CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Notice

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

March 19, 2020

Introduction

The Canadian Securities Administrators (the **CSA** or **we**) are adopting amendments to National Instrument 24-102 *Clearing Agency Requirements* (**Instrument**) and changes to Companion Policy 24-102 *Clearing Agency Requirements* (**Companion Policy** or **CP**), together referred to as the **Amendments**. The Instrument and the Companion Policy are collectively referred to as **NI 24-102**.

The Amendments are expected to be adopted by each member of the CSA. In some jurisdictions, Ministerial approvals are required for the implementation of the Amendments. Provided all necessary ministerial approvals are obtained, the Amendments will come into force on June 19, 2020. Further details can be found in Annex G of this Notice.

The purpose of the Amendments is described in the "Substance and Purpose" section below.

This Notice contains the following annexes:

- **Annex A** – List of commenters
- **Annex B** – Summary of comments and CSA responses
- **Annex C** – Amendments to National Instrument 24-102 *Clearing Agency Requirements*
- **Annex D** – Changes to Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements*
- **Annex E** – Blacklined Amendments to National Instrument 24-102 *Clearing Agency Requirements* (showing the changes under the Amendments to the Instrument)
- **Annex F** – Blacklined Changes to Companion Policy 24-102CP to National Instrument 24-102 *Clearing Agency Requirements* (showing the changes under the Changes to the CP)
- **Annex G** – Adoption of the Instrument

This Notice, including its annexes, is available on websites of CSA jurisdictions, including:

www.albertasecurities.com
www.bcsc.bc.ca
www.fcaa.gov.sk.ca
www.fcnb.ca
www.lautorite.qc.ca
www.mbsecurities.ca
nssc.novascotia.ca
www.osc.gov.on.ca

Background

The Instrument sets out ongoing requirements for regulated clearing agencies, including requirements that are based on international standards applicable to financial market infrastructures (**FMIs**) operating as a central counterparty (**CCP**), central securities depository (**CSD**) or securities settlement system (**SSS**). The Companion Policy includes an annex (**Annex I**) with supplementary guidance (**Joint Supplementary Guidance**) that was developed jointly by the Bank of Canada and CSA regulators to provide additional clarity on the PFMI principles for domestic recognized clearing agencies that are also overseen by the Bank of Canada. The Instrument also sets forth certain requirements for clearing agencies intending to apply for recognition as a clearing agency under securities legislation, or for an exemption from the recognition requirement.

We published proposed amendments to the Instrument and the Companion Policy for comment on October 18, 2018 (the **October 2018 Proposal**).

Summary of Comments Received by the CSA

In response to the October 2018 Proposal, we received submissions from 3 commenters. We have considered the comments received and thank all of the commenters for their input. A list of those who submitted comments and a summary of the comments and our responses are attached to this Notice at Annexes A and B respectively. Copies of the comment letters are available at www.osc.gov.on.ca.

Substance and Purpose

1. Purposes of Amendments

The Amendments seek to enhance operational system requirements, align aspects of NI 24-102 more closely with similar provisions in National Instrument 21-101 *Marketplace Operation* (**NI 21-101**), and reflect the latest developments and findings of the Committee on Payments and Market Infrastructures of the Bank for International Settlements and the International Organization of Securities Commissions (**CPMI-IOSCO**) with relevance for the Canadian market. They also incorporate certain comments we received on the October 2018 Proposal.

Specifically, the Amendments:

- enhance the systems-related requirements in Part 4, Division 3, of the Instrument and related provisions in the Companion Policy by aligning them more closely with similar provisions in NI 21-101, emphasizing the importance of cyber resilience, and clarifying testing and reporting expectations;
- update NI 24-102 to include a general reference in the Companion Policy to CPMI-IOSCO guidance reports that have been published on various aspects of the PFMI Principles since the publication of the PFMI Report;
- adopt findings made by the CPMI-IOSCO PFMI implementation monitoring assessment, including substantially simplifying the Joint Supplementary Guidance; and
- make other non-substantive changes, corrections and clarifications to NI 24-102.

