foreign currency would not qualify because the Bank does not lend in currencies other than the Canadian dollar. The increased reliability of liquidity providers with access to routine credit from the central bank is recognized explicitly within the PFMI's.

**- PFMI Principle 15: General business risk**

**Box 15.1:  
Joint Supplementary Guidance –  
General Business Risk**

**Context**

The PFMI's define general business risk as any potential impairment of the financial condition (as a business concern) of an FMI owing to declines in its revenue or growth in its expenses, resulting in expenses exceeding revenues and a loss that must be charged against capital. These risks arise from an FMI's administration and operation as a business enterprise. They are not related to participant default and are not covered separately by financial resources under the Credit or Liquidity Risk Principles. To manage these risks, the PFMI's state that FMIs should identify, monitor and manage their general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses. This note provides additional guidance for Canadian FMIs to meet the components of the general business risk principle related to: (i) governing general business risk; (ii) determining sufficient liquid net assets; and (iii) identifying qualifying liquid net assets. It also establishes the associated timelines and disclosure requirements.

**(i) Governance of general business risk**

Principle 15, key consideration 1 of the PFMI's states:

*An FMI should have robust management and control systems to identify, monitor, and manage general business risk.*

The following points clarify the authorities' expectations on how an FMI's governance arrangements should address general business risk.

**An FMI's Board of Directors should be involved in the process of identifying and managing business risks.**

Management of business risks should be integrated within an FMI's risk-management framework, and the Board of Directors should be responsible for determining risk tolerances related to business risk and for assigning responsibility for the identification and management of these risks. These risk tolerances and the process for the identification and management of business risk should be the foundation for the FMI's business risk-management policy. Based on the PFMI's, the policies and procedures governing the identification and management of business risk should meet the standards outlined below.

- The FMI's business risk-management policy should be approved by the Board of Directors and reviewed at least annually. The policy should be consistent with the Board's overall risk tolerance and risk-management strategy.
- The Board's Risk Committee should have a role in advising the Board on whether the business risk-management policy is consistent with the FMI's general risk-management strategy and risk tolerance.
- The business risk-management policy should provide clear responsibilities for decision making by the Board, and assign responsibility for the identification, management and reporting of business risks to management.

## (ii) Determining sufficient liquid net assets

Principle 15, key consideration 2 of the PFMI states:

*An FMI should hold liquid net assets funded by equity [...] so that it can continue operations and services as a going concern if it incurs general business losses. The amount of liquid net assets funded by equity an FMI should hold should be determined by its general business risk profile and the length of time required to achieve a recovery or orderly wind-down, as appropriate, of its critical operations and services if such action is taken.*

Principle 15, key consideration 3 of the PFMI states:

*An FMI should maintain a viable recovery or orderly wind-down plan and should hold sufficient liquid net assets funded by equity to implement this plan. At a minimum, an FMI should hold liquid net assets funded by equity equal to at least six months of current operating expenses.*

The following points clarify the authorities' expectations on how FMIs should calculate their sufficient liquid net assets:

**Until guidance for recovery planning and for calculating the associated costs is completed, FMIs are required to hold liquid net assets to cover a minimum of six months of current operating expenses.**

In calculating current operating expenses, FMIs will need to:

- **Assess and understand the various general business risks they face** to allow them to estimate as accurately as possible the required amount of liquid net assets. These estimates should be based on financial projections, which take into consideration, for example, past loss events, anticipated projects and increased operating expenses.
- **Restrict the calculation to ongoing expenses.** FMIs will need to adjust their operating costs such that any extraordinary expenses (i.e., unessential, infrequent or one-off costs) are excluded. Typically, operating costs include both fixed costs (e.g., premises, IT infrastructure, etc.) and variable costs (e.g., salaries, benefits, research and development, etc.).
- **Assess the portion of staff from each corporate department required to ensure the smooth functioning of the FMI during the six-month period.** The calculation of operating expenses would include some indirect costs. FMIs would require not only dedicated operational staff, but also various supporting staff. These could include (but are not limited to) staff from the FMI's Legal, IT and HR departments or staff required to ensure the continued functioning of other FMIs that could be necessary to support the FMI.

To fully observe Principle 15, FMIs must hold sufficient liquid assets to cover the greater of (i) funds required for FMIs to implement their recovery or wind-down; or (ii) six months of current operating expenses. In the interim, until recovery planning guidance is published, only the latter amount will apply.

The amount of liquid net assets required to implement an FMI's recovery or wind-down plans will depend on the scenarios or tools available to the FMI. The acceptable recovery and orderly wind-down plans for Canadian FMIs will be articulated by the authorities in forthcoming guidance. Once this guidance on recovery planning has been developed, the guidance on general business risk will be updated to provide FMIs with additional clarity on how to calculate the costs associated with these plans and determine the amount of liquid net assets required.

## (iii) Qualifying liquid net assets

Explanatory note 3.15.5 of the PFMI states:



*An FMI should hold liquid net assets funded by equity (such as common stock, disclosed reserves or other retained earnings) so that it can continue operations and services as a going concern if it incurs general business losses. Equity allows an FMI to absorb losses on an ongoing basis and should be permanently available for this purpose.*

Principle 15, key consideration 4 of the PFMI states:

*Assets held to cover general business risk should be of high quality and sufficiently liquid to allow the FMI to meet its current and projected operating expenses under a range of scenarios, including in adverse market conditions.*

Principle 15, key consideration 3 of the PFMI states:

*These assets are in addition to resources held to cover participant defaults or other risks covered under the financial resources principles.*

The following points clarify the authorities' expectations on which assets qualify to be held against general business risk, and how these assets should be held to ensure that they are permanently available to absorb general business losses.

**Assets held against general business risk should be of high quality and sufficiently liquid, such as cash, cash equivalents and liquid securities.**

Authorities have developed regulatory guidance related to managing liquidity and investment risks, which provides additional clarity on the definition of cash equivalents and liquid securities, respectively.

- **Cash equivalents** – are considered to be treasury bills<sup>40</sup> issued by either the Canadian or U.S. federal governments. As noted in the liquidity guidance, by market convention, sales of treasuries settle on the same day, allowing funds to be obtained immediately, whereas other bonds can settle as late as three days after the trade date.
- **Liquid securities** – for the purposes of general business risk, liquid securities are defined by the financial instruments criteria listed in the guidance on the Investment Risk Principle. These criteria outline financial instruments considered to have minimal credit, market, and liquidity risk.

**Liquid net assets must be held at the level of the FMI legal entity to ensure that they are unencumbered and can be accessed quickly. Liquid net assets may be pooled with assets held for other purposes, but must be clearly identified as held against general business risk.**

FMI may need to accumulate liquid net assets for purposes other than to meet the General Business Risk Principle. However, assets held against general business risk cannot be used to cover participant default risk or any other risks covered by the financial resources principles.

Liquid net assets can be pooled with assets held for other purposes, but must be clearly identified as held against general business risk in the FMI's reports to its regulators.

#### **(iv) Timelines for assessing and reporting the level of liquid net assets**

Explanatory note 3.15.8 of the PFMI states:

*To ensure the adequacy of its own resources, an FMI should regularly assess and report its liquid net assets funded by equity relative to its potential business risks to its regulators.*

The following clarifies the authorities' expectations of the frequency with which FMIs should assess and report their required level of liquid net assets.

**FMIs should report to authorities the amount of liquid net assets held against business risk annually, at a minimum.**

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<sup>40</sup> Treasury bills refer to short-term (i.e. maturity of one year or less) debt instruments issued by the Canadian or U.S. federal government.

An FMI should report to the authorities the amount of liquid net assets funded by equity held exclusively against business risk and quantify its business risks as major developments arise, or at least on an annual basis. This report should include an explanation of the methodology used to assess the FMI's business risks and to calculate its requirements for liquid net assets.

**FMI should recalculate the required amount of liquid net assets annually, at a minimum.**

Once FMI operators have established the amount of liquid net assets required to cover six months of operating expenses, FMIs should recalculate the required amount of liquid net assets as major developments occur, or annually, at a minimum. Once the authorities have provided further guidance on recovery and FMIs have developed recovery plans, FMIs should also evaluate the need to increase the amount of liquid net assets they should hold to meet the General Business Risk Principle.

To establish clear procedures that improve transparency regarding an FMI's decision-making process and to prevent the FMI from delaying required increases in liquid resources beyond what is reasonably acceptable, FMIs should maintain a viable capital plan for raising additional acceptable resources should these resources fall close to or below the amount needed. This plan should be approved by the Board of Directors and updated annually, or as major developments occur.

**FMI should review their methodology for calculating the required level of liquid net assets at least once every five years, or as major developments occur.**<sup>41</sup>

The methodology for calculating the amount of required liquid net assets should be reviewed at least every five years to ensure that the calculation remains relevant over time.

- **PFMI Principle 16: Custody and investment risks**

**Box 16.1:  
Joint Supplementary Guidance –  
Custody and Investment Risks**

**Context**

The PFMI define investment risk as the risk faced by an FMI when it invests its own assets or those of its participants.

- An FMI holds assets for a variety of purposes, some of which are referred to specifically in the PFMI: to cover its business risk (Principle 15), to cover credit losses (Principle 4) and to cover credit exposures (Principle 6) using the collateral pledged by participants.
- An FMI may also hold financial assets for purposes not directly related to the risk management issues addressed within the PFMI (e.g., employee pensions, general investment assets).

An FMI's strategy for investing assets should be consistent with its overall risk-management strategy (Principle 16). The purpose of this note is to provide further guidance on regulators' expectations regarding the management of investment risk. This guidance helps to ensure that an FMI's investments are managed in a way that protects the financial soundness of the FMI and its participants.<sup>42</sup>

**(i) Governance**

The PFMI state that the Board of Directors is responsible for overseeing the risk-management function and approving material risk decisions. An FMI should develop an investment policy to manage the risk arising from the investment of its own assets and those of its participants.

- The FMI's investment policy should be approved by the Board and reviewed at least annually. The policy should be consistent with the Board's overall risk tolerance and considered part of the FMI's risk-management framework.
- The Risk Committee should advise the Board on whether the investment policy is consistent with the FMI's general risk-management strategy and risk tolerance.

<sup>41</sup> In the context of this specific guidance item, "major developments" refers to the major changes to operations, product and service offerings, or classes of participation.

<sup>42</sup> This guidance on investment risk is based on aspects of Principle 2 – Governance, Principle 3 – Comprehensive Framework for the Management of Risk, and Principle 16 – Custody and Investment Risk.

- The Board should assess the advantages and disadvantages of managing assets internally or outsourcing them to an external manager. The FMI retains full responsibility for any actions taken by its external manager.
- The FMI should establish criteria for the selection of an external manager.<sup>43</sup>

The FMI's investment policy should clearly identify those who are accountable for investment performance. The investment policy should also:

- Provide a clear explanation of the Board's delegated responsibility for investment decision making.
- Specify clear responsibilities for monitoring investment performance (against established benchmarks) and risk exposures (against limits or constraints). Procedures should be established to ensure that appropriate actions are taken when breaches occur, including possible reporting to the Board.
- Investment performance and key risk metrics should be reported to the Board at least quarterly.<sup>44</sup>

## **(ii) Investment strategy**

The investment strategy chosen by an FMI should not allow the pursuit of profit to compromise its financial soundness. As outlined below, additional consideration should be given to the investment strategy governing assets held specifically for risk-management purposes (i.e. Principle 4-7 and Principle 15).

### **Investment objectives**

The investment policy should include appropriate investment objectives for the various assets held for risk-management purposes. The stated expected return and risk tolerance of the investment objectives should reflect the:

- specific purpose of the assets;
- relative importance of the assets in the overall risk management of the FMI; and
- requirement within the PFMI for FMIs to invest in instruments with minimal credit, market and liquidity risk (see the Appendix for the minimum standards of acceptable instruments).

The investment objectives should also help to determine the appropriate benchmarks for measuring investment performance.

### **Investment constraints**

The importance of assets held for risk-management purposes warrants the use of investment constraints. It is paramount that an FMI have prompt access to these assets with minimal price impact to avoid interference with their primary use for risk management. Investment of these assets should, at a minimum, observe the following:

- To reduce concentration risk, no more than 20 per cent of total investments should be invested in municipal and private sector securities. Investment in a single private sector or municipal issuer should be no more than 5 per cent of total investments.
- To mitigate specific wrong-way risk, investments should, as much as possible, be inversely related to market events that increase the likelihood of those assets being required. Investment in financial sector securities should be no more than 10 per cent of total investments. An FMI should not invest assets in the securities of its own affiliates. An FMI is not permitted to reinvest participant assets in a participant's own securities or those of its affiliates, as specified in Principle 16.
- For investments that are subject to counterparty credit risk, an FMI should set clear criteria for choosing investment counterparties and setting exposure limits.

The investment constraints should be clearly stated in the investment policy in order to provide clear guidance for those responsible for investment decision making.<sup>45</sup>

<sup>43</sup> At a minimum, external managers should have demonstrated past performance and expertise, as well as strong risk-management practices such as an internal audit function and processes to protect and segregate the FMI's assets.

<sup>44</sup> Investment performance may also be reported to a Board committee with special expertise to which the Board has delegated the authority to review investment performance (e.g., an Investment Committee).

<sup>45</sup> The use of investment vehicles where investments are held indirectly (e.g. mutual funds and exchange-traded funds) should not result in breaches to the investment constraints listed.

### Link to risk management

FMI's should account for the implications of investing assets on their broader risk-management practices. The following issues should be considered when investing assets held for risk management purposes:

- An FMI's process for determining whether sufficient assets are available for risk management should account for potential investment losses. For example, investing the assets available to a CCP to cover losses from a participant default could lose value in a default scenario, resulting in less credit-risk protection. An FMI should hold additional assets to cover potential losses from its investments held for risk-management purposes.
- An FMI should account for the implications of investing assets on its ability to effectively manage liquidity risk. In particular, identification of the FMI's available liquid resources should account for the investment of its own and participants' assets. For example, cash held at a creditworthy commercial bank would no longer be considered a qualifying liquid resource under Principle 7 if it were invested in the debt instrument of a private sector issuer.
- The investment of an FMI's own assets and those of its participants should not circumvent related risk management requirements. For example, the reinvestment of participants' collateral should still respect the FMI's collateral concentration limits applicable to those assets.

### Appendix

For the purposes of Principle 16, financial instruments can be considered to have minimal credit, market and liquidity risk if they meet *each* of the following conditions:

1. Investments are debt instruments that are:
  - a. securities issued by the Government of Canada;
  - b. securities guaranteed by the Government of Canada;
  - c. marketable securities issued by the United States Treasury;
  - d. securities issued or guaranteed by a provincial government;
  - e. securities issued by a municipal government;
  - f. bankers' acceptances;
  - g. commercial paper;
  - h. corporate bonds; and
  - i. asset-backed securities that meet the following criteria: (1) sponsored by a deposit-taking financial institution that is prudentially regulated at either the federal or provincial level, (2) part of a securitization program supported by a liquidity facility, and (3) backed by assets of an acceptable credit quality.
2. The FMI employs a defined methodology to demonstrate that debt instruments have low credit risk. This methodology should involve more than just mechanistic reliance on credit-risk assessments by an external party.
3. The FMI employs limits on the average time-to-maturity of the portfolio based on relevant stress scenarios in order to mitigate interest rate risk exposures.
4. Instruments have an active market for outright sales or repurchase agreements, including in stressed conditions.
5. Reliable price data on debt instruments are available on a regular basis.
6. Instruments are freely transferable and settled over a securities settlement system compliant with the PFMI's.

### - **PFMI Principle 23: Disclosure of rules, key procedures, and market data**

#### **Box 23.1: Joint Supplementary Guidance – Disclosure of Rules, Key Procedures and Market Data**

##### **Context**

The PFMI's state that FMI's should provide sufficient information to their participants and prospective participants to enable them to clearly understand the risks and responsibilities of participating in the system. This note provides additional guidance for Canadian FMI's to meet the components of the disclosure principle related to: (i) public qualitative disclosure and (ii) public quantitative disclosure.

##### **Requirements included in the PFMI's**

Principle 23 outlines requirements for disclosure to participants as well as the general public. In addition,

specific disclosure requirements are listed in the principles to which they pertain.

The following text has been extracted directly from the PFMLs, Principle 23, key consideration 5:

*An FMI should complete regularly and disclose publicly responses to the CPMI-IOSCO Disclosure framework for financial market infrastructures. An FMI also should, at a minimum, disclose basic data on transaction volumes and values.*

To supplement key consideration 5, CPMI-IOSCO published two documents: the Disclosure framework for financial market infrastructures (the Disclosure Framework),<sup>46</sup> and the Public quantitative disclosure standards for central counterparties (the Quantitative Disclosure Standards).<sup>47</sup> This note will refer to the disclosures that result from completing the templates provided in these documents as the Qualitative Disclosure and the Quantitative Disclosure, respectively.

### **Supplementary guidance for Canadian FMIs designated by the Bank of Canada**

On its public website, an FMI should publish its Qualitative Disclosure and Quantitative Disclosure, as well as any other public disclosure requirements specified in Principle 23 or in other principles. Any public disclosure should be written for an audience with general knowledge of the financial sector.

#### **(a) Qualitative disclosure (Applies to all types of FMIs)**

A Qualitative Disclosure should provide the public with a high-level understanding of an FMI's governance, operation and risk-management framework.

##### **Summary narrative disclosure**

In part four of the Disclosure Framework, FMIs are required to provide a summary narrative of their observance of the Principles. FMIs should provide these narratives at the principle level, and are not required to address key considerations or to provide answers to the detailed questions listed in Section 5 of the Disclosure Framework report. Instead, the narrative disclosure should focus on providing a broad audience with an understanding of how each Principle applies to the FMI, and what the FMI has done or plans to do to ensure its observance.

##### **Timing**

FMIs should update and publish their Qualitative Disclosures following significant changes<sup>48</sup> to the system or its environment, or at least every two years. Only the most current Qualitative Disclosure needs to be maintained on the FMI's website.

#### **(b) Quantitative disclosure (Applies only to CCPs)**

Quantitative Disclosures specify the set of key quantitative information required in the Disclosure Framework. They should follow the format provided by CPMI-IOSCO, allowing stakeholders, including the general public, to easily evaluate and compare FMIs.

Currently, CPMI-IOSCO has developed public quantitative disclosure standards only for CCPs. The following guidance applies only to CCPs; Canadian authorities will provide further guidance on the quantitative disclosure requirements of FMIs other than CCPs when such standards have been developed.

##### **Context**

Where a general audience may need additional context to properly interpret the data, it should be provided in explanatory notes or addressed in the CCP's Qualitative Disclosure. CCPs are

<sup>46</sup> The Disclosure Framework is part of a document published in December 2012, titled "Principles for financial market infrastructures: Disclosure framework and Assessment methodology", and is available at <http://www.bis.org/press/p121214.htm>.

<sup>47</sup> This document is available at <http://www.bis.org/cpmi/publ/d125.pdf>.

<sup>48</sup> Updated Qualitative Disclosures should be published subsequent to regulatory approval, and prior to the effective date of the significant change. Significant changes can include, but are not limited to: (i) any changes to the FMI's constituting documents, bylaws, corporate governance or corporate structure; (ii) any material change to an agreement between the FMI and its participants or to the FMI's rules, operating procedures, user guides, or manuals or the design, operation or functionality of its operations and services; and (iii) the establishment of, or removal or material change to, a link, or commencing or ceasing to engage in a business activity.

encouraged to provide charts, background information and additional documentation where it may aid the reader's understanding.

### **Comparability**

Regulators recognize that, given the different structures and arrangements among CCPs, an overly homogenized presentation format could lead to inaccurate comparability. Subject to regulatory approval, a CCP may provide analogous data in place of a disclosure requirement that is not applicable to its business or representative of the risks it faces. The CCP must justify to authorities the necessity and selection of the alternative metric.<sup>49</sup> If granted approval, the CCP must provide the original data to authorities with the frequency specified in the Quantitative Disclosure Standards, and must explain in each public disclosure why an alternative metric was chosen.

### **Confidentiality**

A CCP's public disclosure obligation does not release it from its confidentiality duties. Where a required disclosure item could reveal (or allow knowledgeable parties to deduce) commercially sensitive information about individual clearing members, clients, third-party contractors or other relevant stakeholders, or where disclosure may amount to a breach of laws or regulations for maintaining market integrity, the data must be omitted. In this case, the CCP must justify the omission to authorities.<sup>50</sup> If granted approval, the CCP must provide the confidential data to authorities with the frequency specified in the Quantitative Disclosure Standards, and must explain the reason for the omission in each public disclosure.

### **Timing**

Quantitative Disclosures should be reported quarterly, and updated with the frequency specified in the Quantitative Disclosure Standards.<sup>51</sup> Even though some required data may already be publicly disclosed in other reports, or may not have changed from the previous quarter, the data should still be included in the disclosure matrix for completeness and consistency. Data should be publicly disclosed no later than 60 days after the end of each fiscal quarter, and should remain available on its website for at least three years so that trends can be examined.

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<sup>49</sup> If the authorities are satisfied with the justification, the CCP need not resubmit the substitution unless the CCP's structure or arrangements change the applicability of the original disclosure requirement, or the CCP wishes to change its substituted metric. CCPs are responsible for informing authorities of any changes that could affect the applicability of the originally required or substituted data.

<sup>50</sup> If the authorities are satisfied with the justification, the CCP need not resubmit the omission unless the circumstances change the confidentiality of the disclosure. CCPs are responsible for informing the authorities of any changes that could affect the confidentiality of such data.

<sup>51</sup> According to the Quantitative Disclosure Standards, items under general business risk should be updated annually, and all other items should be updated on a quarterly basis.

**Annex E**

**Blackline version of final adopted National Instrument 24-102 *Clearing Agency Requirements*  
reflecting revisions made to proposed Instrument  
in the 2014 Documents**

**National Instrument 24 – 102**

***CLEARING AGENCY REQUIREMENTS***

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PART 5 – BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER

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FORMS

Form 24-102F1 – *Clearing Agency Submission to Jurisdiction and Appointment of Agent for Service of Process*

Form 24-102F2 – *Cessation of Operations Report for Clearing Agency*

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**PART 1  
DEFINITIONS, INTERPRETATION AND APPLICATION**

**Definitions**

**1.1** In this Instrument

"accounting principles" means accounting principles as defined in National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

"auditing standards" means auditing standards as defined in National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

"board of directors" means, in the case of a recognized clearing agency that does not have a board of directors, a group of individuals that acts for the clearing agency in a capacity similar to a board of directors;

"central counterparty" means a person or company that interposes itself between the counterparties to securities or derivatives transactions in one or more financial markets, acting functionally as the buyer to every seller and the seller to every buyer or the counterparty to every party;

"central securities depository" means a person or company that provides centralized facilities as a depository of securities, including securities accounts, central safekeeping services and asset services, which may include the administration of corporate actions and redemptions;

"exempt clearing agency" means a clearing agency that has been granted a decision of the securities regulatory authority pursuant to securities legislation exempting it from the requirement in such legislation to be recognized by the securities regulatory authority as a clearing agency;

"link" means, in relation to a clearing agency, contractual and operational arrangements that directly or indirectly through an intermediary connect the clearing agency and one or more other systems for the clearing, settlement or recording of securities or derivatives transactions;

"participant" means a person or company that has entered into an agreement with a clearing agency to access the services of the clearing agency and is bound by the clearing agency's rules and procedures;

"PFMI Disclosure Framework Document" means a disclosure document completed substantially in the form of *Annex A: FMI disclosure template* of the December 2012 report *Principles for financial market infrastructures: Disclosure framework and Assessment methodology* published by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, as amended, supplemented or superseded from time to time, or a similar disclosure document required to be completed regularly and disclosed publicly by a clearing agency in accordance with the regulatory requirements of a foreign jurisdiction in which the clearing agency is located;

"PFMI Principle" means a principle, including applicable key considerations, in the April 2012 report *Principles for financial market infrastructures* published by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, as amended from time to time;

"publicly accountable enterprise" means a publicly accountable enterprise as defined in Part 3 of National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;

"securities settlement system" means a system that enables securities to be transferred and settled by book entry according to a set of predetermined multilateral rules.

### **Interpretation - Affiliated Entity, Controlled Entity and Subsidiary Entity**

**1.2 (1)** In this Instrument, a person or company is considered to be an affiliated entity of another person or company if one is a subsidiary entity of the other or if both are subsidiary entities of the same person or company, or if each of them is a controlled entity of the same person or company.

**(2)** In this Instrument, a person or company is considered to be controlled by a person or company if

- (a) in the case of a person or company,
  - (i) voting securities of the first-mentioned person or company carrying more than fifty percent of the votes for the election of directors are held, otherwise than by way of security only, by or for the benefit of the other person or company, and
  - (ii) the votes carried by the securities are entitled, if exercised, to elect a majority of the directors of the first-mentioned person or company;
- (b) in the case of a partnership that does not have directors, other than a limited partnership, the second-mentioned person or company holds more than fifty percent of the interests in the partnership; or
- (c) in the case of a limited partnership, the general partner is the second-mentioned person or company.

**(3)** In this Instrument, a person or company is considered to be a subsidiary entity of another person or company if

- (a) it is a controlled entity of
  - (i) that other,
  - (ii) that other and one or more persons or companies, each of which is a controlled entity of that other, or
  - (iii) two or more persons or companies, each of which is a controlled entity of that other; or
- (b) it is a subsidiary entity of a person or company that is the other's subsidiary entity.

### **Interpretation – Extended Meaning of Affiliated Entity**



**1.3** For the purposes of the PFMI Principles, a person or company is considered to be an affiliate of a participant, the person or company and the participant each being described in this section as a “party”, where,

- (a) a party holds, otherwise than by way of security only, voting securities of the other party carrying more than 20 percent of the votes for the election of directors.
- (b) in the event paragraph (a) is not applicable,
  - (i) a party holds, otherwise than by way of security only, an interest in the other party that allows it to direct the management or operations of the other party; or
  - (ii) financial information in respect of both parties is consolidated for financial reporting purposes.

#### **Interpretation – Clearing Agency**

**1.4** For the purposes of this Instrument, in Québec, a clearing agency includes a clearing house, a central securities depository and a settlement system within the meaning of the Québec *Securities Act* and a clearing house and a settlement system within the meaning of the Québec *Derivatives Act*.

#### **Application**

**1.5 (1)** Part 3 applies to a recognized clearing agency that operates as any of the following:

- (a) a central counterparty;
- (b) a central securities depository;
- (c) a securities settlement system.

**(2)** Unless the context otherwise indicates, Part 4 applies to a recognized clearing agency whether or not it operates as a central counterparty, central securities depository or securities settlement system.

**(3)** In Québec, if there is a conflict or an inconsistency between section 2.2 and the provisions of the Québec *Derivatives Act* governing the self-certification process with respect to a clearing agency implementing a significant change or a fee change, the provisions of the Québec *Derivatives Act* prevail.

**(4)** The requirements of section 2.2 or 2.5 apply only to the extent that the subject matters of the section are not otherwise governed by the terms and conditions of a decision of the securities regulatory authority that recognizes a clearing agency or that exempts a clearing agency from a recognition requirement.

**PART 2  
CLEARING AGENCY RECOGNITION  
OR EXEMPTION FROM RECOGNITION**

**Application and initial filing of information**

**2.1 (1)** An applicant for recognition as a clearing agency under securities legislation, or for exemption from the requirement to be recognized as a clearing agency under securities legislation, must include in its application all of the following:

- (a) if applicable, the applicant's most recently completed PFMI Disclosure Framework Document;
- (b) sufficient information to demonstrate that the applicant is in compliance with
  - (i) provincial and territorial securities legislation, or
  - (ii) the regulatory regime of a foreign jurisdiction in which the applicant's head office or principal place of business is located;
- (c) any additional relevant information sufficient to demonstrate that it is in the public interest for the securities regulatory authority to recognize or exempt the applicant, as the case may be.

**(2)** In addition to the requirement set out in subsection (1), an applicant that has a head office or principal place of business located in a foreign jurisdiction must

- (a) certify that it will assist the securities regulatory authority in accessing the applicant's books and records and in undertaking an onsite inspection and examination at the applicant's premises, and
- (b) certify that it will provide the securities regulatory authority, if requested by such authority, with an opinion of legal counsel that the applicant has, as a matter of law, the power and authority to
  - (i) provide the securities regulatory authority with prompt access to its books and records, and
  - (ii) submit to onsite inspection and examination by the securities regulatory authority.

**(3)** In addition to the requirements set out in subsections (1) and (2), an applicant whose head office or principal place of business is located in a foreign jurisdiction must file a completed Form 24-102F1 *Submission to Jurisdiction and Appointment of Agent for Service*.

**(4)** An applicant must inform the securities regulatory authority in writing of any material change to the information provided in its application, or if any of the information becomes materially inaccurate for any reason, as soon as the change occurs or the applicant becomes aware of any inaccuracy.

**Significant changes, fee changes and other changes in information**

**2.2 (1)** In this section, for greater certainty, a "significant change" includes, in relation to a clearing agency,

- (a) any change to the clearing agency's constating documents or by-laws;
- (b) any change to the clearing agency's corporate governance or corporate structure, including any change of control of the clearing agency, whether direct or indirect;
- (c) any material change to an agreement among the clearing agency and participants in connection with the clearing agency's operations and services, including those agreements to which the clearing agency is a party and those agreements among participants to which the clearing agency is not a party, but that are expressly referred to in the clearing agency's rules or procedures and are made available by participants to the clearing agency;

- (d) any material change to the clearing agency's rules, operating procedures, user guides, manuals, or other documentation governing or establishing the rights, obligations and relationships among the clearing agency and participants in connection with the clearing agency's operations and services;
- (e) any material change to the design, operation or functionality of any of the clearing agency's operations and services;
- (f) the establishment or removal of a link or any material change to an existing link;
- (g) commencing to engage in a new type of business activity or ceasing to engage in a business activity in which the clearing agency is then engaged;
- (h) any other matter identified as a significant change in the recognition terms and conditions.

**(2)** Subject to subsection (4), a recognized clearing agency must not implement a significant change unless it has filed a written notice of the significant change with the securities regulatory authority at least 45 days before implementing the change.

**(3)** If a proposed significant change referred to in subsection (2) would affect the information set out in its PFMI Disclosure Framework Document filed with the securities regulatory authority, a recognized clearing agency must complete and file with the securities regulatory authority, concurrently with providing the written notice referred to in subsection (2), an appropriate amendment to its PFMI Disclosure Framework Document.

**(4)** If a recognized clearing agency proposes to modify a fee or introduce a new fee for any of its clearing, settlement or depository services, the clearing agency must notify in writing the securities regulatory authority of such fee change before implementing the fee change within a period stipulated by the terms and conditions of a decision of the securities regulatory authority that recognizes the clearing agency.

**(5)** An exempt clearing agency must notify in writing the securities regulatory authority of any material change to the information provided to the securities regulatory authority in its PFMI Disclosure Framework Document and related application materials, or if any of the information becomes materially inaccurate for any reason, as soon as the change occurs or the exempt clearing agency becomes aware of any inaccuracy.

### **Ceasing to carry on business**

**2.3 (1)** A recognized clearing agency or exempt clearing agency that intends to cease carrying on business in the local jurisdiction as a clearing agency must file a report on Form 24-102F2 *Cessation of Operations Report for Clearing Agency* with the securities regulatory authority

- (a) at least 180 days before ceasing to carry on business if a significant reason for ceasing to carry on business relates to the clearing agency's financial viability or any other matter that is preventing, or may potentially prevent, it from being able to provide its operations and services as a going concern, or
- (b) at least 90 days before ceasing to carry on business for any other reason.

**(2)** A recognized clearing agency or exempt clearing agency that involuntarily ceases to carry on business in the local jurisdiction as a clearing agency must file a report on Form 24-102F2 *Cessation of Operations Report for Clearing Agency* with the securities regulatory authority as soon as practicable after it ceases to carry on that business.

### **Filing of initial audited financial statements**

**2.4 (1)** An applicant must file audited financial statements for its most recently completed financial year with the securities regulatory authority as part of its application under section 2.1.

**(2)** The financial statements referred to in subsection (1) must

- (a) be prepared in accordance with Canadian GAAP applicable to publicly accountable enterprises, IFRS or the generally accepted accounting principles of the foreign jurisdiction in which the person or company is incorporated, organized or located,

- (b) identify in the notes to the financial statements the accounting principles used to prepare the financial statements,
- (c) disclose the presentation currency, and
- (d) be audited in accordance with Canadian GAAS, International Standards on Auditing or the generally accepted auditing standards of the foreign jurisdiction in which the person or company is incorporated, organized or located.

**(3)** The financial statements referred to in subsection (1) must be accompanied by an auditor's report that

- (a) expresses an unmodified or unqualified opinion,
- (b) identifies all financial periods presented for which the auditor's report applies,
- (c) identifies the auditing standards used to conduct the audit,
- (d) identifies the accounting principles used to prepare the financial statements,
- (e) is prepared in accordance with the same auditing standards used to conduct the audit, and
- (f) is prepared and signed by a person or company that is authorized to sign an auditor's report under the laws of a jurisdiction of Canada or a foreign jurisdiction, and that meets the professional standards of that jurisdiction.

#### **Filing of annual audited and interim financial statements**

**2.5 (1)** A recognized clearing agency or exempt clearing agency must file annual audited financial statements that comply with the requirements set out in subsections 2.4(2) and (3) with the securities regulatory authority no later than the 90th day after the end of the recognized clearing agency or exempt clearing agency's financial year.

**(2)** A recognized clearing agency or exempt clearing agency must file interim financial statements that comply with the requirements set out in paragraphs 2.4(2)(a) and (2)(b) with the securities regulatory authority no later than the 45th day after the end of each interim period.

**PART 3**  
**PFMI PRINCIPLES APPLICABLE TO**  
**RECOGNIZED CLEARING AGENCIES**

**PFMI Principles**

**3.1** A recognized clearing agency must establish, implement and maintain rules, procedures, policies or operations designed to ensure that it meets or exceeds PFMI Principles 1 to 3, 10, 13, 15 to 19, 20 other than key consideration 9, 21 to 23 and the following:

- (a) if the clearing agency operates as a central counterparty, PFMI Principles 4 to 9, 12 and 14;
- (b) if the clearing agency operates as a securities settlement system, PFMI Principles 4, 5, 7 to 9 and 12; and
- (c) if the clearing agency operates as a central securities depository, PFMI Principle 11.

**PART 4  
OTHER REQUIREMENTS OF  
RECOGNIZED CLEARING AGENCIES**

**Division 1 – Governance:**

**Board of directors**

**4.1 (1)** A recognized clearing agency must have a board of directors.

**(2)** The board of directors must include appropriate representation by individuals who are

- (a) independent of the clearing agency, and
- (b) not employees or executive officers of a participant or their immediate family members.

**(3)** For the purposes of paragraph (2)(a), an individual is independent of a clearing agency if he or she has no direct or indirect material relationship with the clearing agency.

**(4)** For the purposes of subsection (3), a “material relationship” is a relationship that could, in the view of the clearing agency’s board of directors, be reasonably expected to interfere with the exercise of a member’s independent judgment.

**Documented procedures regarding risk spill-overs**

**4.2** The board of directors and management of a recognized clearing agency must have documented procedures to manage possible risk spill over where the clearing agency provides services with a different risk profile than its depository, clearing and settlement services.

**Chief Risk Officer and Chief Compliance Officer**

**4.3 (1)** A recognized clearing agency must designate a chief risk officer and a chief compliance officer, who must report directly to the board of directors or, if determined by the board of directors, to the chief executive officer of the clearing agency.

**(2)** The chief risk officer must

- (a) have full responsibility and authority to maintain, implement and enforce the risk management framework established by the clearing agency,
- (b) make recommendations to the clearing agency’s board of directors regarding the clearing agency’s risk management framework,
- (c) monitor the effectiveness of the clearing agency’s risk management framework, and
- (d) report to the clearing agency’s board of directors on a timely basis upon becoming aware of any significant deficiency with the risk management framework.

**(3)** The chief compliance officer must

- (a) establish, implement, maintain and enforce written policies and procedures to identify and resolve conflicts of interest and ensure that the clearing agency complies with securities legislation,
- (b) monitor compliance with the policies and procedures described in paragraph (a),
- (c) report to the board of directors of the clearing agency as soon as practicable upon becoming aware of any circumstance indicating that the clearing agency, or any individual acting on its behalf, is not in compliance with securities legislation and one or more of the following apply:
  - (i) the non-compliance creates a risk of harm to a participant,
  - (ii) the non-compliance creates a risk of harm to the broader financial system,
  - (iii) the non-compliance is part of a pattern of non-compliance, or

- (iv) the non-compliance may have an impact on the ability of the clearing agency to carry on business in compliance with securities legislation,
- (d) prepare and certify an annual report assessing compliance by the clearing agency, and individuals acting on its behalf, with securities legislation and submit the report to the board of directors,
- (e) report to the clearing agency's board of directors as soon as practicable upon becoming aware of a conflict of interest that creates a risk of harm to a participant or to the capital markets, and
- (f) concurrently with submitting a report under paragraphs (c), (d) or (e), file a copy of such report with the securities regulatory authority.

#### **Board or advisory committees**

**4.4 (1)** The board of directors of a recognized clearing agency must, at a minimum, establish and maintain committees on risk management, finance and audit.

**(2)** If a committee is a board committee, it must be chaired by a sufficiently knowledgeable individual who is independent of the clearing agency.

**(3)** Subject to subsection (4), a committee must have an appropriate representation by individuals who are independent of the clearing agency.

**(4)** An audit or risk committee must have an appropriate representation by individuals who are

- (a) independent of the clearing agency, and
- (b) not employees or executive officers of a participant or their immediate family members.

#### ***Division 2 – Default management:***

##### **Use of own capital**

**4.5** A recognized clearing agency that operates as a central counterparty must dedicate and use a reasonable portion of its own capital to cover losses resulting from one or more participant defaults.

#### ***Division 3 – Operational risk:***

##### **Systems requirements**

**4.6** For each system operated by or on behalf of a recognized clearing agency that supports the clearing agency's clearing, settlement and depository functions, the clearing agency must

- (a) develop and maintain
  - (i) an adequate system of internal controls over that system, and
  - (ii) adequate information technology general controls, including, without limitation, controls relating to information systems operations, information security, change management, problem management, network support and system software support,
- (b) in accordance with prudent business practice, on a reasonably frequent basis and, in any event, at least annually
  - (i) make reasonable current and future capacity estimates, and
  - (ii) conduct capacity stress tests to determine the ability of that system to process transactions in an accurate, timely and efficient manner, and
- (c) promptly notify the regulator or, in Québec, the securities regulatory authority of any material systems failure, malfunction, delay or security breach, and provide timely updates on the status of the failure, malfunction, delay or security breach, the resumption of

service, and the results of the clearing agency's internal review of the failure, malfunction, delay or security breach.

### **Systems reviews**

**4.7 (1)** A recognized clearing agency must annually engage a qualified party to conduct an independent systems review and vulnerability assessment and prepare a report in accordance with established audit standards and best industry practices to ensure that the clearing agency is in compliance with paragraph 4.6(a) and section 4.9.

**(2)** The clearing agency must provide the report resulting from the review conducted under subsection (1) to

- (a) its board of directors, or audit committee, promptly upon the report's completion, and
- (b) the regulator or, in Québec, the securities regulatory authority, by the earlier of the 30th day after providing the report to its board of directors or the audit committee or the 60th day after the calendar year end.

### **Clearing agency technology requirements and testing facilities**

**4.8 (1)** A recognized clearing agency must make available to participants, in their final form, all technology requirements regarding interfacing with or accessing the clearing agency

- (a) if operations have not begun, sufficiently in advance of operations to allow a reasonable period for testing and system modification by participants, and
- (b) if operations have begun, sufficiently in advance of implementing a material change to technology requirements to allow a reasonable period for testing and system modification by participants.

**(2)** After complying with subsection (1), the clearing agency must make available testing facilities for interfacing with or accessing the clearing agency

- (a) if operations have not begun, sufficiently in advance of operations to allow a reasonable period for testing and system modification by participants, and
- (b) if operations have begun, sufficiently in advance of implementing a material change to technology requirements to allow a reasonable period for testing and system modification by participants.

**(3)** The clearing agency must not begin operations before

- (a) it has complied with paragraphs (1)(a) and (2)(a), and
- (b) the chief information officer of the clearing agency, or an individual performing a similar function, has certified in writing to the regulator or, in Québec, the securities regulatory authority, that all information technology systems used by the clearing agency have been tested according to prudent business practices and are operating as designed.

**(4)** The clearing agency must not implement a material change to the systems referred to in section 4.6 before

- (a) it has complied with paragraphs (1)(b) and (2)(b), and
- (b) the chief information officer of the clearing agency, or an individual performing a similar function, has certified in writing to the regulator or, in Québec, the securities regulatory authority, that the change has been tested according to prudent business practices and is operating as designed.

**(5)** Subsection (4) does not apply to the clearing agency if the change must be made immediately to address a failure, malfunction or material delay of its systems or equipment and if

- (a) the clearing agency immediately notifies the regulator or, in Québec, the securities regulatory authority, of its intention to make the change, and



- (b) the clearing agency discloses to its participants the changed technology requirements as soon as practicable.

### **Testing of business continuity plans**

#### **4.9** A recognized clearing agency must

- (a) develop and maintain reasonable business continuity plans, including disaster recovery plans, and
- (b) test its business continuity plans, including its disaster recovery plans, according to prudent business practices and on a reasonably frequent basis and, in any event, at least annually.

### **Outsourcing**

#### **4.10** If a recognized clearing agency outsources a critical service or system to a service provider, including to an affiliated entity of the clearing agency, the clearing agency must do all of the following:

- (a) establish, implement, maintain and enforce written policies and procedures to conduct suitable due diligence for selecting service providers to which a critical service and system may be outsourced and for the evaluation and approval of those outsourcing arrangements;
- (b) identify any conflicts of interest between the clearing agency and the service provider to which a critical service and system is outsourced, and establish, implement, maintain and enforce written policies and procedures to mitigate and manage those conflicts of interest;
- (c) enter into a written contract with the service provider to which a critical service or system is outsourced that
  - (i) is appropriate for the materiality and nature of the outsourced activities,
  - (ii) includes service level provisions, and
  - (iii) provides for adequate termination procedures;
- (d) maintain access to the books and records of the service provider relating to the outsourced activities;
- (e) ensure that the securities regulatory authority has the same access to all data, information and systems maintained by the service provider on behalf of the clearing agency that it would have absent the outsourcing arrangements;
- (f) ensure that all persons conducting audits or independent reviews of the clearing agency under this Instrument have appropriate access to all data, information and systems maintained by the service provider on behalf of the clearing agency that such persons would have absent the outsourcing arrangements;
- (g) take appropriate measures to determine that the service provider to which a critical service or system is outsourced establishes, maintains and periodically tests an appropriate business continuity plan, including a disaster recovery plan;
- (h) take appropriate measures to ensure that the service provider protects the clearing agency's proprietary information and participants' confidential information, including taking measures to protect information from loss, thefts, vulnerabilities, threats, unauthorized access, copying, use and modification, and discloses it only in circumstances where legislation or an order of a court or tribunal of competent jurisdiction requires the disclosure of such information;
- (i) establish, implement, maintain and enforce written policies and procedures to monitor the ongoing performance of the service provider's contractual obligations under the outsourcing arrangements.