2. Summary of Amendments

We have set out below a brief summary of the key changes and policy rationales for the Amendment.

a. Financial reporting

Under subsection 2.5(2) of the October 2018 Proposal, we had proposed to clarify that an interim period for financial statements had the same meaning as under National Instrument 51-102 *Continuous Disclosure Obligations* (**NI 51-102**). To avoid potential confusion arising from the reference to NI 51-102 and the applicability of exemptions from that instrument, we have removed this language from the Amendments. Instead, we have clarified in the CP our expectation that exempt clearing agencies should file interim financial statements in accordance with the interim filing requirements of their home regulator, as our intention is not to require such entities to produce and file additional financial statements. We have also clarified in the CP the content of interim financial statements required to be filed by exempt and recognized clearing agencies under the Instrument.

b. Systems requirements

(i) Cyber resilience has been added to subparagraph 4.6(a)(ii) as one of the controls a recognized clearing agency must develop and maintain. While cyber resilience should already be covered by an entity's general controls, its explicit addition to the Instrument reflects its increasing importance, as discussed in the June 2016 CPMI-IOSCO *Guidance on cyber resilience for financial market infrastructures*.[1]

(ii) The concept of "security breach" in relation to the notifications that must be provided by a recognized clearing agency pursuant to subsection 4.6(c) has been broadened to "security incident". The change extends the concept beyond actual breaches, as we are of the view that a material event may include one where a breach has not necessarily occurred. We

[1]The guidance is available at https://www.bis.org/cpmi/publ/d146.pdf.

describe “security incidents” in the CP with reference to the general definition used by the National Institute of Standards and Technology (U.S. Department of Commerce) (**NIST**),[2] a recognized standard also followed by CPMI-IOSCO.

(iii) We have adopted a requirement in the Instrument under section 4.6 that recognized clearing agencies must keep records of any systems failures, malfunctions, delays or security incidents and identify whether they are material. In response to concerns raised in the comments, and to avoid placing an undue burden on recognized clearing agencies, we have not proceeded with additional related reporting requirements that were included in the October 2018 Proposal. However, as noted in the revised CP language, in circumstances where we consider it appropriate we may nonetheless request additional information from a recognized clearing agency. We have also clarified the CP language and aligned it with the revised Instrument.

(iv) A new section 4.6.1 regarding auxiliary systems has been adopted. An auxiliary system of a recognized clearing agency is a system that is operated by or on behalf of the clearing agency that, if breached, would pose a security threat to one or more of the systems operated by or on behalf of the agency that support its clearing, settlement and depository functions. We have made minor changes to the definition of auxiliary system in the October 2018 proposal to clarify its intended scope. Consistent with section 4.6, section 4.6.1 includes requirements relating to auxiliary systems with respect to controls and records, and notifications in connection with security incidents.

(v) Amended section 4.7 states that a recognized clearing agency must engage a “qualified external auditor” to conduct and report on its independent systems reviews. We expect the clearing agency to discuss with us its choice of qualified external auditor and the scope of the systems review mandate.

c. Additional CPMI-IOSCO guidance reports

The Companion Policy states that, in interpreting and implementing the PFMI Principles, regard is to be given to the explanatory notes in the PFMI Report unless otherwise indicated in section 3.1 or Part 3 of the CP. Since the publication of the PFMI Report, CPMI-IOSCO has published related documents and additional guidance on certain specific aspects of the PFMI Principles.[3] We have therefore adopted an addition to the CP that these and other future CPMI-IOSCO reports should be used as guidance in interpreting and implementing the PFMI Principles.

d. CPMI-IOSCO implementation monitoring assessment for Canada

The CPMI-IOSCO implementation monitoring assessment[4] noted that a reporting line from the chief compliance officer and the chief risk officer to the chief executive officer may result in insufficient independence of the risk and audit functions unless there are adequate safeguards in place that address potential conflicts of interest. In the October 2018 Proposal, proposed amendments to subsection 4.3(1) could have been interpreted as removing the ability of a recognized clearing agency’s board of directors to determine that the chief risk officer and chief compliance officer should report directly to the chief executive officer. In response to the comments we received regarding the October 2018 Proposal, we decided not to proceed with this change. Instead, we have clarified in the CP that dual line reporting is permitted if there are adequate safeguards in place to ensure that the chief risk officer and chief compliance officer are sufficiently independent from the other members of management.

Also in response to the CPMI-IOSCO assessment, we have simplified and clarified the Joint Supplementary Guidance with respect to the application of the PFMI Principles to domestic recognized clearing agencies that are also overseen by the Bank of Canada.

e. Additional non-substantive changes

Lastly, a number of non-substantive changes, corrections and clarifications were adopted, including modernizing the drafting of NI 24-102 in accordance with recently revised CSA rule-making drafting guidelines. By their nature, none of the non-substantive changes should have any impact on the application of NI 24-102 to market participants.