### ***Division 4 – Participation requirements:***

#### **Access requirements and due process**

#### **4.11 (1)** A recognized clearing agency must not

- (a) unreasonably prohibit, condition or limit access by a person or company to the services offered by the clearing agency,
- (b) unreasonably discriminate among its participants or indirect participants,
- (c) impose any burden on competition that is not reasonably necessary and appropriate,
- (d) unreasonably require the use or purchase of another service for a person or company to utilize the clearing agency's services offered by it, and
- (e) impose fees or other material costs on its participants that are unfairly or inequitably allocated among the participants.

**(2)** For any decision made by the clearing agency that terminates, suspends or restricts a participant's membership in the clearing agency or that declines entry to membership to an applicant that applies to become a participant, the clearing agency must ensure that

- (a) the participant or applicant is given an opportunity to be heard or make representations, and
- (b) it keeps records of, gives reasons for, and provides for reviews of its decisions, including, for each applicant, the reasons for granting access or for denying or limiting access to the applicant, as the case may be.

**(3)** Nothing in subsection (2) limits or prevents the clearing agency from taking timely action in accordance with its rules and procedures to manage the default of one or more participants or in connection with the clearing agency's recovery or orderly wind-down, whether or not such action adversely affects a participant.

**PART 5**  
**BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER**

**Books and records**

**5.1 (1)** A recognized clearing agency or exempt clearing agency must keep books, records and other documents as are necessary to account for the conduct of its clearing, settlement and depository activities, business transactions and financial affairs and must keep those other books, records and documents as may otherwise be required under securities legislation.

**(2)** The clearing agency must retain the books and records maintained under this section

- (a) for a period of seven years from the date the record was made or received, whichever is later,
- (b) in a safe location and a durable form, and
- (c) in a manner that permits them to be provided promptly to the securities regulatory authority.

**Legal Entity Identifier**

**5.2 (1)** In this section,

“Global Legal Entity Identifier System” means the system for unique identification of parties to financial transactions developed by the LEI Regulatory Oversight Committee, and

“LEI Regulatory Oversight Committee” means the international working group established by the Finance Ministers and the Central Bank Governors of the Group of Twenty nations and the Financial Stability Board, under the Charter of the Regulatory Oversight Committee for the Global Legal Entity Identifier System dated November 5, 2012.

**(2)** For the purposes of any recordkeeping and reporting requirements required under securities legislation, a recognized clearing agency or exempt clearing agency must identify itself by means of a single legal entity identifier assigned to the clearing agency in accordance with the standards set by the Global Legal Entity Identifier System.

**(3)** If the Global Legal Entity Identifier System is unavailable to the clearing agency, all of the following apply:

- (a) the clearing agency must obtain a substitute legal entity identifier that complies with the standards established by the LEI Regulatory Oversight Committee for pre-legal entity identifiers;
- (b) the clearing agency must use the substitute legal entity identifier until a legal entity identifier is assigned to the clearing agency in accordance with the standards set by the Global Legal Entity Identifier System;
- (c) after the holder of a substitute legal entity identifier is assigned a legal entity identifier in accordance with the standards set by the Global Legal Entity Identifier System, the clearing agency must ensure that it is identified only by the assigned identifier.

**PART 6  
EXEMPTIONS**

**Exemption**

**6.1 (1)** The regulator or the securities regulatory authority may grant an exemption from the provisions of this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

**(2)** Despite subsection (1), in Ontario, only the regulator may grant an exemption.

**(3)** Except in Ontario, an exemption referred to in subsection (1) is granted under the statute referred to in Appendix B of National Instrument 14-101 *Definitions* opposite the name of the local jurisdiction.

**PART 7  
EFFECTIVE DATE AND TRANSITION**

**Effective date and transition**

**7.1 (1)** This Instrument comes into force on February 17, 2016.

**(2)** Despite section 3.1, until December 31, 2016, a recognized clearing agency is not required to implement rules, procedures, policies or operations designed to ensure that a recognized clearing agency meets or exceeds the following:

- (a) PFMI Principle 14;
- (b) key consideration 4 of PFMI Principle 3 and key consideration 3 of PFMI Principle 15 with respect to a clearing agency's recovery and orderly wind down plans; and
- (c) PFMI Principle 19.

**(3)** In Saskatchewan, despite subsection (1), if these regulations are filed with the Registrar of Regulations after February 17, 2016, these regulations come into force on the day on which they are filed with the Registrar of Regulations.

**FORM 24-102F1  
CLEARING AGENCY SUBMISSION TO  
JURISDICTION AND APPOINTMENT OF  
AGENT FOR SERVICE OF PROCESS**

1. Name of clearing agency (the "Clearing Agency"):  
\_\_\_\_\_
2. Jurisdiction of incorporation, or equivalent, of Clearing Agency:  
\_\_\_\_\_
3. Address of principal place of business of Clearing Agency:  
\_\_\_\_\_
4. Name of the agent for service of process (the "Agent") for the Clearing Agency:  
\_\_\_\_\_
5. Address of the Agent in \_\_\_\_\_ [name of local jurisdiction]:  
\_\_\_\_\_
6. The \_\_\_\_\_ [name of securities regulatory authority] ("securities regulatory authority") issued an order recognizing the Clearing Agency as a clearing agency pursuant to securities legislation, or the securities regulatory authority issued an order exempting the Clearing Agency from the requirement to be recognized as a clearing agency pursuant to such legislation, on \_\_\_\_\_.
7. The Clearing Agency designates and appoints the Agent as its agent upon whom may be served a notice, pleading, subpoena, summons or other process in any action, investigation or administrative, criminal, quasi-criminal, penal or other proceeding arising out of or relating to or concerning the activities of the Clearing Agency in \_\_\_\_\_ [province of local jurisdiction]. The Clearing Agency hereby irrevocably waives any right to challenge service upon its Agent as not binding upon the Clearing Agency.
8. The Clearing Agency agrees to unconditionally and irrevocably attorn to the non-exclusive jurisdiction of (i) the courts and administrative tribunals of \_\_\_\_\_ [name of local jurisdiction] and (ii) any proceeding in any province or territory arising out of, related to, concerning

or in any other manner connected with the regulation and oversight of the activities of the Clearing Agency in \_\_\_\_\_ [name of local jurisdiction].

9. The Clearing Agency must file a new submission to jurisdiction and appointment of agent for service of process in this form at least 30 days before the Clearing Agency ceases to be recognized or exempted by the securities regulatory authority, to be in effect for six years from the date it ceases to be recognized or exempted unless otherwise amended in accordance with section 10.
10. Until six years after it has ceased to be a recognized or exempted by the securities regulatory authority, the Clearing Agency must file an amended submission to jurisdiction and appointment of agent for service of process at least 30 days before any change in the name or above address of the Agent.
11. The Clearing Agency agrees that this submission to jurisdiction and appointment of agent for service of process is to be governed by and construed in accordance with the laws of \_\_\_\_\_ [name of local jurisdiction].

Dated: \_\_\_\_\_

\_\_\_\_\_  
Signature of the Clearing Agency

\_\_\_\_\_  
Print name and title of signing officer of  
the Clearing Agency

**AGENT  
CONSENT TO ACT AS AGENT FOR SERVICE**

I, \_\_\_\_\_ [name of Agent in full; if a corporation, full corporate name] of \_\_\_\_\_ [business address], hereby accept the appointment as agent for service of process of \_\_\_\_\_ [insert name of Clearing Agency] and hereby consent to act as agent for service pursuant to the terms of the appointment executed by \_\_\_\_\_ [insert name of Clearing Agency] on \_\_\_\_\_ [insert date].

Dated: \_\_\_\_\_

\_\_\_\_\_  
Signature of Agent

\_\_\_\_\_  
Print name of person signing and, if Agent is not an individual, the title of the person

**FORM 24-102F2**

**CESSATION OF OPERATIONS REPORT FOR CLEARING AGENCY**

1. Identification:
  - A. Full name of the recognized or exempted clearing agency:
  - B. Name(s) under which business is conducted, if different from item 1A:
2. Date clearing agency proposes to cease carrying on business as a clearing agency:
3. If cessation of business was involuntary, date clearing agency has ceased to carry on business as a clearing agency:

**Exhibits**

File all exhibits with the Cessation of Operations Report. For each exhibit, include the name of the clearing agency, the date of filing of the exhibit and the date as of which the information is accurate (if different from the date of the filing). If any exhibit required is inapplicable, a statement to that effect must be provided instead of the exhibit.

**Exhibit A**

The reasons for the clearing agency ceasing to carry on business as a clearing agency.

**Exhibit B**

A list of all participants in Canada during the last 30 days prior to ceasing business as a clearing agency.

**Exhibit C**

A description of the alternative arrangements available to participants in respect of the services offered by the clearing agency immediately before the cessation of business as a clearing agency.

**Exhibit D**

A description of all links the clearing agency had immediately before the cessation of business as a clearing agency with other clearing agencies or trade repositories.

**CERTIFICATE OF CLEARING AGENCY**

The undersigned certifies that the information given in this report is true and correct.

DATED at \_\_\_\_\_ this \_\_\_\_\_ day of \_\_\_\_\_ 20 \_\_\_\_\_

\_\_\_\_\_  
(Name of clearing agency)

\_\_\_\_\_  
(Name of director, officer or partner – please type or print)

\_\_\_\_\_  
(Signature of director, officer or partner)

\_\_\_\_\_  
(Official capacity – please type or print)



**Annex F**

**Blacklined version of final adopted Companion Policy 24-102CP to National Instrument 24-102  
Clearing Agency Requirements reflecting revisions made to proposed Companion Policy in the 2014  
Documents**

**Companion Policy 24-102CP**

**TO**

**National Instrument 24 – 102**

**CLEARING AGENCY REQUIREMENTS**

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## PART I GENERAL COMMENTS

### Introduction

**1.1 (1)** This Companion Policy (CP) sets out how the Canadian Securities Administrators (the CSA or we) interpret or apply provisions of National Instrument 24-102 *Clearing Agency Requirements* (the Instrument) and related securities legislation.

**(2)** Except for this Part 1 of the CP, section 3.2 and 3.3 of Part 3 of this CP, and the *text boxes* in Annex I to this CP, the numbering of Parts, sections and subsections in this CP generally corresponds to the numbering in the Instrument. Any general guidance or introductory comments for a Part appears immediately after the Part's name. Specific guidance on a section or subsection in the Instrument follows any general guidance. If there is no guidance for a Part, section or subsection, the numbering in this CP will skip to the next provision that does have guidance.

**(3)** Unless otherwise stated, any reference in this CP to a Part, section, subsection, paragraph or defined term is a reference to the corresponding Part, section, subsection, paragraph or defined term of the Instrument. The CP also makes references to certain paragraphs in the April 2012 report *Principles for financial market infrastructures* (the PFMI or PFMI Report, as the context requires) and the PFMI Principles set out therein. A reference to a PFMI Principle may include a reference to an applicable key consideration (see definition of "PFMI Principle" in section 1.1).

### Background and overview

**1.2 (1)** Securities legislation in certain jurisdictions of Canada requires an entity seeking to carry on business as a clearing agency in the jurisdiction to be (i) recognized by the securities regulatory authority in that jurisdiction, or (ii) exempted from the recognition requirement.<sup>1</sup> Accordingly, Part 2 sets out certain requirements in connection with the application process for recognition as a clearing agency or exemption from the recognition requirement. Guidance on the CSA's regulatory approach to such an application is set out in this CP.

**(2)** Parts 3 and 4 set out on-going requirements applicable to a recognized clearing agency. Part 3 adopts the PFMI Principles generally but does restrict their application only to a clearing agency that operates as a central counterparty (CCP), securities settlement system (SSS) or central securities depository (CSD), as relevant. Part 4 applies to a clearing agency whether or not it operates as a CCP, SSS or CSD. The PFMI Principles were developed jointly by the Committee on Payments and Market Infrastructures (CPMI)<sup>2</sup> and the International Organization of Securities Commissions (IOSCO).<sup>3</sup> The PFMI Principles harmonize and strengthen previous international standards for financial market infrastructures (FMIs).<sup>4</sup>

**(3)** Annex I to this CP includes supplementary guidance in *text boxes* that applies to recognized domestic clearing agencies that are also overseen by the Bank of Canada (BOC). The supplementary guidance (Joint Supplementary Guidance) was prepared jointly by the CSA and BOC to provide additional clarity on certain aspects of the PFMI Principles within the Canadian context.

### Definitions, interpretation and application

**1.3 (1)** Unless defined in the Instrument or this CP, defined terms used in the Instrument and this CP have the meaning given to them in the securities legislation of each jurisdiction or in National Instrument 14-101 *Definitions*.

**(2)** The terms "clearing agency" and "recognized clearing agency" are generally defined in securities legislation. For the purposes of the Instrument, a clearing agency includes, in Quebec, a clearing house, central securities depository and settlement system within the meaning of the Québec *Securities Act* and a clearing house and settlement system within the meaning of the Québec *Derivatives Act*. See section 1.5.

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<sup>1</sup> The entity is prohibited from carrying on business as a clearing agency unless recognized or exempted.

<sup>2</sup> Prior to September 1, 2014, CPMI was known as the Committee on Payment and Settlement Systems (CPSS).

<sup>3</sup> See the CPMI-IOSCO *Principles for Financial Market Infrastructures* Report, published in April 2012, available on the Bank for International Settlements' website ([www.bis.org](http://www.bis.org)) and the IOSCO website ([www.iosco.org](http://www.iosco.org)).

<sup>4</sup> See (i) 2001 CPMI report *Core principles for systemically important payment systems*, (ii) 2001 CPMI-IOSCO report *Recommendations for securities settlement systems* (together with the 2002 CPMI-IOSCO report *Assessment methodology for Recommendations for securities settlement systems*); and (iii) 2004 CPMI-IOSCO report *Recommendations for central counterparties*. All of these reports are available on the Bank for International Settlements' website ([www.bis.org](http://www.bis.org)). The CPMI-IOSCO reports are also available on IOSCO website ([www.iosco.org](http://www.iosco.org)).

The CSA notes that, while Part 3 applies only to a recognized clearing agency that operates as a CCP, CSD or SSS, the term “clearing agency” may incorporate certain other centralized post-trade functions that are not necessarily limited to those of a CCP, CSD or SSS, e.g., an entity that provides centralized facilities for comparing data respecting the terms of settlement of a trade or transaction may be considered a clearing agency, but would not be considered a CCP, CSD or SSS. Except in Québec, such an entity would be required to apply either for recognition as a clearing agency or an exemption from the requirement to be recognized.<sup>5</sup> The CSA considers that a recognized clearing agency, which is not a CCP, CSD or SSS, should not be subject to the application of Part 3. Such a clearing agency is, however, subject to provisions in Part 2 and all of Parts 4 and 5.

**(3)** A clearing agency may serve either or both the securities and derivatives markets. A clearing agency serving the securities markets can be a CCP, CSD or SSS. A clearing agency serving the derivatives markets is typically only a CCP.

**(4)** In this CP, FMI means a financial market infrastructure, which the PFMI Report describes as follows: payment systems, CSDs, SSSs, CCPs and trade repositories.

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<sup>5</sup> In Québec, an entity that provides such centralized facilities for comparing data would be required to apply either for recognition as a matching service utility or for an exemption from the recognition requirement, in application of the *Securities Act* or the *Derivatives Act*.

**PART 2  
CLEARING AGENCY RECOGNITION  
OR EXEMPTION FROM RECOGNITION**

**Recognition and exemption**

**2.0 (1)** An entity seeking to carry on business as a clearing agency in certain jurisdictions in Canada is required under the securities legislation of such jurisdictions to apply for recognition or an exemption from the recognition requirement. For greater clarity, a foreign-based clearing agency that provides, or will provide, its services or facilities to a person or company resident in a jurisdiction would be considered to be carrying on business in that jurisdiction.

- ***Recognition of a clearing agency***

**(2)** The CSA takes the view that a clearing agency that is systemically important to a jurisdiction's capital markets, or that is not subject to comparable regulation by another regulatory body, will generally be recognized by a securities regulatory authority.<sup>6</sup> A securities regulatory authority may consider the systemic importance of a clearing agency to its capital markets based on the following list of guiding factors: value and volume of transactions processed, cleared and settled by the clearing agency;<sup>7</sup> risk exposures (particularly credit and liquidity) of the clearing agency to its participants; complexity of the clearing agency,<sup>8</sup> and centrality of the clearing agency with respect to its role in the market, including its substitutability, relationships, interdependencies and interactions.<sup>9</sup> The list of guiding factors is non-exhaustive, and no single factor described above will be determinative in an assessment of systemic importance. A securities regulatory authority retains the ability to consider additional quantitative and qualitative factors as may be relevant and appropriate.<sup>10</sup>

**(3)** Because of the approach described in subsection 2.0(2) of this CP, a securities regulatory authority may require a foreign-based clearing agency to be recognized if the clearing agency's proposed business activities in the local jurisdiction are systemically important to the jurisdiction's capital markets, even if it is already subject to comparable regulation in its home jurisdiction. In such circumstances, the recognition decision would focus on key areas that pose material risks to the jurisdiction's market and rely, where appropriate, on the current regulatory requirements and processes to which the entity is already subject in its home jurisdiction. Terms and conditions of a recognition decision that require a foreign clearing agency to report information to a Canadian securities regulatory authority may vary among foreign clearing agencies. Among other factors, they will depend on whether Canadian securities regulatory authorities have entered into an agreement or memorandum of understanding with the home regulator for sharing information and cooperation.

- ***Exemption from recognition***

**(4)** Depending on the circumstances, a clearing agency may be granted an exemption from recognition pursuant to securities legislation and subject to appropriate terms and conditions, where it is not considered systemically important or where it does not otherwise pose significant risk to the capital markets. For example, such an approach may be considered for an entity that provides limited services or facilities, thereby not warranting full regulation, such as a clearing agency that does not perform the functions of a CCP, CSD or SSS. However, in such cases, terms and conditions may be imposed. In addition, a foreign-based clearing agency that is already subject to a comparable regulatory regime in its home jurisdiction may be granted an exemption from the recognition requirement as full regulation may be duplicative and inefficient when imposed in addition to the regulation of the home jurisdiction. The exemption may be subject to certain terms and conditions, including reporting requirements and prior notification of certain material changes to information provided to the securities regulatory authority.

**Application and initial filing of information**

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<sup>6</sup> We would consider comparable regulation by another regulatory body to be regulation that generally results in similar outcomes in substance to the requirements of Part 3 and 4.

<sup>7</sup>We would consider, for example, the current aggregate monetary values and volumes of such transactions, as well as the entity's potential for growth.

<sup>8</sup> We would look, for example, to the nature and complexity of the clearing agency, taking into account an analysis of the various products it processes, clears or settles.

<sup>9</sup> We would consider, for example, the centrality or importance of the clearing agency to the particular market or markets it serves, based on the degree to which it critically supports, or that its failure or disruption would affect, such markets or the entire Canadian financial infrastructure.

<sup>10</sup> Additional factors may be based on the characteristics of the clearing agency under review, such as the nature of its operations, its corporate structure, or its business model.

**2.1** The application process for both recognition and exemption from recognition as a clearing agency is similar. The entity that applies will typically be the entity that operates the facility or performs the functions of a clearing agency. The application for recognition or exemption will require completion of appropriate documentation. This will include the items listed in subsection 2.1(1). Together, the application materials should present a detailed description of the history, regulatory structure, and business operations of the clearing agency. A clearing agency that operates as a CCP, CSD or SSS will need to describe how it meets or will meet the requirements of Parts 3 and 4. An applicant based in a foreign jurisdiction should also provide a detailed description of the regulatory regime of its home jurisdiction and the requirements imposed on the clearing agency, including how such requirements are similar to the requirements in Parts 3 and 4.

Where specific information items of the PFMI Disclosure Framework Document are not relevant to an applicant because of the nature or scope of its clearing agency activities, its structure, the products it clears or settles, or its regulatory environment, the application should explain in reasonable detail why the information items are not relevant.

The application filed by an applicant will generally be published for public comment for a 30-day period. Other materials filed with the application, which the applicant wishes to maintain confidential, will generally be kept confidential in accordance with securities and privacy legislation. However, the clearing agency will be required to publicly disclose its PFMI Disclosure Framework Document. See PFMI Principle 23, key consideration 5.

### **Significant changes, fee changes, and other changes in information**

**2.2** Section 2.2 is subject to the application provisions of subsections 1.5(3) and (4). For example, where the terms and conditions of a recognition decision made by a securities regulatory authority require a recognized clearing agency to obtain the approval of the authority before implementing a new fee for a service, the process to seek such approval set forth in the terms and conditions will apply instead of the prior notification requirement in subsection 2.2(4).

(2) The written notice should provide a reasonably detailed description of the significant change (as defined in subsection 2.2(1)) and the expected date of the implementation of the change. It should enclose or attach updated relevant documentation, including clean and blacklined versions of the documentation that show how the significant change will be implemented. If the notice is being filed by a foreign-based clearing agency, the notice should also describe the approval process or other involvement by the primary or home-jurisdiction regulator for implementing the significant change. The clearing agency is required to file concurrently with the notice any changes required to be made to the clearing agency's PFMI Disclosure Framework Document as a result of implementing the significant change, in accordance with subsection 2.2(3).

### **Ceasing to carry on business**

**2.3** A recognized or exempt clearing agency that ceases to carry on business in a local jurisdiction as a clearing agency, either voluntarily or involuntarily, must file a completed Form 24-102F2 *Cessation of Operations Report for Clearing Agency* within the appropriate timelines. In certain jurisdictions, the clearing agency intending to cease carrying on business must also make an application to voluntarily surrender its recognition to the securities regulatory authority pursuant to securities legislation. The securities regulatory authority may accept the voluntary surrender subject to terms and conditions.<sup>11</sup>

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<sup>11</sup> See, for example, section 21.4 of the *Securities Act* (Ontario).

## PART 3 PFMI PRINCIPLES APPLICABLE TO RECOGNIZED CLEARING AGENCIES

### Introduction

**3.0 (1)** Section 3.1 adopts the PFMI Principles generally but excludes the application of specific PFMI Principles for certain types of clearing agencies. We have adopted only those PFMI Principles that are relevant to clearing agencies operating as a CCP, CSD or SSS.<sup>12</sup>

**(2)** Part 3, together with the PFMI Principles, is intended to be consistent with a flexible and principles-based approach to regulation. In this regard, Part 3 anticipates that a clearing agency's rules, procedures, policies and operations will need to evolve over time so that it can adequately respond to changes in technology, legal requirements, the needs of its participants and their customers, trading volumes, trading practices, linkages between financial markets, and the financial instruments traded in the markets that a clearing agency serves.

### PFMI Principles

**3.1** The definition of PFMI Principles in the Instrument includes the applicable key considerations for each principle. Annex E to the PFMI Report provides additional guidance on how each key consideration will apply to the specified types of clearing agencies. In interpreting and implementing the PFMI Principles, regard is to be given to the explanatory notes in the PFMI Report, as appropriate, unless otherwise indicated in section 3.1 or this Part 3 of the CP.<sup>13</sup> As discussed in subsection 1.2(3) of this CP, the CSA and BOC have together developed Joint Supplementary Guidance to provide additional clarity on certain aspects of some PFMI Principles within the Canadian context. The Joint Supplementary Guidance is directed at recognized domestic clearing agencies that are also overseen by the BOC. The Joint Supplementary Guidance is included in separate *text boxes* in Annex I to this CP under the relevant headings of the PFMI Principles. Except as otherwise indicated in this Part 3 of the CP, other recognized domestic clearing agencies should assess the applicability of the Joint Supplementary Guidance to their respective entity as well.

### PFMI Principle 5: Collateral

**3.2** Notwithstanding section 3.1 of the CP and the Joint Supplementary Guidance relating to PFMI Principle 5: *Collateral* (see Box 5.1 in Annex I to this CP), we are of the view that letters of credit may be permitted as collateral by a recognized domestic clearing agency operating as a CCP serving derivatives markets that is not also overseen by the BOC, provided that the collateral and the clearing agency's collateral policies and procedures otherwise meet the requirements of PFMI Principle 5: *Collateral*. However, the recognized clearing agency must first obtain regulatory approval of its rules and procedures that govern the use of letters of credit as collateral before accepting letters of credit.

### PFMI Principle 14: Segregation and portability for CCPs serving cash markets

**3.3** PFMI Principle 14: *Segregation and portability* requires, pursuant to section 3.1, that a CCP have rules and procedures that enable the segregation and portability<sup>14</sup> of positions and related collateral of a CCP participant's customers, particularly to protect the customers from the default or insolvency of the participant. The explanatory notes in the PFMI Report offer an "alternate approach" to meeting PFMI Principle 14. The report notes that, in certain jurisdictions, cash market CCPs operate in legal regimes that facilitate segregation and portability to achieve the protection of customer assets by alternate means that offer the same degree of protection as the approach in PFMI Principle 14.<sup>15</sup> The features of the alternate approach are described in the PFMI Report.<sup>16</sup>

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<sup>12</sup> PFMI Principles that are relevant to payment systems and trade repositories, but not CCPs, SSSs and CSDs, are not adopted in Part 3.

<sup>13</sup> For example, the Instrument uses specialized terminology related to the clearing and settlement area. Not all such terminology is defined in the Instrument, but instead may be defined or explained in the PFMI Report. Regard should be given to the PFMI Report in understanding such terminology, as appropriate, including Annex H: *Glossary*.

<sup>14</sup> Portability refers to the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party. See paragraph 3.14.3 of the PFMI Report.

<sup>15</sup> See paragraph 3.14.6 of the PFMI Report, at p. 83.

<sup>16</sup> Features of such regimes are that, if a participant fails, (a) the customer positions can be identified in a 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

- *Customers of IIROC dealer members:*

Currently, most participants of domestic cash market CCPs that clear for customers are investment dealers.<sup>17</sup> They are required to be members of the Investment Industry Regulatory Organization of Canada (IIROC)<sup>18</sup> and to contribute to the Canadian Investor Protection Fund (CIPF).<sup>19</sup> The CSA is of the view that the customer asset protection regime applicable to investment dealers (IIROC-CIPF regime) is an appropriate alternative framework for customers of investment dealers that are direct participants of a cash-market CCP. The IIROC-CIPF regime meets the criteria for the alternate approach for CCPs serving certain domestic cash markets because:

- IIROC's requirements governing, among other things, an investment dealer's books and records, capital adequacy, internal controls, client account margining, and segregation of client securities and cash help ensure that customer positions and collateral can be identified timely,
- customers of an investment dealer are protected by CIPF, and
- through a combination of IIROC's member rules and oversight powers, CIPF's role in the administration of the bankruptcy of a dealer, and the overarching policy objectives of Part XII of the federal *Bankruptcy and Insolvency Act* (BIA) (discussed below), customer accounts can be moved from a failing dealer to another dealer in a timely manner and customers' assets can be restored.

Part XII of the BIA sets out a special bankruptcy regime for administering the insolvency of a securities firm. The regime generally provides for all cash and securities of a bankrupt securities firm, whether held for its own account and for its customers, to vest in the appointed trustee in bankruptcy. The trustee, in turn, is directed to pool such assets into a "customer pool fund" for the benefit of the customers, which are entitled to a pro rata share of the customer pool fund according to their respective "net equity" claims as a priority claim before the general creditors are paid. To the extent there is a shortfall in customer recovery from the customer pool fund and any remaining assets in the insolvent estate, the assets are allocated among the customers on a pro rata basis. CIPF, which works in conjunction with IIROC and the bankruptcy trustee,<sup>20</sup> provides protection to eligible customers for losses up to \$1 million per account.<sup>21</sup>

- *Customers of other types of participants:*

A recognized clearing agency operating as a cash market CCP for participants that are not IIROC investment dealers will need to have segregation and portability arrangements at the CCP level that meet PFMI Principle 14. Where the clearing agency is proposing to rely on an alternate approach for the purposes of protecting the customers of such participants, the clearing agency will need to demonstrate how the applicable legal or regulatory framework in which it operates achieves the same degree of protection and efficiency for such customers that would otherwise be achieved by segregation and portability arrangements at the CCP level described in PFMI Principle 14. See the PFMI Report, at paragraph 3.14.6.

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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.

<sup>17</sup> Investment dealers are firms registered in the category of "investment dealer" under provincial securities legislation. Investment dealers are required to be members of IIROC. See section 9.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

<sup>18</sup> IIROC is the national self-regulatory organization (SRO) which oversees all investment dealers and trading activity on debt and equity marketplaces in Canada. It is a recognized SRO in all 10 provinces in Canada and is subject to regulation and oversight by the CSA.

<sup>19</sup> CIPF is an investor compensation protection fund that is sponsored by IIROC and approved by the CSA.

<sup>20</sup> CIPF is a "customer compensation body" for the purposes of Part XII of the BIA. Where the accounts of a securities firm are protected (in whole or in part) by CIPF, the trustee in bankruptcy is required to consult with CIPF on the administration of the bankruptcy, and CIPF may designate an inspector to act on its behalf. See section 264 of the BIA.

<sup>21</sup> The losses must be in respect of a claim for the failure of the dealer to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property received, acquired or held by the dealer in an account for the customer.

**PART 4  
OTHER REQUIREMENTS OF  
RECOGNIZED CLEARING AGENCIES**

**Introduction**

**4.0** As discussed in section 1.2(2) of this CP, the provisions of Part 4 are in addition to the requirements of Part 3, and apply to a clearing agency whether or not it operates as a CCP, SSS or CSD.

**Division 1 – Governance:**

**Board of directors**

**4.1 (4)** Consistent with the explanatory notes in the PFMI Report (see paragraph 3.2.10), we are of the view that the following individuals have a relationship with a clearing agency that would reasonably be expected to interfere with the exercise of the individual's independent judgment:

- (a) an individual who is, or has been within the last year, an employee or executive officer of the clearing agency or any of its affiliated entities;
- (b) an individual whose immediate family member is, or has been within the last year, an executive officer of the clearing agency or any of its affiliated entities;
- (c) an individual who beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding;
- (d) an individual whose immediate family member beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding;
- (e) an individual who is, or has been within the last year, an executive officer of a person or company that beneficially owns, directly or indirectly, voting securities carrying more than ten per cent of the voting rights attached to all voting securities of the clearing agency or any of its affiliated entities for the time being outstanding; and
- (f) an individual who accepts or who received within the last year, directly or indirectly, any audit, consulting, advisory or other compensatory fee from the clearing agency or any of its affiliated entities, other than as remuneration for acting in his or her capacity as a member of the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee.

For the purposes of paragraph (f) above, compensatory fees would not normally include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the clearing agency if the compensation is not contingent in any way on continued service. Also, the indirect acceptance by an individual of any audit, consulting, advisory or other compensatory fee includes acceptance of a fee by (a) an individual's immediate family member; or (b) an entity in which such individual is a partner, a member, an officer such as a managing director occupying a comparable position or an executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the clearing agency or any of its affiliated entities.

In addition, an individual appointed to the board of directors or board committee of the clearing agency or any of its affiliated entities or of a person or company referred to in paragraph (e) above would not be considered to have a material relationship with the clearing agency solely because the individual acts, or has previously acted, as a chair or vice-chair of the board of directors or a board committee.

**Documented procedures regarding risk spill-overs**

**4.2** For guidance on this provision, see the Joint Supplementary Guidance in Box 2.2 in Annex I of this CP.

**Chief Risk Officer (CRO) and Chief Compliance Officer (CCO)**



**4.3** Section 4.3 is consistent with PFMI Principle 2, key consideration 5, which requires a clearing agency to have an experienced management with a mix of skills and the integrity necessary to discharge its operations and risk management responsibilities.

**(3)** The reference to “harm to the broader financial system” in subparagraph 4.3(3)(c)(ii) may be in relation to the domestic or international financial system. The CSA is of the view that the role of a CCO may, in certain circumstances, be performed by the Chief Legal Officer or General Counsel of the clearing agency, where the individual has sufficient time to properly carry out his or her duties and, provided that there are appropriate safeguards in place to avoid conflicts of interest.

#### **Board or advisory committees**

**4.4** Section 4.4 is intended to reinforce the clearing agency’s obligations to meet the PFMI Principles, particularly PFMI Principles 2 and 3. The CSA is of the view that the mandates of the committees should, at a minimum, include the following:

- (a) providing advice and recommendations to the board of directors to assist it in fulfilling its risk management responsibilities, including reviewing and assessing the clearing agency’s risk management policies and procedures, the adequacy of the implementation of appropriate procedures to mitigate and manage such risks, and the clearing agency’s participation standards and collateral requirements;
- (b) ensuring adequate processes and controls are in place over the models used to quantify, aggregate, and manage the clearing agency’s risks;
- (c) monitoring the financial performance of the clearing agency and providing financial management oversight and direction to the business and affairs of the clearing agency;
- (d) implementing policies and processes to identify, address, and manage potential conflicts of interest of board members; and
- (e) regularly reviewing the board of directors’ and senior management’s performance and the performance of each individual member.

Section 4.4 is a minimum requirement. Consistent with the explanatory notes in the PFMI Principles (see paragraph 3.2.9), a recognized clearing agency should also consider forming other types of board committees, such as a compensation committee. All committees should have clearly assigned responsibilities and procedures. The clearing agency’s internal audit function should have sufficient resources and independence from management to provide, among other activities, a rigorous and independent assessment of the effectiveness of its risk-management and control processes. See section 4.1 for the concept of independence. A board will typically establish an audit committee to oversee the internal audit function. In addition to reporting to senior management, the audit function should have regular access to the board through an additional reporting line.

#### ***Division 2 – Default management:***

##### **Use of own capital**

**4.5** The CSA is of the view that a CCP’s own capital contribution should be used in the default waterfall, immediately after a defaulting participant’s contributions to margin and default fund resources have been exhausted, and prior to non-defaulting participants’ contributions. Such equity should be significant enough to attract senior management’s attention, and separately retained and not form part of the CCP’s resources for other purposes, such as to cover general business risk.

#### ***Division 3 – Operational risk:***

**4.6 to 4.10** Sections 4.6 to 4.10 complement PFMI Principle 17, which requires a clearing agency to identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. PFMI Principle 17 further requires that systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity, and business continuity management should aim for timely recovery of operations and fulfilment of the FMI’s obligations, including in the event of a wide-scale or major disruption.

## **Systems requirements**

**4.6 (a)** The intent of these provisions is to ensure that controls are implemented to support information technology planning, acquisition, development and maintenance, computer operations, information systems support, and security. Recognized guides as to what constitutes adequate information technology controls include 'Information Technology Control Guidelines' from the Canadian Institute of Chartered Accountants (CICA) and 'COBIT' from the IT Governance Institute.

(b) Capacity management requires that the clearing agency monitor, review, and test (including stress test) the actual capacity and performance of the system on an ongoing basis. Accordingly, under subsection 4.6(b), the clearing agency is required to meet certain standards for its estimates and for testing. These standards are consistent with prudent business practice. The activities and tests required in this subsection are to be carried out at least once a year. In practice, continuing changes in technology, risk management requirements and competitive pressures will often result in these activities being carried out or tested more frequently.

(c) A failure, malfunction or delay or other incident is considered to be "material" if the clearing agency would, in the normal course of operations, escalate the matter to or inform its senior management ultimately accountable for technology. It is also expected that, as part of this notification, the clearing agency will provide updates on the status of the failure and the resumption of service. Further, the clearing agency should have comprehensive and well-documented procedures in place to record, report, analyze, and resolve all operational incidents. In this regard, the clearing agency should undertake a "post-incident" review to identify the causes and any required improvement to the normal operations or business continuity arrangements. Such reviews should, where relevant, include the clearing agency's participants. The results of such internal reviews are required to be communicated to the securities regulatory authority as soon as practicable. Subsection 4.6(c) also refers to a material security breach. A material security breach or systems intrusion is considered to be any unauthorized entry into any of the systems that support the functions of the clearing agency or any system that shares resources with one or more of these systems. Virtually any security breach would be considered material and thus reportable to the securities regulatory authority. The onus would be on the clearing agency to document the reasons for any security breach it did not consider material.

## **Systems reviews**

**4.7 (1)** A qualified party is a person or company or a group of persons or companies with relevant experience in both information technology and in the evaluation of related internal systems or controls in a complex information technology environment. Qualified persons may include external auditors or third party information system consultants, as well as employees of the clearing agency or an affiliated entity of the clearing agency, but may not be persons responsible for the development or operation of the systems or capabilities being tested. Before engaging a qualified party, a clearing agency should discuss its choice with the regulator or, in Québec, the securities regulatory authority.

## **Clearing agency technology requirements and testing facilities**

**4.8 (1)** The technology requirements required to be disclosed under subsection 4.8(1) do not include detailed proprietary information.

(5) We expect the amended technology requirements to be disclosed as soon as practicable, either while the changes are being made or immediately after.

## **Testing of business continuity plans**

**4.9** Business continuity management is a key component of a clearing agency's operational risk-management framework. A recognized clearing agency's business continuity plan and its associated arrangements should be subject to frequent review and testing. At a minimum, under section 4.9, such tests must be conducted annually. Tests should address various scenarios that simulate wide-scale disasters and inter-site switchovers. The clearing agency's employees should be thoroughly trained to execute the business continuity plan and participants, critical service providers, and linked clearing agencies should be regularly involved in the testing and be provided with a general summary of the testing results. The CSA expects that the clearing agency will also facilitate and participate in industry-wide testing of the business continuity plan (domestically-based recognized clearing agencies are required to participate in all industry-wide business continuity tests, as determined by a regulation services provider, regulator, or in Québec, the securities regulatory authority, pursuant to National Instrument 21-101 *Marketplace Operation*). The clearing agency should make appropriate adjustments to its business continuity plan and associated arrangements based on the results of the testing exercises.

## **Outsourcing**

**4.10** Where a recognized clearing agency relies upon or outsources some of its operations to a service provider, it should generally ensure that those operations meet the same requirements they would need to meet if they were provided internally. Under section 4.10, the clearing agency must meet various requirements in respect of the outsourcing of critical services or systems to a service provider. These requirements apply regardless of whether the outsourcing arrangements are with third-party service providers, or with affiliated entities of the clearing agency.

Generally, the clearing agency is required to establish, implement, maintain and enforce policies and procedures to evaluate and approve outsourcing agreements to critical service providers. Such policies and procedures should include assessing the suitability of potential service providers and the ability of the clearing agency to continue to comply with securities legislation in the event of the service provider's bankruptcy, insolvency or termination of business. The clearing agency is also required to monitor and evaluate the on-going performance and compliance of the service provider to which they outsourced critical services, systems or facilities. Accordingly, the clearing agency should define key performance indicators that will measure the service level. Further, the clearing agency should have robust arrangements for the substitution of such providers, timely access to all necessary information, and the proper controls and monitoring tools.

Under section 4.10, a contractual relationship should be in place between the clearing agency and the critical service provider allowing it and relevant authorities to have full access to necessary information. The contract should ensure that the clearing agency's approval is mandatory before the critical service provider can itself outsource material elements of the service provided to the clearing agency, and that in the event of such an arrangement, full access to the necessary information is preserved. Clear lines of communication should be established between the outsourcing clearing agency and the critical service provider to facilitate the flow of functions and information between parties in both ordinary and exceptional circumstances.

Where the clearing agency outsources operations to critical service providers, it should disclose the nature and scope of this dependency to its participants. It should also identify the risks from its outsourcing and take appropriate actions to manage these dependencies through appropriate contractual and organisational arrangements. The clearing agency should inform the securities regulatory authority about any such dependencies and the performance of these critical service providers. To that end, the clearing agency can contractually provide for direct contacts between the critical service provider and the securities regulatory authority, contractually ensure that the securities regulatory authority can obtain specific reports from the critical service provider, or the clearing agency may provide full information to the securities regulatory authority.

### ***Division 4 – Participation requirements:***

#### **Access requirements and due process**

**4.11** Section 4.11 complements PFMI Principle 18, which requires a clearing agency to have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

**(1)(b)** We consider an indirect participant to be an entity that relies on the services provided by other entities (participants) to use a clearing agency's clearing and settlement facilities. As defined in the Instrument, a participant (sometimes also referred to as a "direct participant") is an entity that has entered into an agreement with a clearing agency to access the services of the clearing agency and is bound by the clearing agency's rules and procedures. While indirect participants are generally not bound by the rules of the clearing agency, their transactions are cleared and settled through the clearing agency in accordance with the clearing agency's rules and procedures. The concept of indirect participant is discussed in the PFMI Report, at paragraph 3.19.1.

**(1)(d)** We are of the view that a requirement on participants of a clearing agency serving the derivatives markets to use a trade repository that is an affiliated entity to report derivatives trades would be unreasonable.

**PART 5**  
**BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER**

**Legal Entity Identifiers**

**5.2 (1)** The Global Legal Entity Identifier System defined in subsection 5.2(1) and referred to in subsections 5.2(2) and 5.2(3) is a G20 endorsed system<sup>22</sup> that will serve as a public-good utility responsible for overseeing the issuance of legal entity identifiers (LEIs) globally to counterparties that enter into transactions in order to uniquely identify parties to transactions. It is currently being designed and implemented under the direction of the LEI Regulatory Oversight Committee (ROC), a governance body endorsed by the G20.

**(3)** If the Global LEI System is not available at the time a clearing agency is required to fulfill their recordkeeping or reporting requirements under securities legislation, they must use a substitute LEI. The substitute LEI must be in accordance with the standards established by the LEI ROC for pre-LEI identifiers. At the time the Global LEI System is operational, a clearing agency or its affiliated entities must cease using their substitute LEI and commence using their LEI. It is conceivable that the two identifiers could be identical.

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<sup>22</sup> See [http://www.financialstabilityboard.org/list/fsb\\_publications/tid\\_156/index.htm](http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm) for more information.

## **PART 6 EXEMPTIONS**

### **Exemptions**

**6.1** As Part 3 adopts a principles-based approach to incorporating the PFMI Principles into the Instrument, the CSA has sought to minimize any substantive duplication or material inefficiency due to cross-border regulation. Where a recognized foreign-based clearing agency does face some conflict or inconsistency between the requirements of sections 2.2 and 2.5 and Part 4 and the requirements of the regulatory regime in its home jurisdiction, the clearing agency is expected to comply with the Instrument. However, where such a conflict or inconsistency causes a hardship for the clearing agency, and provided that the entity is subject to requirements in its home jurisdiction resulting in similar outcomes in substance to the requirements of sections 2.2 and 2.5 and Part 4, an exemption from a provision of the Instrument may be considered by a securities regulatory authority. The exemption may be subject to appropriate terms or conditions.

## Annex I

### to Companion Policy 24-102CP

#### Joint Supplementary Guidance

Developed by the Bank of Canada and Canadian Securities Administrators

#### - **PFMI Principle 2: Governance**

##### **Box 2.1: Joint Supplementary Guidance – Financial Stability and Other Public Interest Considerations**

###### **Context**

The PFMI's define governance as the set of relationships between an FMI's owners, board of directors (or equivalent), management, and other relevant parties, including participants, authorities, and other stakeholders (such as participants' customers, other interdependent FMIs, and the broader market). Governance provides the processes through which an organization sets its objectives, determines the means for achieving those objectives, and monitors performance against those objectives. This note provides supplementary regulatory guidance for Canadian FMIs on their governance arrangements as it relates to supporting relevant public interest considerations.

###### **Public interest considerations in the context of the PFMI's**

The PFMI's indicate that FMIs should "explicitly support financial stability and other relevant public interests." However, there may be circumstances where providing explicit support of relevant public interests conflict with other FMI objectives and therefore require appropriate prioritization and balancing. For example, addressing the potential trade-offs between protecting the participants and the FMI while ensuring the financial stability interests are upheld.

###### **Guidance within the PFMI's**

The following text has been extracted directly from the PFMI's. The pertinent information is in bold italics.

PFMI paragraph 3.2.2:

***Given the importance of FMIs and the fact that their decisions can have widespread impact, affecting multiple financial institutions, markets, and jurisdictions, it is essential for each FMI to place a high priority on the safety and efficiency of its operations and explicitly support financial stability and other relevant public interests. Supporting the public interest is a broad concept that includes, for example, fostering fair and efficient markets. For example, in certain over the counter derivatives markets, industry standards and market protocols have been developed to increase certainty, transparency, and stability in the market. If a CCP in such markets were to diverge from these practices, it could, in some cases, undermine the market's efforts to develop common processes to help reduce uncertainty. An FMI's governance arrangements should also include appropriate consideration of the interests of participants, participants' customers, relevant authorities, and other stakeholders. (...) For all types of FMIs, governance arrangements should provide for fair and open access (see Principle 18 on access and participation requirements) and for effective implementation of recovery or wind-down plans, or resolution.***

PFMI paragraph 3.2.8:

***An FMI's board has multiple roles and responsibilities that should be clearly specified. These roles and responsibilities should include (a) establishing clear strategic aims for the entity; (b) ensuring effective monitoring of senior management (including selecting its senior managers, setting their objectives, evaluating their performance, and, where appropriate, removing them); (c) establishing appropriate compensation policies (which should be consistent with best practices and based on long-term achievements, in particular, the safety and efficiency of the FMI); (d) establishing and overseeing the risk-management function and material risk decisions; (e) overseeing internal control functions (including ensuring independence and adequate resources); (f) ensuring compliance with all supervisory and oversight requirements; (g) ensuring consideration of financial stability and other relevant***

*public interests; and (h) providing accountability to the owners, participants, and other relevant stakeholders.*

The CPMI-IOSCO PFMI Disclosure framework and Assessment methodology provides questions to guide the assessment of the FMI against the PFMI. Questions related to public interest considerations are focused on ensuring that the FMI's objectives are clearly defined, giving a high priority to safety, financial stability and efficiency while also ensuring all other public interest considerations are identified and reflected in the FMI's objectives.

### **Supplementary Guidance for designated Canadian FMIs**

By definition the PFMI apply to systemically important FMIs, so safety and financial stability objectives should be given a high priority.

Efficiency is also a high priority that should contribute to (but not supersede) the safety and financial stability objectives.

Other public interest considerations such as competition and fair and open access should also be considered in the broader safety and financial stability context.

A framework (objectives, policies and procedures) should be in place for default and other emergency situations. The framework should articulate explicit principles to ensure financial stability and other relevant public interests are considered as part of the decision making process. For example, it should provide guidance on discretionary management decisions, consider the trade-offs between protecting the participants and the FMI while also ensuring the financial stability interests are upheld, and articulate a communication protocol with the board and regulators.

Practical questions/approaches to assessing the appropriateness of the framework include:

- Does the enabling legislation, articles of incorporation, corporate by-laws, corporate mission, vision statements, corporate risk statements/frameworks/methodology clearly articulate the objectives and are they appropriately aligned and communicated (transparent)?
- Do the objectives give appropriate priority to safety, financial stability, efficiency and other public interest considerations?
- Does the Board structure ensure the right mix of skills/experience and interests are in place to ensure the objectives are clear, appropriately prioritized, achieved and measured?
- What is the training provided to the Board and management to support the objectives?
- Do the service offerings and business plans support the objectives?
- Do the system design, rules, procedures support the objectives?
- Are the inter-dependencies and key dependencies considered and managed in the context of the broader financial stability objectives? For instance, do problem and default management policies and procedures appropriately provide for consideration of the broader financial stability interests and do they engage the key stakeholders and regulators?
- Are there procedures in place to get timely engagement of the Board to discuss emerging/current issues, consider scenarios, provide guidance and make decision?
- Does the framework ensure that the broader financial stability issues are considered in any actions relating to a participant suspension?

### **Box 2.2: Joint Supplementary Guidance– Vertically and Horizontally Integrated FMIs**

#### **Context**

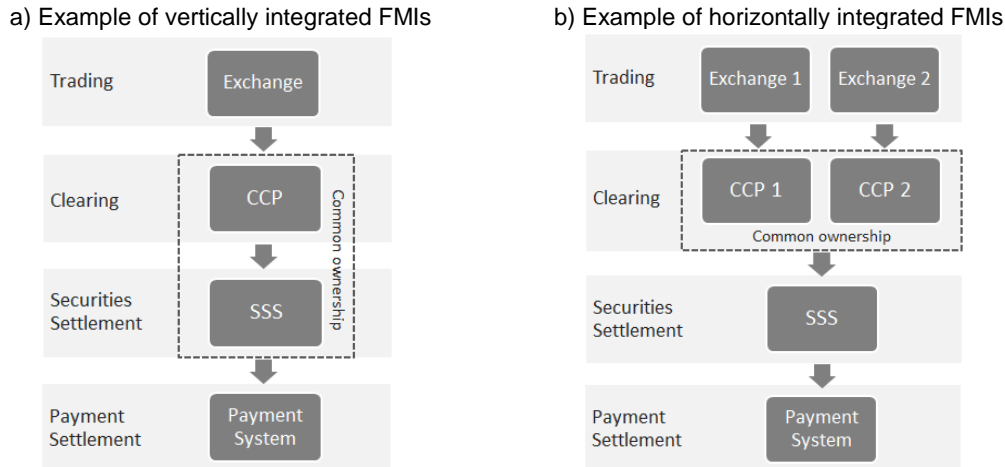
Consolidation, or integration, of FMI services may bring about benefits for merging FMIs; however it may also create new governance challenges. The PFMI contain some general guidance regarding how FMIs should manage governance issues that arise in integrated entities. This note provides supplementary regulatory guidance for Canadian FMIs that either belong to an integrated entity or are considering consolidating with another entity to form one. The guidance applies to both vertically and horizontally integrated entities.

#### **Vertical and horizontal integration in the context of FMIs**

The PFMI define a vertically integrated FMI group as one that brings together post-trade infrastructure providers under common ownership with providers of other parts of the value chain (for example, one entity owning and operating an exchange, CCP and SSS) and a horizontally integrated group as one that provides the same post-trade service offerings across a number of different products (for example, one entity offering

CCP services for derivatives and cash markets).<sup>23</sup> Examples are shown in Figure 1.

**Figure 1: Examples of FMI integration in the value chain**



### Guidance within the PFMI

The following text has been extracted directly from the PFMI. The pertinent information is in bold italics.

PFMI paragraph 3.2.5:

*Depending on its ownership structure and organisational form, an FMI may need to focus particular attention on certain aspects of its governance arrangements. **An FMI that is part of a larger organisation, for example, should place particular emphasis on the clarity of its governance arrangements, including in relation to any conflicts of interests and outsourcing issues that may arise because of the parent or other affiliated organisation’s structure. The FMI’s governance arrangements should also be adequate to ensure that decisions of affiliated organisations are not detrimental to the FMI.**<sup>24</sup> An FMI that is, or is part of, a for-profit entity may need to place particular emphasis on managing any conflicts between income generation and safety.*

PFMI paragraph 3.2.6:

*An FMI may also need to focus particular attention on certain aspects of its risk-management arrangements as a result of its ownership structure or organisational form. **If an FMI provides services that present a distinct risk profile from, and potentially pose significant additional risks to, its payment, clearing, settlement, or recording function, the FMI needs to manage those additional risks adequately. This may include separating the additional services that the FMI provides from its payment, clearing, settlement, and recording function legally, or taking equivalent action.** The ownership structure and organisational form may also need to be considered in the preparation and implementation of the FMI’s recovery or wind-down plans or in assessments of the FMI’s resolvability.*

### Supplementary guidance for designated Canadian FMIs

An FMI that is part of a larger entity faces additional risk considerations compared to stand-alone FMIs. While there are potential benefits from integrating services into one large entity, including potential risk reduction benefits, integrated entities could face additional risks such as a greater degree of general business risk. Examples of how this could occur include the following:

- losses in one function may spill-over to the entity’s other functions;
- the consolidated entity may face high combined exposures across its functions; and

<sup>23</sup> CPMI-IOSCO 2010. “Market structure developments in the clearing industry: implications for financial stability.” CPMI-IOSCO Paper No 92. Available at: <http://www.bis.org/publ/cpss92.htm>.

<sup>24</sup> If an FMI is wholly owned or controlled by another entity, authorities should also review the governance arrangements of that entity to see that they do not have adverse effects on the FMI’s observance of this principle.



- the consolidated entity may face exposures to the same participants across its functions.

For a more extensive discussion of potentially heightened risks that integrated FMIs may face, see CPMI, “Market structure developments in the clearing industry: implications for financial stability” (2010).<sup>25</sup>

If an FMI belongs to a larger entity, or is considering consolidating with another entity, it should consider how its risk profile differs as part of the consolidated entity, and take appropriate measures to mitigate these risks.

In addition, FMIs that either belong to an integrated entity or are considering merging to form one should meet the following conditions.

#### **5) Measures to protect critical FMI functions**

- FMIs may be part of a larger consolidated entity. These FMIs must either:
  - legally separate FMI-related functions<sup>26</sup> from non-FMI-related functions performed by the consolidated entity in order to maximize bankruptcy remoteness of the FMI-related functions; or
  - have satisfactory policies and procedures in place to manage additional risks resulting from the non-FMI-related functions appropriately to ensure the FMI’s financial and operational viability.
- If an FMI performs multiple FMI-related functions with distinct risk profiles within the same entity, the operator should effectively manage the additional risks that may result. The FMI should hold sufficient financial resources to manage the risks in all services it offers, including the combined or compounded risks that would be associated with offering the services through a single legal entity. If the FMI provides multiple services, it should disclose information about the risks of the combined services to existing and prospective participants to give an accurate understanding of the risks they incur by participating in the FMI. The FMI should carefully consider the benefits of offering critical services with distinct risk profiles through separate legal entities.
- If an FMI offers CCP services as part of its FMI-related functions, further conditions apply. CCPs take on more risk than other FMIs, and are inherently at higher risk of failure. Therefore, the FMI must either legally separate its CCP functions from other critical (non-CCP) FMI-related functions, or have satisfactory policies and procedures in place to manage additional risks appropriately to ensure the FMI’s financial and operational viability.
- Legal separation of critical functions is intended to maximize their bankruptcy remoteness and would not necessarily preclude integration of common organizational management activities such as IT and legal services across functions as long as any related risks are appropriately identified and mitigated.

#### **6) Independence of governance and risk management**

- FMIs and non-FMIs may have different corporate objectives and risk management appetites which could conflict at the parent level. For example, non-FMI-related functions, such as trading venues, are generally more focused on profit generation than risk management and do not have the same risk profile as FMI-related functions. A trading venue in a vertically integrated entity may benefit from increased participation in its service if its associated clearing function lessens its participation requirements.
- To mitigate potential conflicts, in particular the ability of other functions to negatively influence the FMI’s risk controls, each FMI subsidiary should have a governance structure and risk management decision-making process that is separate and independent from the other functions and should maintain an appropriate level of autonomy from the parent and other functions to ensure efficient decision making and effective management of any potential conflicts of interest. In addition, the consolidated entity’s broad governance arrangements should be reviewed to ensure they do not impede the FMI-related function’s observance of the CPMI-IOSCO principle on governance.

#### **7) Comprehensive management of risks**

- Although risk management governance and decision-making should remain independent, it is

<sup>25</sup> Available at <http://www.bis.org/cpmi/publ/d92.pdf>.

<sup>26</sup> FMI-related functions are CCP, SSS, and CSD functions, including other core aspects of clearing and settlement necessary to perform the CCP, SSS, and CDS functions (see the CPMI-IOSCO glossary definitions of “clearing” and “settlement”, available at <http://www.bis.org/cpmi/publ/d00b.pdf>).

nonetheless necessary that the consolidated entity is able to manage risk appropriately across the entity. At a consolidated level, the entity should have an appropriate risk management framework that considers the risks of each subsidiary and the additional risks related to their interdependencies.

- An FMI should identify and manage the risks it bears from and poses to other entities as a result of interdependencies. Consolidated FMIs should also identify and manage the risks they pose to one another as a result of their interdependencies. Consolidated FMIs may have exposures to the same participants, liquidity providers, and other critical service providers across products, markets and/or functions. This may increase the entity's dependence on these providers and may heighten the systemic risk associated with the consolidated entity compared to a stand-alone FMI. Where possible, the consolidated entity and its FMIs should consider ways to mitigate risks arising from shared dependencies. The consolidated entity and its FMIs should also consider conducting entity-wide operational risk testing related to identifying and mitigating these risks.

#### **8) Sufficient capital to cover potential losses**

- Consolidated entities face the risk that a single participant defaults in more than one subsidiary simultaneously. This could result in substantial losses for the consolidated entity which will then also need to replenish resources for the FMIs to continue to operate. FMIs should consider such risks in developing their resource replenishment plan.
- Consolidated entities may face higher or lower business risk than individual FMIs depending on size, complexity and diversification across affiliates. Consolidated entities should consider these impacts in their general business risk profiles and in determining the appropriate level of liquid assets needed to cover their potential general business losses.<sup>27</sup>

#### **- PFMI Principle 5: Collateral**

##### **Box 5.1: Joint Supplementary Guidance – Collateral**

#### **Context**

The PFMI establish the form and attributes of collateral that an FMI holds to manage its own credit exposures or those of its participants. This note provides additional guidance for Canadian FMIs to meet the components of the collateral principle related to: (i) acceptance of collateral with low credit, liquidity and market risk; (ii) concentrated holdings of certain assets; and (iii) calculating haircuts. In certain circumstances, regulators may allow exceptions to the collateral policy on a case-by-case basis if the FMI demonstrates that the risks can be adequately managed.

#### **(i) Acceptable collateral**

An FMI should conduct its own assessment of risks when determining collateral eligibility. In general, collateral held to manage the credit exposures of the FMI or those of its participants should have minimal credit, liquidity and market risk, even in stressed market conditions. However, asset categories with additional risk may be accepted when subject to conservative haircuts and adequate concentration limits.<sup>28</sup>

The following clarifies regulators' expectations on what is acceptable collateral by specifying:

- 4) minimum requirements for all assets that are acceptable as collateral;
- 5) the asset categories that are judged to have minimal credit, liquidity and market risk; and
- 6) additional asset categories that could be acceptable as collateral if subject to conservative haircuts and concentration limits.

- 4) An FMI should conduct its own internal assessment of the credit, liquidity and market risk of the assets eligible as collateral. The FMI should review its collateral policy at least annually, and whenever market factors justify a more frequent review. At a minimum, acceptable assets should:**

- vi) be freely transferable without legal, regulatory, contractual or any other**

<sup>27</sup> Liquid assets held for general business losses must be funded by equity (such as common stock, disclosed reserves, or retained earnings) rather than debt.

<sup>28</sup> See PFMI Principle 5, key considerations 1 and 4.

- vii) **constraints that would impair liquidation in a default;**
- be marketable securities that have an active outright sale market even in stressed market conditions;**
- viii) **have reliable price data published on a regular basis;**
- ix) **be settled over a securities settlement system compliant with the Principles; and**
- x) **be denominated in the same currency as the credit exposures being managed, or in a currency that the FMI can demonstrate it has the ability to manage.**

An FMI should not rely only on external opinions to determine what acceptable collateral is. The FMI should conduct its own assessment of the riskiness of assets, including differences within a particular asset category, to determine whether the risks are acceptable. Since the primary purpose of accepting collateral is to manage the credit exposures of the FMI and its participants, it is paramount that assets eligible as collateral can be liquidated for fair value within a reasonable time frame to cover credit losses following a default. The annual review of the FMI's collateral policy provides an opportunity to assess whether risks continue to be adequately managed. Owing to the dynamic nature of capital markets, the FMI should monitor changes in the underlying risk of the specific assets accepted as collateral, and should adjust its collateral policy in the interim period between annual reviews, when required.

At a minimum, an asset should have certain characteristics in order to provide sufficient assurance that it can be liquidated for fair value within a reasonable time frame. These characteristics relate primarily to the FMI's ability to reliably sell the asset as required to manage its credit exposures. The asset should be unencumbered, that is, it must be free of legal, regulatory, contractual or other restrictions that would impede the FMI's ability to sell it. The challenges associated with selling or transferring non-marketable assets, or those without an active secondary market, preclude their acceptance as collateral.

**5) Assets generally judged to have minimal credit, liquidity and market risk are the following:**

- v) **cash;**
- vi) **securities issued or guaranteed by the Government of Canada;<sup>29</sup>**
- vii) **securities issued or guaranteed by a provincial government; and**
- viii) **securities issued by the U.S. Treasury.**

In general, the assets judged to have minimal risk are cash and debt securities issued by government entities with unique powers, such as the ability to raise taxes and set laws, and that have a low probability of default. Total Canadian debt outstanding is currently dominated by securities issued or guaranteed by the Government of Canada and by provincial governments. The relatively large supply of securities issued by these entities and their generally high creditworthiness contribute to the liquidity of these assets in the domestic capital market. Securities issued by the U.S. Treasury are also deemed to be of high quality for the same reasons. The overall riskiness of securities issued by the Government of Canada and the U.S. Treasury is further reduced by their previous record of maintaining value in stressed market conditions, when they tend to benefit from a "flight to safety."

It is essential that an FMI regularly assesses the riskiness of even the specific high-quality assets identified in this section to determine their adequacy as eligible collateral. In some cases, only certain assets within the more general asset category may be deemed acceptable.

**6) An FMI should consider its own distinct arrangements for allocating credit losses and managing credit exposures when accepting a broader range of assets as collateral. The following asset classes may be acceptable as collateral if they are subject to conservative haircuts and concentration limits:**

- viii) **securities issued by a municipal government;**
- ix) **bankers' acceptances;**
- x) **commercial paper;**
- xi) **corporate bonds;**
- xii) **asset-backed securities that meet the following criteria: (1) sponsored by**

<sup>29</sup> Guarantees include securities issued by federal and provincial Crown corporations or other entities with an explicit statement that debt issued by the entity represents the general obligations of the sovereign.

- xiii) **a deposit-taking financial institution that is prudentially regulated at either the federal or provincial level, (2) part of a securitization program supported by a liquidity facility , and (3) backed by assets of an acceptable credit quality;**
- xiv) **equity securities traded on marketplaces regulated by a member of the CSA and the Investment Industry Regulatory Organization of Canada; and other securities issued or guaranteed by a government, central bank or supranational institution classified as Level 1 high-quality assets by the Basel Committee on Banking Supervision.**

An FMI should take into account its specific risk profile when assessing whether accepting certain assets as collateral would be appropriate. The decision to broaden the range of acceptable collateral should also consider the size of collateral holdings to cover the credit exposures of the FMI relative to the size of asset markets. In cases where the total collateral required to cover credit exposures is small compared with the market for high-quality assets, there is less potential strain on participants to meet collateral requirements.

Accepting a broader range of collateral has certain advantages. Most importantly, it provides participants with more flexibility to meet the FMI's collateral requirements, which may be especially important in stressed market conditions. A broader range of collateral diversifies the risk exposures faced by the FMI, since it may be easier to liquidate diversified collateral holdings when liquidity unexpectedly dries up for a particular asset class. It also diversifies market risk by reducing potential exposure to idiosyncratic shocks. Accepting a broader range of assets recognizes the increased cost to market participants of posting only the highest-quality assets, as well as the increasing encumbrance of these assets in order to meet new regulatory standards.<sup>30</sup>

## **(ii) Concentration Limits**

An FMI should avoid concentrated holding of assets where this could potentially introduce credit, market and liquidity risk beyond acceptable levels. In addition, the FMI should mitigate specific wrong-way risk by limiting the acceptance of collateral that would likely lose value in the event of a participant default, and prevent participants from posting assets they or their affiliates have issued. The FMI should measure and monitor the collateral posted by participants on a regular basis, with more frequent analysis required when more flexible collateral policies have been implemented.<sup>31</sup>

The following points clarify regulators' expectations regarding the composition of collateral accepted by an FMI by specifying:

- 4) broad limits for riskier asset classes to mitigate concentration risk;
  - 5) targeted limits for securities issued by financial sector entities to mitigate specific wrong-way risk; and
  - 6) the level of monitoring required for collateral posted by participants.
- 4) An FMI should limit assets from the broader range of acceptable assets identified in section (i)3 to a maximum of 40 per cent of the total collateral posted from each participant. Within the broader range of acceptable assets, the FMI should consider implementing more specific concentration limits for different asset categories.**

**An FMI should limit securities issued by a single issuer from the broader range of acceptable assets to a maximum of 5 per cent of total collateral from each participant.**

The guidance limits the acceptance of collateral from the broader range of assets to a maximum of 40 per cent because a higher proportion could potentially create unacceptable risks to FMIs and their participants. This limit is currently applied to the Bank's Standing Liquidity Facility and the Liquidity Coverage Ratio under Basel III. The benefits of expanding collateral—namely, providing participants with more flexibility and achieving greater diversification—are achieved within the limit of 40 per cent, with collateral in excess of this limit increasing the overall risk exposures with less benefit. In some circumstances, regulators may permit an FMI to accept more than 40 per cent of total collateral from the broader range of assets if the risk from a particular participant is low. Employing a limit of 5 per cent of total collateral for securities issued by a single issuer is a prudent measure to limit exposures from idiosyncratic shocks. It also reduces the need for procyclical

<sup>30</sup> The encumbrance of high-quality assets is expected to increase through a number of regulatory reforms, including Basel III, over-the-counter derivatives reform and the Principles.

<sup>31</sup> See Principle 5, key considerations 1 and 4.

adjustments to collateral requirements following a decline in value.

An FMI should consider implementing more stringent concentration limits, as well as imposing limits on certain asset categories, depending on the FMI's specific arrangements for managing credit exposures. The considerations described in section (i) 3) for accepting a broader range of assets as collateral apply equally to the decision over whether more stringent concentration limits should be implemented.

**5) An FMI should limit the collateral from financial sector issuers to a maximum of 10 per cent of total collateral pledged from each participant. The FMI should not allow participants to post their own securities or those of their affiliates as collateral.**

An FMI is exposed to specific wrong-way risk when the collateral posted is highly likely to decrease in value following a participant default. It is highly likely that the value of debt and equity securities issued by companies in the financial sector would be adversely affected by the default of an FMI participant, introducing wrong-way risk. This is especially the case for interconnected FMI participants with activities that are concentrated in domestic financial markets. Implementing a limit on financial sector issuers mitigates potential risk exposures from specific wrong-way risk. More stringent limits should be implemented where appropriate.

**6) In cases where only the highest-quality assets are accepted, an FMI is required to measure and monitor the collateral posted by participants during periodic evaluations of participant creditworthiness. The FMI should measure and monitor the correlation between a participant's creditworthiness and the collateral posted more frequently when a broader range of collateral is accepted. The FMI should have the ability to adjust the composition and to increase the collateral required from participants experiencing a reduction in creditworthiness.**

When only the highest-quality assets are accepted as collateral, there is less risk associated with the composition of collateral posted by a participant; hence, such risk does not need to be monitored as closely. The FMI should monitor the composition of collateral pledged by participants more frequently when riskier assets are eligible, since such assets are more likely to be correlated with the participant's creditworthiness. FMIs should also consider the general credit risk of their participants when deciding how frequently monitoring should be conducted. In all circumstances, the FMI should have the contractual and legal ability to unilaterally require more collateral and to request higher-quality collateral from a participant that is judged to present a greater risk.

**(iii) Haircuts**

An FMI should establish stable and conservative haircuts that consider all aspects of the risks associated with the collateral. An FMI should evaluate the performance of haircuts by conducting backtesting and stress testing on a regular basis.<sup>32</sup>

The following points clarify regulators' expectations regarding the calculation and testing of haircuts by outlining:

- 3) requirements for calculating haircuts; and
  - 4) requirements for testing the adequacy of haircuts and overall collateral accepted.
- 3) An FMI should apply stable and conservative haircuts that are calibrated against stressed market conditions. When the same haircut is applied to a group of securities, it should be sufficient to cover the riskiest security within the group. Haircuts should reflect both the specific risks of the collateral accepted and the general risks of an FMI's collateral policy.**

Including periods of stressed market conditions in the calibration of haircuts should increase the haircut rate. In addition to representing a conservative approach, this helps to mitigate the risk of a procyclical increase in haircuts during a period of high volatility. Typically, FMIs group similar securities by shared characteristics for the purposes of calculating haircuts (e.g., Government of Canada bonds with similar maturities). An FMI should recognize the different risks associated with each individual security by ensuring that the haircut is sufficient to cover the security with the most risk within each group. Haircuts should always account for all of the specific risks associated with each asset accepted as collateral. However, the FMI should also consider the portfolio risk of the

<sup>32</sup> See PFMI Principle 5, key considerations 2 and 3.

total collateral posted by a participant; the FMI may consider employing deeper haircuts for concentration and wrong-way risk above certain thresholds.

- 4) An FMI should perform backtesting of its collateral haircuts on at least a monthly basis, and conduct a more thorough review of haircuts quarterly. The FMI's stress tests should take into account the collateral posted by participants.**

FMI's are expected to calculate stable and conservative haircuts by considering stressed market conditions. In general, including stressed market conditions in the calibration of haircuts should provide a high level of coverage that does not require continuous testing and verification. Nonetheless, backtesting on a monthly basis allow the adequacy of haircuts to be evaluated against observed outcomes. A quarterly review of haircuts balances the objective of stable haircuts with the need to adjust haircuts as required. Including changes to collateral values as part of stress testing provides a more accurate assessment of potential losses in a default scenario.

- **PFMI Principle 7: Liquidity risk**

**Box 7.1:  
Joint Supplementary Guidance –  
Liquidity Risk**

**Context**

The PFMI's define liquidity risk as risk that arises when the FMI, its participants or other entities cannot settle their payment obligations when due as part of the clearing or settlement process. This note provides additional guidance for Canadian FMI's to meet the components of the liquidity-risk principle related to: (i) maintaining sufficient liquid resources and (ii) qualifying liquid resources.

**(i) Maintaining sufficient liquid resources**

An FMI should maintain sufficient qualifying liquid resources to cover its liquidity exposures to participants with a high degree of confidence. An FMI should maintain additional liquid resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible conditions. Liquidity stress testing should be performed on a daily basis. An FMI should verify that its liquid resources are sufficient through comprehensive stress testing conducted at least monthly.<sup>33</sup>

The information provided in this section clarifies regulators' expectations of sufficient qualifying liquid resources by specifying:

- 4) the degree of confidence required to cover liquidity exposures;
- 5) the total liquid resources that should be maintained; and
- 6) how the FMI should verify that its liquid resources are sufficient and adjust liquid resources when necessary.

- 1) Qualifying liquid resources should meet an established single-tailed confidence level of at least 97 per cent with respect to the estimated distribution of potential liquidity exposures.<sup>34</sup> The FMI should have an appropriate method for estimating potential exposures that accounts for the design of the FMI and other relevant risk factors.**

The guidance requires a high threshold for covering liquidity exposures with qualifying liquid resources, while also considering the expense associated with obtaining these resources. A 97 per cent degree of confidence is equivalent to less than one observation per month (on average) in which a liquidity exposure is greater than the FMI's qualifying liquid resources. However, if it is to meet the required threshold, the FMI should estimate its potential liquidity exposures accurately. The FMI should account for all relevant predictive factors when estimating potential exposures. While historical exposures are expected to form the basis of estimated potential exposures, the FMI should account for the impact of new products, additional participants,

<sup>33</sup> See PFMI Principle 7, key considerations 3, 5, 6 and 9.

<sup>34</sup> A "potential liquidity exposure" is defined as the estimated maximum daily liquidity needs resulting from the market value of the FMI's payment obligations under normal business conditions. FMI's should consider potential liquidity exposures over a rolling one-year time frame.

changes in the way transactions settle or other relevant market- risk factors.

**2a) An FMI should maintain additional liquid resources that are sufficient to cover a wide range of potential**

**stress scenarios. Total liquid resources should cover the FMI's largest potential exposure under a variety of extreme but plausible conditions. The FMI should have a liquidity plan that justifies the use of other liquid resources and provides the supporting rationale for the total liquid resources that it maintains.**

The guidance requires that total liquid resources be determined by the largest potential exposure in extreme but plausible conditions. This implies maintaining total liquid resources sufficient to cover at least the FMI's largest observed liquidity exposures, but the liquidity resources would likely be larger, based on an assessment of potential liquidity exposures in extreme but plausible conditions. The FMI's liquidity plan should explain why the FMI's estimated largest potential exposure is an accurate assessment of the FMI's liquidity needs in extreme but plausible conditions, thereby demonstrating the adequacy of the FMI's total liquid resources.

It is permissible for an FMI to manage this risk in part with other liquid resources because it may be prohibitively expensive, or even impossible, for the FMI to obtain sufficient qualifying liquid resources. FMIs face increased risk from liquid resources that do not meet the strict definition of "qualifying," and thus an FMI should include in its liquidity plan a clear explanation of how these resources could be used to satisfy a liquidity obligation. This additional explanation is warranted in all cases, even when the FMI's dependence on other liquid resources is minimal.

**2b) When applicable, the possibility that a defaulting participant is also a liquidity provider should be taken into account.**

Generally, the liquidity providers for Canadian FMIs are also participants in the FMI. When a defaulting participant is also a liquidity provider, it is important that the FMI's liquidity facilities are arranged in such a way that it has sufficient liquidity. To do so, the FMI should either have additional liquid resources or negotiate a backup liquidity provider, so that the FMI has sufficient liquidity (as specified in this guidance) in the event that one of its liquidity providers defaults.

**3) FMIs should perform liquidity stress testing on a daily basis to assess their liquidity needs. At least**

**monthly, FMIs should conduct comprehensive stress tests to verify the adequacy of their total liquid resources and to serve as a tool for informing risk management. Stress-testing results should be reviewed by the FMI's risk-management committee and reported to regulators on a regular basis.**

**FMIs should have clear procedures to determine whether their liquid resources are sufficient and to adjust their available liquid resources when necessary. A full review and potential resizing of liquid resources should be completed at least annually.**

**The annual validation of an FMI's model for managing liquidity risk should determine whether its stress testing follows best practices and captures the potential risks faced by the FMI.**

FMIs should assess their liquidity needs through stress testing that includes the measurement of the largest daily liquidity exposure that they face. FMIs should also conduct stress testing to verify whether their liquid resources are sufficient to cover potential liquidity exposures under a wide range of stress scenarios. An annual full review and potential resizing of liquid resources provides adequate time to negotiate with liquidity providers. While it may be impractical for FMIs to frequently obtain additional liquid resources, it is important that FMIs clearly define the circumstances requiring prompt adjustment of their available liquid resources, and have a reliable plan for doing so. Establishing clear procedures provides transparency regarding an FMI's decision-making process and prevents the FMI from delaying required increases in liquid resources beyond what is reasonably acceptable. The review of stress- testing results by the FMI's risk-management committee provides additional assurance that liquid resources are sufficient, and whether an interim resizing is necessary. Reporting results to regulators on a monthly basis allows for timely intervention if liquid resources have been deemed inadequate.

Comprehensive stress testing should also encompass a broad range of stress scenarios, not just to verify whether the FMI's liquid resources are sufficient, but also to identify potential risk factors. Reverse stress testing, more extreme stress scenarios, valuation of liquid assets and focusing on

individual risk factors (e.g., available collateral) all help to inform the FMI of potential risks. The annual validation of the FMI's risk-management model enables it to fully assess the appropriateness of the stress scenarios conducted and the procedures for adjusting liquid resources.

## **(ii) Qualifying liquid resources**

Qualifying liquid resources should be highly reliable and have same-day availability. Liquid resources are reliable when the FMI has near certainty that the resources it expects will be available when required. Qualifying liquid resources should be available on the same day that they are needed by the FMI to meet any immediate liquidity obligation (e.g., a participant's default). Qualifying liquid resources that are denominated in the same currency as the FMI's exposures count toward its minimum liquid-resource requirement.<sup>35</sup>

The following section clarifies regulators' expectations as to what is considered a qualifying liquid resource by:

- 3) identifying the assets in the possession, custody or control of the FMI that are considered qualifying liquid resources; and
- 4) setting clear standards for liquidity facilities to be considered qualifying liquid resources, including more-stringent standards for uncommitted liquidity facilities.

### **1) Cash and treasury bills<sup>36</sup> in the possession, custody or control of an FMI are qualifying liquid resources for liquidity exposures denominated in the same currency.<sup>37</sup>**

Cash held by an FMI does not fluctuate in value and can be used immediately to meet a liquidity obligation, thereby satisfying the criteria for liquid resources to be highly reliable and available on the same day.<sup>38</sup> Treasury bills issued by the Government of Canada or the U.S. Treasury also meet the definition of a qualifying liquid resource. By market convention, sales of treasury bills settle on the same day, allowing funds to be obtained immediately, whereas other bonds can settle as late as three days after the date of the trade. Treasury bills can also be transacted in larger sizes with less market impact than most other bonds. In addition, the shorter-term nature of treasury bills makes them more liquid than other securities during a crisis (i.e., they benefit from a "flight to liquidity"). Thus, there is a high degree of certainty that the FMI would obtain liquid resources in the amount expected following the sale of treasury bills.

### **2a) Committed liquidity facilities are qualifying liquid resources for liquidity exposures denominated in the same currency if the following criteria are met:**

- iv) **facilities are pre-arranged and fully collateralized;**
- v) **there is a minimum of three independent liquidity providers;<sup>39</sup> and**
- vi) **the FMI conducts a level of due diligence that is as stringent as the risk assessment completed for FMI participants.**

For liquidity facilities to be considered reliable, an FMI should have near certainty that the liquidity provider will honour its obligation. Pre-arranged liquidity facilities provide clarity on terms and conditions, allowing greater certainty regarding the obligations and risks of the liquidity providers. Pre-arranged facilities also reduce complications associated with obtaining liquidity, when required. Furthermore, a liquidity provider is most likely to honour its obligations when lending is fully collateralized. Therefore, only the amount that is collateralized will be considered a qualifying liquid resource. A liquidity facility is more reliable when the risk of non-performance is not concentrated in a single institution. By having at least three independent liquidity providers, the FMI would continue to diversify its risks should even a single provider default. To monitor the continued reliability of a liquidity facility, the FMI should assess its liquidity providers on an

<sup>35</sup> See PFMI Principle 7, key considerations 4, 5 and 6

<sup>36</sup> "Treasury bills" refers to bonds issued by the Government of Canada and the U.S. Treasury with a maturity of one year or less.

<sup>37</sup> This section refers to unencumbered assets free of legal, regulatory, contractual or other restrictions on the ability of the FMI to liquidate, sell, transfer or assign the asset.

<sup>38</sup> "Cash" refers to currency deposits held at the issuing central bank and at creditworthy commercial banks.

"Value" in this context refers to the nominal value of the currency.

<sup>39</sup> The Liquidity providers should not be affiliates to be considered independent.



ongoing basis. In this respect, an FMI's risk exposures to its liquidity providers are similar to the risks posed to it by its participants. Therefore, it is appropriate for the FMI to conduct comparable evaluations of the financial health of its liquidity providers to ensure that the providers have the capacity to perform as expected.

**2b) Uncommitted liquidity facilities are considered qualifying liquid resources for liquidity exposures in**

**Canadian dollars if they meet the following additional criteria:**

- iv) the liquidity provider has access to the Bank of Canada's Standing Liquidity Facility (SLF);**
- v) the facility is fully collateralized with SLF-eligible collateral; and**
- vi) the facility is denominated in Canadian dollars.**

More-stringent standards are warranted for uncommitted facilities because a liquidity provider's incentives to honour its obligations are weaker. However, the risk that the liquidity provider will be unwilling or unable to provide liquidity is reduced by the requirement that it needs to be a direct participant in the Large Value Transfer System and that the collateral be eligible for the Standing Liquidity Facility (SLF). This is because the collateral obtained from the FMI in exchange for liquidity can be pledged to the Bank of Canada under the SLF. This option significantly reduces the liquidity pressures faced by the liquidity provider that could interfere with its ability to perform on its obligations. A facility in a foreign currency would not qualify because the Bank does not lend in currencies other than the Canadian dollar. The increased reliability of liquidity providers with access to routine credit from the central bank is recognized explicitly within the PFMI's.

**- PFMI Principle 15: General business risk**

**Box 15.1:  
Joint Supplementary Guidance –  
General Business Risk**

**Context**

The PFMI's define general business risk as any potential impairment of the financial condition (as a business concern) of an FMI owing to declines in its revenue or growth in its expenses, resulting in expenses exceeding revenues and a loss that must be charged against capital. These risks arise from an FMI's administration and operation as a business enterprise. They are not related to participant default and are not covered separately by financial resources under the Credit or Liquidity Risk Principles. To manage these risks, the PFMI's state that FMIs should identify, monitor and manage their general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses. This note provides additional guidance for Canadian FMIs to meet the components of the general business risk principle related to: (i) governing general business risk; (ii) determining sufficient liquid net assets; and (iii) identifying qualifying liquid net assets. It also establishes the associated timelines and disclosure requirements.

**(i) Governance of general business risk**

Principle 15, key consideration 1 of the PFMI's states:

*An FMI should have robust management and control systems to identify, monitor, and manage general business risk.*

The following points clarify the authorities' expectations on how an FMI's governance arrangements should address general business risk.

**An FMI's Board of Directors should be involved in the process of identifying and managing business risks.**

Management of business risks should be integrated within an FMI's risk-management framework, and the Board of Directors should be responsible for determining risk tolerances related to business risk and for assigning responsibility for the identification and management of these risks. These risk tolerances and the process for the identification and management of business risk should be the foundation for the FMI's business risk-management policy. Based on the PFMI's, the policies and procedures governing the identification and management of business risk should meet the standards outlined below.

- The FMI's business risk-management policy should be approved by the Board of Directors and reviewed at least annually. The policy should be consistent with the Board's overall risk tolerance and risk-management strategy.
- The Board's Risk Committee should have a role in advising the Board on whether the business risk-management policy is consistent with the FMI's general risk-management strategy and risk tolerance.
- The business risk-management policy should provide clear responsibilities for decision making by the Board, and assign responsibility for the identification, management and reporting of business risks to management.

## (ii) Determining sufficient liquid net assets

Principle 15, key consideration 2 of the PFMI states:

*An FMI should hold liquid net assets funded by equity [...] so that it can continue operations and services as a going concern if it incurs general business losses. The amount of liquid net assets funded by equity an FMI should hold should be determined by its general business risk profile and the length of time required to achieve a recovery or orderly wind-down, as appropriate, of its critical operations and services if such action is taken.*

Principle 15, key consideration 3 of the PFMI states:

*An FMI should maintain a viable recovery or orderly wind-down plan and should hold sufficient liquid net assets funded by equity to implement this plan. At a minimum, an FMI should hold liquid net assets funded by equity equal to at least six months of current operating expenses.*

The following points clarify the authorities' expectations on how FMIs should calculate their sufficient liquid net assets:

**Until guidance for recovery planning and for calculating the associated costs is completed, FMIs are required to hold liquid net assets to cover a minimum of six months of current operating expenses.**

In calculating current operating expenses, FMIs will need to:

- **Assess and understand the various general business risks they face** to allow them to estimate as accurately as possible the required amount of liquid net assets. These estimates should be based on financial projections, which take into consideration, for example, past loss events, anticipated projects and increased operating expenses.
- **Restrict the calculation to ongoing expenses.** FMIs will need to adjust their operating costs such that any extraordinary expenses (i.e., unessential, infrequent or one-off costs) are excluded. Typically, operating costs include both fixed costs (e.g., premises, IT infrastructure, etc.) and variable costs (e.g., salaries, benefits, research and development, etc.).
- **Assess the portion of staff from each corporate department required to ensure the smooth functioning of the FMI during the six-month period.** The calculation of operating expenses would include some indirect costs. FMIs would require not only dedicated operational staff, but also various supporting staff. These could include (but are not limited to) staff from the FMI's Legal, IT and HR departments or staff required to ensure the continued functioning of other FMIs that could be necessary to support the FMI.

To fully observe Principle 15, FMIs must hold sufficient liquid assets to cover the greater of (i) funds required for FMIs to implement their recovery or wind-down; or (ii) six months of current operating expenses. In the interim, until recovery planning guidance is published, only the latter amount will apply.

The amount of liquid net assets required to implement an FMI's recovery or wind-down plans will depend on the scenarios or tools available to the FMI. The acceptable recovery and orderly wind-down plans for Canadian FMIs will be articulated by the authorities in forthcoming guidance. Once this guidance on recovery planning has been developed, the guidance on general business risk will be updated to provide FMIs with additional clarity on how to calculate the costs associated with these plans and determine the amount of liquid net assets required.

## (iii) Qualifying liquid net assets

Explanatory note 3.15.5 of the PFMI states:

*An FMI should hold liquid net assets funded by equity (such as common stock, disclosed reserves or other retained earnings) so that it can continue operations and services as a going concern if it incurs general business losses. Equity allows an FMI to absorb losses on an ongoing basis and should be permanently available for this purpose.*

Principle 15, key consideration 4 of the PFMI states:

*Assets held to cover general business risk should be of high quality and sufficiently liquid to allow the FMI to meet its current and projected operating expenses under a range of scenarios, including in adverse market conditions.*

Principle 15, key consideration 3 of the PFMI states:

*These assets are in addition to resources held to cover participant defaults or other risks covered under the financial resources principles.*

The following points clarify the authorities' expectations on which assets qualify to be held against general business risk, and how these assets should be held to ensure that they are permanently available to absorb general business losses.

**Assets held against general business risk should be of high quality and sufficiently liquid, such as cash, cash equivalents and liquid securities.**

Authorities have developed regulatory guidance related to managing liquidity and investment risks, which provides additional clarity on the definition of cash equivalents and liquid securities, respectively.

- **Cash equivalents** – are considered to be treasury bills<sup>40</sup> issued by either the Canadian or U.S. federal governments. As noted in the liquidity guidance, by market convention, sales of treasuries settle on the same day, allowing funds to be obtained immediately, whereas other bonds can settle as late as three days after the trade date.
- **Liquid securities** – for the purposes of general business risk, liquid securities are defined by the financial instruments criteria listed in the guidance on the Investment Risk Principle. These criteria outline financial instruments considered to have minimal credit, market, and liquidity risk.

**Liquid net assets must be held at the level of the FMI legal entity to ensure that they are unencumbered and can be accessed quickly. Liquid net assets may be pooled with assets held for other purposes, but must be clearly identified as held against general business risk.**

FMI may need to accumulate liquid net assets for purposes other than to meet the General Business Risk Principle. However, assets held against general business risk cannot be used to cover participant default risk or any other risks covered by the financial resources principles.

Liquid net assets can be pooled with assets held for other purposes, but must be clearly identified as held against general business risk in the FMI's reports to its regulators.

#### **(iv) Timelines for assessing and reporting the level of liquid net assets**

Explanatory note 3.15.8 of the PFMI states:

*To ensure the adequacy of its own resources, an FMI should regularly assess and report its liquid net assets funded by equity relative to its potential business risks to its regulators.*

The following clarifies the authorities' expectations of the frequency with which FMIs should assess and report their required level of liquid net assets.

**FMIs should report to authorities the amount of liquid net assets held against business risk annually, at a minimum.**

<sup>40</sup> Treasury bills refer to short-term (i.e. maturity of one year or less) debt instruments issued by the Canadian or U.S. federal government.

An FMI should report to the authorities the amount of liquid net assets funded by equity held exclusively against business risk and quantify its business risks as major developments arise, or at least on an annual basis. This report should include an explanation of the methodology used to assess the FMI's business risks and to calculate its requirements for liquid net assets.

**FMI's should recalculate the required amount of liquid net assets annually, at a minimum.**

Once FMI operators have established the amount of liquid net assets required to cover six months of operating expenses, FMI's should recalculate the required amount of liquid net assets as major developments occur, or annually, at a minimum. Once the authorities have provided further guidance on recovery and FMI's have developed recovery plans, FMI's should also evaluate the need to increase the amount of liquid net assets they should hold to meet the General Business Risk Principle.

To establish clear procedures that improve transparency regarding an FMI's decision-making process and to prevent the FMI from delaying required increases in liquid resources beyond what is reasonably acceptable, FMI's should maintain a viable capital plan for raising additional acceptable resources should these resources fall close to or below the amount needed. This plan should be approved by the Board of Directors and updated annually, or as major developments occur.

**FMI's should review their methodology for calculating the required level of liquid net assets at least once every five years, or as major developments occur.**<sup>41</sup>

The methodology for calculating the amount of required liquid net assets should be reviewed at least every five years to ensure that the calculation remains relevant over time.

- **PFMI Principle 16: Custody and investment risks**

**Box 16.1:  
Joint Supplementary Guidance –  
Custody and Investment Risks**

**Context**

The PFMI's define investment risk as the risk faced by an FMI when it invests its own assets or those of its participants.

- An FMI holds assets for a variety of purposes, some of which are referred to specifically in the PFMI's: to cover its business risk (Principle 15), to cover credit losses (Principle 4) and to cover credit exposures (Principle 6) using the collateral pledged by participants.
- An FMI may also hold financial assets for purposes not directly related to the risk management issues addressed within the PFMI's (e.g., employee pensions, general investment assets).

An FMI's strategy for investing assets should be consistent with its overall risk-management strategy (Principle 16). The purpose of this note is to provide further guidance on regulators' expectations regarding the management of investment risk. This guidance helps to ensure that an FMI's investments are managed in a way that protects the financial soundness of the FMI and its participants.<sup>42</sup>

**(i) Governance**

The PFMI's state that the Board of Directors is responsible for overseeing the risk-management function and approving material risk decisions. An FMI should develop an investment policy to manage the risk arising from the investment of its own assets and those of its participants.

- The FMI's investment policy should be approved by the Board and reviewed at least annually. The policy should be consistent with the Board's overall risk tolerance and considered part of the FMI's risk-management framework.
- The Risk Committee should advise the Board on whether the investment policy is consistent with the FMI's general risk-management strategy and risk tolerance.

<sup>41</sup> In the context of this specific guidance item, "major developments" refers to the major changes to operations, product and service offerings, or classes of participation.

<sup>42</sup> This guidance on investment risk is based on aspects of Principle 2 – Governance, Principle 3 – Comprehensive Framework for the Management of Risk, and Principle 16 – Custody and Investment Risk.

- The Board should assess the advantages and disadvantages of managing assets internally or outsourcing them to an external manager. The FMI retains full responsibility for any actions taken by its external manager.
- The FMI should establish criteria for the selection of an external manager.<sup>43</sup>

The FMI's investment policy should clearly identify those who are accountable for investment performance. The investment policy should also:

- Provide a clear explanation of the Board's delegated responsibility for investment decision making.
- Specify clear responsibilities for monitoring investment performance (against established benchmarks) and risk exposures (against limits or constraints). Procedures should be established to ensure that appropriate actions are taken when breaches occur, including possible reporting to the Board.
- Investment performance and key risk metrics should be reported to the Board at least quarterly.<sup>44</sup>

## **(ii) Investment strategy**

The investment strategy chosen by an FMI should not allow the pursuit of profit to compromise its financial soundness. As outlined below, additional consideration should be given to the investment strategy governing assets held specifically for risk-management purposes (i.e. Principle 4-7 and Principle 15).

### **Investment objectives**

The investment policy should include appropriate investment objectives for the various assets held for risk-management purposes. The stated expected return and risk tolerance of the investment objectives should reflect the:

- specific purpose of the assets;
- relative importance of the assets in the overall risk management of the FMI; and
- requirement within the PFMI for FMIs to invest in instruments with minimal credit, market and liquidity risk (see the Appendix for the minimum standards of acceptable instruments).

The investment objectives should also help to determine the appropriate benchmarks for measuring investment performance.

### **Investment constraints**

The importance of assets held for risk-management purposes warrants the use of investment constraints. It is paramount that an FMI have prompt access to these assets with minimal price impact to avoid interference with their primary use for risk management. Investment of these assets should, at a minimum, observe the following:

- To reduce concentration risk, no more than 20 per cent of total investments should be invested in municipal and private sector securities. Investment in a single private sector or municipal issuer should be no more than 5 per cent of total investments.
- To mitigate specific wrong-way risk, investments should, as much as possible, be inversely related to market events that increase the likelihood of those assets being required. Investment in financial sector securities should be no more than 10 per cent of total investments. An FMI should not invest assets in the securities of its own affiliates. An FMI is not permitted to reinvest participant assets in a participant's own securities or those of its affiliates, as specified in Principle 16.
- For investments that are subject to counterparty credit risk, an FMI should set clear criteria for choosing investment counterparties and setting exposure limits.

The investment constraints should be clearly stated in the investment policy in order to provide clear guidance for those responsible for investment decision making.<sup>45</sup>

<sup>43</sup> At a minimum, external managers should have demonstrated past performance and expertise, as well as strong risk-management practices such as an internal audit function and processes to protect and segregate the FMI's assets.

<sup>44</sup> Investment performance may also be reported to a Board committee with special expertise to which the Board has delegated the authority to review investment performance (e.g., an Investment Committee).

<sup>45</sup> The use of investment vehicles where investments are held indirectly (e.g. mutual funds and exchange-traded funds) should not result in breaches to the investment constraints listed.

### Link to risk management

FMI's should account for the implications of investing assets on their broader risk-management practices. The following issues should be considered when investing assets held for risk management purposes:

- An FMI's process for determining whether sufficient assets are available for risk management should account for potential investment losses. For example, investing the assets available to a CCP to cover losses from a participant default could lose value in a default scenario, resulting in less credit-risk protection. An FMI should hold additional assets to cover potential losses from its investments held for risk-management purposes.
- An FMI should account for the implications of investing assets on its ability to effectively manage liquidity risk. In particular, identification of the FMI's available liquid resources should account for the investment of its own and participants' assets. For example, cash held at a creditworthy commercial bank would no longer be considered a qualifying liquid resource under Principle 7 if it were invested in the debt instrument of a private sector issuer.
- The investment of an FMI's own assets and those of its participants should not circumvent related risk management requirements. For example, the reinvestment of participants' collateral should still respect the FMI's collateral concentration limits applicable to those assets.

### Appendix

For the purposes of Principle 16, financial instruments can be considered to have minimal credit, market and liquidity risk if they meet *each* of the following conditions:

7. Investments are debt instruments that are:
  - a. securities issued by the Government of Canada;
  - b. securities guaranteed by the Government of Canada;
  - c. marketable securities issued by the United States Treasury;
  - d. securities issued or guaranteed by a provincial government;
  - e. securities issued by a municipal government;
  - f. bankers' acceptances;
  - g. commercial paper;
  - h. corporate bonds; and
  - i. asset-backed securities that meet the following criteria: (1) sponsored by a deposit-taking financial institution that is prudentially regulated at either the federal or provincial level, (2) part of a securitization program supported by a liquidity facility, and (3) backed by assets of an acceptable credit quality.
8. The FMI employs a defined methodology to demonstrate that debt instruments have low credit risk. This methodology should involve more than just mechanistic reliance on credit-risk assessments by an external party.
9. The FMI employs limits on the average time-to-maturity of the portfolio based on relevant stress scenarios in order to mitigate interest rate risk exposures.
10. Instruments have an active market for outright sales or repurchase agreements, including in stressed conditions.
11. Reliable price data on debt instruments are available on a regular basis.
12. Instruments are freely transferable and settled over a securities settlement system compliant with the PFMI's.

### - **PFMI Principle 23: Disclosure of rules, key procedures, and market data**

#### **Box 23.1: Joint Supplementary Guidance – Disclosure of Rules, Key Procedures and Market Data**

##### **Context**

The PFMI's state that FMI's should provide sufficient information to their participants and prospective participants to enable them to clearly understand the risks and responsibilities of participating in the system. This note provides additional guidance for Canadian FMI's to meet the components of the disclosure principle related to: (i) public qualitative disclosure and (ii) public quantitative disclosure.

##### **Requirements included in the PFMI's**

Principle 23 outlines requirements for disclosure to participants as well as the general public. In addition,

specific disclosure requirements are listed in the principles to which they pertain.

The following text has been extracted directly from the PFMLs, Principle 23, key consideration 5:

*An FMI should complete regularly and disclose publicly responses to the CPMI-IOSCO Disclosure framework for financial market infrastructures. An FMI also should, at a minimum, disclose basic data on transaction volumes and values.*

To supplement key consideration 5, CPMI-IOSCO published two documents: the Disclosure framework for financial market infrastructures (the Disclosure Framework),<sup>46</sup> and the Public quantitative disclosure standards for central counterparties (the Quantitative Disclosure Standards).<sup>47</sup> This note will refer to the disclosures that result from completing the templates provided in these documents as the Qualitative Disclosure and the Quantitative Disclosure, respectively.

### **Supplementary guidance for Canadian FMIs designated by the Bank of Canada**

On its public website, an FMI should publish its Qualitative Disclosure and Quantitative Disclosure, as well as any other public disclosure requirements specified in Principle 23 or in other principles. Any public disclosure should be written for an audience with general knowledge of the financial sector.

#### **(a) Qualitative disclosure (Applies to all types of FMIs)**

A Qualitative Disclosure should provide the public with a high-level understanding of an FMI's governance, operation and risk-management framework.

##### **Summary narrative disclosure**

In part four of the Disclosure Framework, FMIs are required to provide a summary narrative of their observance of the Principles. FMIs should provide these narratives at the principle level, and are not required to address key considerations or to provide answers to the detailed questions listed in Section 5 of the Disclosure Framework report. Instead, the narrative disclosure should focus on providing a broad audience with an understanding of how each Principle applies to the FMI, and what the FMI has done or plans to do to ensure its observance.

##### **Timing**

FMIs should update and publish their Qualitative Disclosures following significant changes<sup>48</sup> to the system or its environment, or at least every two years. Only the most current Qualitative Disclosure needs to be maintained on the FMI's website.

#### **(b) Quantitative disclosure (Applies only to CCPs)**

Quantitative Disclosures specify the set of key quantitative information required in the Disclosure Framework. They should follow the format provided by CPMI-IOSCO, allowing stakeholders, including the general public, to easily evaluate and compare FMIs.

Currently, CPMI-IOSCO has developed public quantitative disclosure standards only for CCPs. The following guidance applies only to CCPs; Canadian authorities will provide further guidance on the quantitative disclosure requirements of FMIs other than CCPs when such standards have been developed.

##### **Context**

Where a general audience may need additional context to properly interpret the data, it should be provided in explanatory notes or addressed in the CCP's Qualitative Disclosure. CCPs are

<sup>46</sup> The Disclosure Framework is part of a document published in December 2012, titled "Principles for financial market infrastructures: Disclosure framework and Assessment methodology", and is available at <http://www.bis.org/press/p121214.htm>.

<sup>47</sup> This document is available at <http://www.bis.org/cpmi/publ/d125.pdf>.

<sup>48</sup> Updated Qualitative Disclosures should be published subsequent to regulatory approval, and prior to the effective date of the significant change. Significant changes can include, but are not limited to: (i) any changes to the FMI's constituting documents, bylaws, corporate governance or corporate structure; (ii) any material change to an agreement between the FMI and its participants or to the FMI's rules, operating procedures, user guides, or manuals or the design, operation or functionality of its operations and services; and (iii) the establishment of, or removal or material change to, a link, or commencing or ceasing to engage in a business activity.

encouraged to provide charts, background information and additional documentation where it may aid the reader's understanding.

### **Comparability**

Regulators recognize that, given the different structures and arrangements among CCPs, an overly homogenized presentation format could lead to inaccurate comparability. Subject to regulatory approval, a CCP may provide analogous data in place of a disclosure requirement that is not applicable to its business or representative of the risks it faces. The CCP must justify to authorities the necessity and selection of the alternative metric.<sup>49</sup> If granted approval, the CCP must provide the original data to authorities with the frequency specified in the Quantitative Disclosure Standards, and must explain in each public disclosure why an alternative metric was chosen.

### **Confidentiality**

A CCP's public disclosure obligation does not release it from its confidentiality duties. Where a required disclosure item could reveal (or allow knowledgeable parties to deduce) commercially sensitive information about individual clearing members, clients, third-party contractors or other relevant stakeholders, or where disclosure may amount to a breach of laws or regulations for maintaining market integrity, the data must be omitted. In this case, the CCP must justify the omission to authorities.<sup>50</sup> If granted approval, the CCP must provide the confidential data to authorities with the frequency specified in the Quantitative Disclosure Standards, and must explain the reason for the omission in each public disclosure.

### **Timing**

Quantitative Disclosures should be reported quarterly, and updated with the frequency specified in the Quantitative Disclosure Standards.<sup>51</sup> Even though some required data may already be publicly disclosed in other reports, or may not have changed from the previous quarter, the data should still be included in the disclosure matrix for completeness and consistency. Data should be publicly disclosed no later than 60 days after the end of each fiscal quarter, and should remain available on its website for at least three years so that trends can be examined.

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<sup>49</sup> If the authorities are satisfied with the justification, the CCP need not resubmit the substitution unless the CCP's structure or arrangements change the applicability of the original disclosure requirement, or the CCP wishes to change its substituted metric. CCPs are responsible for informing authorities of any changes that could affect the applicability of the originally required or substituted data.

<sup>50</sup> If the authorities are satisfied with the justification, the CCP need not resubmit the omission unless the circumstances change the confidentiality of the disclosure. CCPs are responsible for informing the authorities of any changes that could affect the confidentiality of such data.

<sup>51</sup> According to the Quantitative Disclosure Standards, items under general business risk should be updated annually, and all other items should be updated on a quarterly basis.



## Annex G

### Proposed amendments to final adopted Companion Policy 24-102CP to National Instrument 24-102 Clearing Agency Requirements

Companion Policy 24-102CP is amended by inserting in Annex I the following immediately after Box 2.2:

“- **PFMI Principle 3: Framework for the comprehensive management of risks**

#### Box 3.1: Joint Supplementary Guidance – Recovery Plans

##### **Context**

In 2012, to enhance the safety and efficiency of payment, clearing and settlement systems, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (CPMI-IOSCO) released a set of international risk-management standards for FMIs, known as the Principles for Financial Market Infrastructures (PFMIs). The PFMIs provide standards regarding FMI recovery planning and orderly wind-down, which were adopted by the Bank of Canada as Standard 24 of the Bank's *Risk-Management Standards for Designated FMIs* and by the CSA as part of National Instrument 24-102.<sup>1,2</sup> The Bank's Standard 24 is described as follows:

*An FMI is expected to identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern and assess the effectiveness of a full range of options for recovery or orderly wind-down. This entails preparing appropriate plans for its recovery or orderly wind-down based on the results of that assessment.*

In October 2014, the CPMI-IOSCO released its report, “Recovery of Financial Market Infrastructures” (the Recovery Report), providing additional guidance specific to the recovery of FMIs.<sup>3</sup> The Recovery Report explains the required structure and components of an FMI recovery plan and provides guidance on FMI critical services and recovery tools at a level sufficient to accommodate possible differences in the legal and institutional environments of each jurisdiction.

For the purpose of this guidance, FMI recovery is defined as the set of actions that an FMI can take, consistent with its rules, procedures and other ex ante contractual agreements, to address any uncovered loss, liquidity shortfall or capital inadequacy, whether arising from participant default or other causes (such as business, operational or other structural weakness), including actions to replenish any depleted pre-funded financial resources and liquidity arrangements, as necessary, to maintain the FMI's viability as a going concern and the continued provision of critical services.<sup>4,5</sup>

Recovery planning is not intended as a substitute for robust day-to-day risk management. Rather, it serves to extend and strengthen an FMI's risk-management framework, enhancing the resilience of the FMI and bolstering confidence in the FMI's ability to function effectively even under extreme but plausible market conditions and operating environments,

##### **Key Components of Recovery Plans**

###### **Overview of existing risk-management and legal structures**

As part of their recovery plans, FMIs should include overviews of their legal entity structure and capital structure to provide context for stress scenarios and recovery activities.

FMIs should also include an overview of their existing risk-management frameworks—i.e., their pre-recovery risk-management activities. As part of this overview, and to determine the relevant point(s) where standard risk-management frameworks are exhausted, FMIs should identify all the material risks they are exposed to and explain how they use their existing risk-management tools to manage these risks to a high degree of

<sup>1</sup> See key consideration 4 of PFMI Principle 3 and key consideration 3 of PFMI Principle 15 which are adopted in the Canadian Securities Administrators' (CSA) National Instrument 24-102 *Clearing Agency Requirements*, section 3.1.

<sup>2</sup> The Bank of Canada's *Risk-Management Standards for Designated FMIs* is available at <http://www.bankofcanada.ca/core-functions/financial-system/bank-canada-risk-management-standards-designated-fmis/>.

<sup>3</sup> Available at <http://www.bis.org/cpmi/publ/d121.pdf>.

<sup>4</sup> Recovery Report, Paragraph 1.1.1

<sup>5</sup> For a precise definition of orderly wind-down, see the Recovery Report, Paragraph 2.2.2.

confidence.

### **Critical services<sup>6</sup>**

In their recovery plans, FMIs should identify, in consultation with Canadian authorities and stakeholders, the services they provide that are critical to the smooth functioning of the markets that they serve and to the maintenance of financial stability. FMIs may find it useful to consider the degree of **substitutability** and **interconnectedness** of each of these critical services, specifically

- ❖ The degree of criticality of an FMI's service is likely to be high if there are no, or only a small number of, alternative service providers. Factors related to the substitutability of a service could include (i) the size of a service's market share, (ii) the existence of alternative providers that have the capacity to absorb the number of customers and transactions the FMI maintains, and (iii) the FMI participants' capability to transfer positions to the alternative provider(s).
- ❖ The degree of criticality of an FMI's service may be high if the service is significantly interconnected with other market participants, both in terms of breadth and depth, thereby increasing the likelihood of contagion if the service were to be discontinued. Potential factors to consider when determining an FMI's interconnectedness are (i) what services it provides to other entities and (ii) which of those services are critical for other entities to function.

### **Stress scenarios<sup>7</sup>**

In their recovery plans, FMIs should identify scenarios that may prevent them from being able to provide their critical services as a going concern. Stress scenarios should be focused on the risks an FMI faces from its payment, clearing and settlement activity. An FMI should then consider stress scenarios that cause financial stress in excess of the capacity of its existing risk controls, thereby pushing the FMI into recovery. An FMI should organize stress scenarios by the types of risk it faces; for each stress scenario, the FMI should clearly explain the following:

- ❖ the assumptions regarding market conditions and the state of the FMI within the stress scenario, accounting for the differences that may exist depending on whether the stress scenario is systemic or idiosyncratic;
- ❖ the estimated impact of a stress scenario on the FMI, its participants, participants' clients and other stakeholders; and
- ❖ the extent to which an FMI's existing pre-recovery risk-management tools are insufficient to withstand the impacts of realized risks in a recovery stress scenario and the value of the loss and/or of the negative shock required to generate a gap between existing risk-management tools and the losses associated with the realized risks.

### **Triggers for recovery**

For each stress scenario, FMIs should identify the triggers that would move them from their pre-recovery risk-management activities (e.g., those found in a CCP's default waterfall) to recovery. These triggers should be both qualified (i.e., outlined) and, where relevant, quantified to demonstrate a point at which recovery plans will be implemented without ambiguity or delay.

While the boundary between pre-recovery risk-management activities and recovery can be clear (for example, when pre-funded resources are fully depleted), judgment may be needed in some cases. When this boundary is not clear, FMIs should lay out in their recovery plans how they will make decisions.<sup>8</sup> This includes detailing in advance their communication plans, as well as the escalation process associated with their decision-making procedures. They should also specify the decision-makers responsible for each step of the escalation process to ensure that there is adequate time for recovery tools to be implemented if required.

More generally, it is important to identify and place the triggers for recovery early enough in a stress scenario to allow for sufficient time to implement recovery tools. Triggers placed too late in a scenario will impede the effective rollout of these tools and hamper recovery efforts. Overall, in determining the moment when recovery should commence, and especially where there is uncertainty around this juncture, an FMI

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<sup>6</sup> Recovery Report, Paragraphs 2.4.2–2.4.4

<sup>7</sup> Recovery Report, Paragraph 2.4.5

<sup>8</sup> Recovery Report, Paragraph 2.4.8

should be prudent in its actions and err on the side of caution.

### ***Selection and Implementation of Recovery Tools***<sup>9</sup>

#### **A comprehensive plan for recovery**

The success of a recovery plan relies on a comprehensive set of tools that can be effectively implemented during recovery. The applicability of these tools and their contribution to recovery varies by system, stress event and the order in which they are applied.

A robust recovery plan relies on a range of tools to form an adequate response to realized risks. Canadian authorities will provide feedback on the comprehensiveness of selected recovery tools when reviewing an FMI's complete recovery plan.

#### **Characteristics of recovery tools**

In providing this guidance, Canadian authorities used a broad set of criteria (described below), including those from the CPMI-IOSCO Recovery Report, to determine the characteristics of effective recovery tools.<sup>10</sup> FMIs should aim for consistency with these criteria in the selection and application of tools. In this context, recovery tools should be

- ❖ Reliable and timely in their application and have a strong legal and regulatory basis. This includes the need for FMIs to mitigate the risk that a participant may be unable or unwilling to meet a call for financial resources in a timely manner, or at all (i.e., performance risk), and to ensure that all recovery activities have a strong legal and regulatory basis.
- ❖ Measurable, manageable and controllable to ensure that they can be applied effectively while keeping in mind the objective of minimizing their negative effects on participants, and the broader financial system. To this end, using tools that have predictable and capped participant exposure provides better certainty of a tool's impact on FMI participants and its contribution to recovery. Fairness in the allocation of uncovered losses and shortfalls, and the capacity to manage the associated costs, should also be considered.
- ❖ Transparent to participants: this should include a predefined description of each recovery tool, its purpose and the responsibilities and procedures of participants and the FMIs subject to the recovery tool's application to effectively manage participants' expectations. Transparency also mitigates performance risk by detailing the obligations and procedures of FMIs and participants beforehand to support the timely and effective rollout of recovery tools.
- ❖ Designed to create appropriate incentives for sound risk management and encourage voluntary participation in recovery to the greatest extent possible. This includes distributing post-recovery proceeds to participants that supported the FMI through the recovery process.

#### **Systemic stability**

Certain tools may have serious consequences for participants and for the stability of financial markets more generally. FMIs should use prudence and judgment in the selection of appropriate tools. Canadian authorities are of the view that FMIs should avoid uncapped, unpredictable or ill-defined participant exposures, which could create uncertainty and disincentives to participate in an FMI. Participants' ability to predict and manage their exposures to recovery tools is important, both for their own stability and for the stability of the indirect participants of an FMI.

In assessing FMI recovery plans, Canadian authorities are concerned with the possibility of systemic disruptions from the use of certain tools or tools that pose unquantifiable risks to participants. When selecting recovery tools, FMIs should keep in mind the objective of minimizing their negative impacts on participants, the FMI and the broader financial system.

#### **Recommended recovery tools**

This section outlines recommended recovery tools for use in FMI recovery plans. Not all tools are applicable for the different types of FMIs (e.g., a payment system versus a central counterparty). Each FMI should use discretion when selecting the most appropriate tools for its recovery plans, consistent with the considerations discussed above.

##### ❖ **Cash calls**

Cash calls are recommended for recovery plans if they are capped and limited to a maximum number of

<sup>9</sup> Recovery Report, Paragraph 2.3.6 – 2.3.7 and 2.5.6 and Paragraphs 3.4.1 – 3.4.7

<sup>10</sup> Recovery Report, Paragraph 3.3.1

rounds established in advance. The cap (on participant exposure) should be linked to each participant's risk-weighted level of FMI activity.

By providing predictable exposures pro-rated to a participant's risk-weighted level of activity, FMIs create incentives for better risk management on the part of participants, while giving the FMI greater certainty over the amount of resources that can be made available during recovery.

Since cash calls rely on contingent resources held by FMI participants, there is a risk that they may not be honoured, reducing their effectiveness as a recovery tool. The management of participants' expectations, especially placing clear limits on participant exposure, can mitigate this concern.

Cash calls can be designed in multiple ways to structure incentives, vary their impacts on participants and respond to different stress scenarios. When designing cash calls, FMIs should, to the greatest extent possible, seek to minimize the negative consequences of the tool's use.

❖ **Variation margin gains haircutting (VMGH)**

VMGH is recommended for recovery plans if its use is limited to a maximum number of rounds that are predefined by the FMI.

VMGH relies on participant resources posted at the FMI as variation margin (VM). Where the price movements of underlying instruments create sufficient VM gains for use in recovery, VMGH provides an FMI with a reliable and timely source of financial resources without the performance risk that is associated with tools reliant on resources held by participants.

VMGH assigns losses and shortfalls only to participants with net position gains; as a result, the pro rata financial burden is higher for these participants. The negative effects of VMGH can also be compounded for participants who rely on variation margin gains to honour obligations outside the FMI.

Participant exposure under VMGH can be measured with reasonable confidence since it is tied to the level of risk held in the VM fund and the potential for gains. By specifying the maximum number of rounds to which VMGH can be applied, an FMI will limit this exposure, providing better predictability of the tool's impact.

❖ **Voluntary contract allocation**

To recover from an unmatched book caused by a participant default, a CCP can use its powers to allocate unmatched contracts.<sup>11</sup> In the context of recovery, contract allocation should only be applied on a *voluntary* basis. Voluntary contract allocation (e.g., by auction) addresses unmatched positions while taking participant welfare into account since only participants who are willing to take on positions will participate.

The reliance on a voluntary process, such as an auction, introduces the risk that not all positions will be matched or that the auction process is not carried out in a timely manner. Defining the responsibilities and procedures for voluntary contract allocation (e.g., the auction rules) in advance will mitigate this risk and increase the reliability of the tool. To ensure that there is adequate participation in an auction process, FMIs should create incentives for participants to take on unmatched positions. FMIs may also wish to consider expanding the auction beyond direct participants to increase the chances that all positions will be matched.

❖ **Voluntary contract tear-up**

Since eliminating positions can help re-establish a matched book, Canadian authorities view contract tear-up as a potentially effective tool for FMI recovery. However, to the extent that the termination of an incomplete trade represents a disruption of a critical FMI service (albeit on a limited and intended basis), it can be too invasive to apply. Where contract tear-up is included in a recovery plan, FMIs should keep this in mind and perform tear-up only on a voluntary basis. To this end, FMIs may want to consider using incentives to encourage voluntary tear-up during recovery.

To the extent that a voluntary contract tear-up still disrupts critical FMI services, it can produce disincentives to participate in an FMI. There should be a strong legal basis for the relevant processes and procedures when a voluntary contract tear-up is included in a recovery plan. This will help to manage participant expectations for this tool and ensure that confidence in the FMI is maintained.

Other tools available for FMI recovery include standing third-party liquidity lines, contractual liquidity arrangements with participants, insurance against financial loss, increased contributions to pre-funded resources, and use of an FMI's own capital beyond the default waterfall. These and other tools are often already found in the pre-recovery risk-management frameworks of FMIs; nonetheless, Canadian authorities

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<sup>11</sup> A "matched book" occurs when there is an equal distribution of assets and liabilities. In the context of a CCP, and at a simplified level, this refers to the matched positions that form the two sides of an active trade. A matched book must be maintained for the CCP to complete a trade. An unmatched book occurs when one participant defaults on its position in the trade, leaving the CCP unable to complete the transaction.

encourage their use for recovery as well, provided they are in keeping with the criteria for effective recovery tools as found in the Recovery Report and in this guidance.<sup>12</sup>

To the extent that the costs of recovery are shared less equally under some tools (e.g., VMGH), if it is financially feasible, FMIs could consider post-recovery actions to restore fairness where participants have been disproportionately affected. Such actions may include the repayment of participant contributions used to address liquidity shortfalls and other instruments that aim to redistribute the burden of losses allocated during recovery. It is important to note that these actions in the post-recovery period should not impair the financial viability of the FMI as a going concern.

#### **Tools not recommended for recovery plans**

Due to their uncertain and potentially negative effects on the broader financial system, Canadian authorities do not encourage the inclusion of uncapped and unlimited rounds of cash calls, unlimited rounds of VMGH, involuntary (forced) contract allocation, involuntary (forced) contract tear-up, and the use of non-defaulting participants' initial margin in FMI recovery plans. These could potentially be used by a resolution authority but would need to be carefully assessed against their potential impact on participants and the stability of the broader financial system.

While these tools can potentially address liquidity or capital shortfalls, it could be to the detriment of the broader financial system and the viability of the FMI. Uncapped and unlimited cash calls and unlimited rounds of VMGH can create ambiguous participant exposures, while exposures to involuntary contract allocation and tear-up activities can be difficult to manage, measure and control, even when they offer incentives to assist with recovery.

Where FMIs believe that these tools should be included in a recovery plan, the tools must be carefully considered and accompanied by a strong rationale for their use. Canadian authorities will provide feedback on the suitability of any such tools as part of their review of a recovery plan.

#### **Recovery from non-default-related losses and structural weaknesses**

Consistent with a defaulter-pays principle, an FMI should rely on FMI-funded resources to address recovery from non-default-related losses (i.e., operational and business losses on the part of an FMI), including losses arising from structural weakness.<sup>13</sup> To this end, FMIs should examine ways to increase the loss absorbency between the FMI's pre-recovery risk-management activities and participant-funded resources (e.g., by using FMI-funded insurance against operational risks).

Structural weakness can be an impediment to the effective rollout of recovery tools and may itself result in non-default-related losses that are a trigger for recovery. An FMI recovery plan should include a process detailing how to promptly identify, evaluate and address the sources of underlying structural weakness on a continuous basis (e.g., unprofitable business lines, investment losses) and the tools available to address them within a concrete time frame.

The use of participant-funded resources to recover from non-default-related losses can lessen incentives for robust risk management within an FMI and provide disincentives to participate. If, despite these concerns, participants consider it in their interest to keep the FMI as a going concern, an FMI and its participants may agree to include a certain amount of participant-funded recovery tools to address some non-default-related losses. Under these circumstances, the FMI should clearly explain under what conditions participant resources would be used and how costs would be distributed.

#### **Defining full allocation of uncovered losses and liquidity shortfalls**

Principles 4 (credit risk)<sup>14</sup> and 7 (liquidity risk)<sup>15</sup> of the PFMI require that FMIs should specify rules and procedures to fully allocate both uncovered losses and liquidity shortfalls caused by stress events, such as participant default. Rules to fully allocate all uncovered credit losses and liquidity shortfalls may be implemented either as part of recovery and/or resolution. To be consistent with this requirement, **Canadian FMIs should consider various stress scenarios and have rules and procedures that allow them to**

<sup>12</sup> Recovery Report, Paragraph 3.3.1

<sup>13</sup> Structural weakness can be caused by factors such as poor business strategy, poor investment and custody policy, poor organizational structure, IM/IT-related obstacles, poor legal or regulatory risk frameworks, and other insufficient internal controls.

<sup>14</sup> Under key consideration 7 of PFMI Principle 4, an FMI should establish explicit rules and procedures that fully address any credit losses it may face as a result of any individual or combined default among its participants with respect to any of their obligations to the FMI.

<sup>15</sup> Under key consideration 10 of PFMI Principle 7, FMIs should establish rules and procedures that address unforeseen and potentially uncovered liquidity shortfalls and should aim to avoid unwinding, revoking or delaying the same-day settlement of payment obligations.

**fully allocate any loss or liquidity shortfall arising from those stress scenarios.** For additional guidance on stress scenarios and triggers for recovery, see the Recovery Report, Sections 2.4.5 and 2.4.6 and page 3 of this document.

#### **Legal consideration for full allocation**

**An FMI's rules for allocating losses and liquidity shortfalls should be supported by relevant laws and regulations.** There should be a high level of certainty that rules and procedures to fully allocate all uncovered losses and liquidity shortfalls are enforceable and will not be voided, reversed or stayed.<sup>16</sup> This requires that Canadian FMIs design their recovery tools in compliance with Canadian laws. For example, if the FMI's loss-allocation rules involve a guarantee, Canadian law generally requires that the guaranteed amount be determinable and preferably capped by a fixed amount.<sup>17</sup>

FMIs should consider whether it is appropriate to involve indirect participants that do not benefit from a customer-protection regime in the allocation of losses and shortfalls during recovery. Such loss or shortfall allocation arrangement should have a strong legal and regulatory basis and involve consultation with indirect participants to ensure that all relevant concerns are taken into account.

Overall, FMIs are responsible for seeking appropriate legal advice on how their recovery tools can be designed and for ensuring that all recovery tools and activities are in compliance with the relevant laws and regulations.

#### ***Additional Considerations in Recovery Planning***

##### **Transparency and coherence<sup>18</sup>**

An FMI should ensure that its recovery plan is coherent and transparent to all relevant levels of management within the FMI, as well as to its regulators and overseers. To do so, a recovery plan should

- ❖ contain information at the appropriate level and detail; and
- ❖ be sufficiently coherent to relevant parties within the FMI, as well as to the regulators and overseers of the FMI, to effectively support the implementation of the recovery tools.

An FMI should ensure that the assumptions, preconditions, key dependencies and decision-making processes in a recovery plan are transparent and clearly identified.

##### **Relevance and flexibility<sup>19</sup>**

An FMI's recovery plan should thoroughly cover the information and actions relevant to extreme but plausible market conditions and other situations that would call for the use of recovery tools. An FMI should take into account the following elements when developing its recovery plan:

- ❖ the nature, size and complexity of its operations;
- ❖ its interconnectedness with other entities;
- ❖ operational functions, processes and/or infrastructure that may affect the FMI's ability to implement its recovery plan; and
- ❖ any upcoming regulatory reforms that may have the potential to affect the recovery plan.

Recovery plans should be sufficiently flexible to address a range of FMI-specific and market-wide stress events. Recovery plans should also be structured and written at a level that enables the FMI's management to assess the recovery scenario and initiate appropriate recovery procedures. As part of this expectation, the recovery plan should demonstrate that senior management has assessed the potential two-way interaction between recovery tools and the FMI's business model, legal entity structure, and business and risk-management practices.

##### ***Implementation<sup>20</sup>***

An FMI should have credible and operationally feasible approaches to recovery planning in place and be able to act upon them in a timely manner, under both idiosyncratic and market-wide stress scenarios. To this end, recovery plans should describe

- ❖ potential impediments to implementing recovery tools effectively and strategies to address them;

<sup>16</sup> CPMI-IOSCO Principles for Financial Market Infrastructures, Paragraph 3.1.10

<sup>17</sup> The Bank Act, Section 414.1 and IIROC Rule 100.14 prohibit banks and securities dealers, respectively, from providing unlimited guarantees to an FMI or a financial institution.

<sup>18</sup> Recovery Report, Section 2.3.

<sup>19</sup> Recovery Report, Section 2.3.

<sup>20</sup> Recovery Report, Paragraph 2.3.9

- and
- ❖ the impact of a major operational disruption.<sup>21</sup>

This information is important to strengthen a recovery plan's resilience to shocks and ensure that the recovery tools are actionable.

***A recovery plan should also include an escalation process and the associated communication procedures that an FMI would take in a recovery situation. Such a process should define the associated timelines, objectives and key messages of each communication step, as well as the decision-makers who are responsible for it.***

### **Consulting Canadian authorities when taking recovery actions**

While the responsibility for implementing the recovery plan rests with the FMI, Canadian authorities consider it critical to be informed when an FMI triggers its recovery plan and before the implementation of recovery tools and other recovery actions. This includes the authorities responsible for the regulation, supervision and oversight of the FMI, as well as any authorities who would be responsible for the FMI if it were to be put into resolution.

Canadian FMIs should consult Canadian authorities before implementing any and all recovery tools and actions to ensure that decisions take into account potential financial stability implications and other relevant public interest considerations. This action should occur early on and should be explicitly identified in the escalation process of a recovery plan. Acknowledging the speed at which an FMI may enter recovery, FMIs are encouraged to develop formal communications protocols with authorities in the event that recovery is triggered and immediate action is required.

### ***Review of Recovery Plan***<sup>22</sup>

An FMI should include in its recovery plan a robust assessment of the recovery tools presented and detail the key factors that may affect their implementation. It should recognize that, while some recovery tools may be effective in returning the FMI to viability, these tools may not have a desirable effect on its participants or the broader financial system.

A framework for testing the recovery plan (for example, through scenario exercises, periodic simulations, back-testing and other mechanisms) should be presented either in the plan itself or linked to a separate document. This impact assessment should include an analysis of the effect of implementing recovery tools on financial stability and other relevant public interest considerations.<sup>23</sup> Furthermore, an FMI should demonstrate that the appropriate business units and levels of management have assessed the potential consequences of recovery tools on FMI participants and entities linked to the FMI.

### **Annual review of recovery plan**

An FMI should review and, if necessary, update its recovery plan on an annual basis. The recovery plan should be subject to approval by the FMI's Board of Directors.<sup>24</sup> Under the following circumstances, an FMI is expected to review its recovery plan more frequently:

- ❖ if there is a significant change to market conditions or to an FMI's business model, corporate structure, services provided, risk exposures or any other element of the firm that could have a relevant impact on the recovery plan;
- ❖ if an FMI encounters a severe stress situation that requires appropriate updates to the recovery plan to address the changes in the FMI's environment or lessons learned through the stress period; and
- ❖ if the Canadian authorities request that the FMI update the recovery plan to address specific concerns or for additional clarity.

Canadian authorities will also review and provide their views on an FMI's recovery plan before it comes into effect. This is to ensure that the plan is in line with the expectations of Canadian authorities.

### ***Orderly Wind-Down Plan as Part of a Recovery Plan***<sup>25</sup>

<sup>21</sup> This is also related to the FMI's backup and contingency planning, which are distinct from recovery plans.

<sup>22</sup> Recovery Report, Paragraph 2.3.8

<sup>23</sup> This is in line with key consideration 1 of PFMI Principle 2 (Governance), which states that an FMI should have objectives that place a high priority on the safety and efficiency of the FMI and explicitly support financial stability and other relevant public interest considerations.

<sup>24</sup> Recovery Report, Paragraph 2.3.3

<sup>25</sup> Recovery Report, Paragraph 2.2.2

Canadian authorities expect FMIs to prepare, as part of their recovery plans, for the possibility of an orderly wind-down. However, developing an orderly wind-down plan may not be appropriate or operationally feasible for some critical services. In this instance, FMIs should consult with the relevant authorities on whether they can be exempted from this requirement.

**Considerations when developing an orderly wind-down plan**

An FMI should ensure that its orderly wind-down plan has a strong legal basis. This includes actions concerning the transfer of contracts and services, the transfer of cash and securities positions of an FMI, or the transfer of all or parts of the rights and obligations provided in a link arrangement to a new entity. In developing orderly wind-down plans, an FMI should elaborate on

- ❖ the scenarios where an orderly wind-down is initiated, including the services considered for wind-down;
- ❖ the expected wind-down period for each scenario, including the timeline for when the wind-down process for critical services (if applicable) would be complete; and
- ❖ measures in place to port critical services to another FMI that is identified and assessed as operationally capable of continuing the services.

**Disclosure of recovery and orderly wind-down plans**

An FMI should disclose sufficient information regarding the effects of its recovery and orderly wind-down plans on FMI participants and stakeholders, including how they would be affected by (i) the allocation of uncovered losses and liquidity shortfalls and (ii) any measures the CCP would take to re-establish a matched book. In terms of disclosing the degree of discretion an FMI has in implementing recovery tools, an FMI should make it clear to FMI participants and all other stakeholders ahead of time that all recovery tools and orderly wind-down actions that an FMI can implement will only be employed after consulting with the relevant Canadian authorities.

Note that recovery and orderly wind-down plans need not be two separate documents; the orderly wind-down of critical services may be a part or subset of the recovery plan. Furthermore, Canadian FMIs may consider developing orderly wind-down plans for non-critical services in the context of recovery if winding down non-critical services could assist in or benefit the recovery of the FMI.

**Annex: Guidelines on the Practical Aspects of FMI Recovery Plans**

The following example provides suggestions on how an FMI recovery plan could be organized.