Questions

Please refer questions to any of the following:

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[2] The NIST definition of “security incident” is available at https://csrc.nist.gov/Glossary.
[3] Links to this material are presently available at https://www.bis.org/cpmi/info_pfmi.htm.
[4] See *Implementation monitoring of PFMI: Level 2 assessment report for Canada*, August 2018 at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD608.pdf.

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ANNEX A

List of Commenters on Proposed Amendments to National Instrument 24-102
***Clearing Agency Requirements* and related Companion Policy 24-102CP**

(as published for comment on October 18, 2018)

Commenters:

CME Group Inc.
LCH Limited
TMX Group Limited

ANNEX B

Summary of Comments on Proposed Amendments to National Instrument 24-102
***Clearing Agency Requirements* and related Companion Policy 24-102CP and CSA Responses**

1. Theme/question[1]	2. Summary of comments	3. CSA response
Records retention period	One commenter noted that while subsection 5.1(1) requires that books and records be retained for seven years, the equivalent requirement under U.S. law is five years. The commenter asked that the retention period in the Instrument be reduced to five years, or that substituted compliance be permitted.	The commenter's proposal is beyond the scope of this initiative, as there are no proposed amendments to subsection 5.1(1) in the materials published for comment. This comment will be considered outside of the proposed amendments, for example as part of the OSC's initiative to reduce regulatory burden. A clearing agency may also choose to apply for an exemption from this requirement on the basis of substituted compliance, and the relevant CSA jurisdictions will consider any application on a case by case basis.
Reporting changes to PFMI Disclosure Document	One commenter requested that substituted compliance with an entity's home-country regulatory requirements be permitted for exempt clearing agencies with respect to the requirement in subsection 2.2(5). Subsection 2.2(5) requires that the securities regulatory authority be notified in writing of any material change to, or subsequent inaccuracy in, its PFMI Disclosure Framework Document and related application materials.	The commenter's proposal is beyond the scope of this initiative, as there are no proposed amendments to subsection 5.1(1) in the materials published for comment. This comment will be considered outside of the proposed amendments, for example as part of the OSC's initiative to reduce regulatory burden. A clearing agency may also choose to apply for an exemption from this requirement on the basis of compliance with an entity's home country regulatory requirements, and the relevant CSA jurisdictions will consider any application on a case by case basis.
Chief Risk Officer (CRO) and Chief Compliance Officer (CCO) reporting line	Two commenters expressed concern that the proposed amendments to paragraph 4.3(1) could be interpreted to eliminate dual reporting lines of the CRO and CCO to both the management and Board of Directors. The commenters stated that the elimination of dual reporting would require a change in their current practices, even though such practices do not contravene the PFMIs. They find the flexibility of direct reporting to the Board of Directors, while retaining administrative reporting to management, to be efficient and practical, as long as there are parallel mechanisms to ensure that the independence of the	It is not our intention to prohibit dual reporting lines for the CRO and CCO to management and the Board of Directors. Rather, our intention is to avoid interpretations and practices that may undermine the independence of key risk and audit roles, a concern raised in the CPMI-IOSCO implementation monitoring assessment and which we share. We recognize, however, that the deletion of language referencing reporting to the CEO may have caused some confusion. We have therefore added explanatory language in a new subsection 4.3(1) to the CP to better reflect our intent.

[1] 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.

	CRO and CCO functions from the management is preserved. One of the commenters also noted that dual reporting can be found in a number of foreign clearing agencies, including non-domestic clearing agencies that operate in Canada.	
Filing of interim financial statements	One commenter submitted that substituted compliance should be permitted for exempt clearing agencies with respect to the interim financial statement filing requirement in subsection 2.5(2).	We have modified the amendment to subsection 2.5(2) to allow clearing agencies to file interim financial statements in CSA jurisdictions at the same intervals they are required to file them in their home jurisdictions, which is generally consistent with the approach taken in NI 51-102 and NI 71-102. We have also added clarifying language to the CP to this effect. Given that the proposed reference in subsection 2.5(2) to NI 51-102 has now been deleted, we have also amended the CP to clarify the content of interim financial statements based on IFRS IAS 34.
Independent system reviews	One commenter disagreed with the proposed amendment to paragraph 4.7(1)(a) that would require an external party, as opposed to an internal auditor, from conducting independent system reviews of recognized clearing agencies. The commenter expressed the view that the independent nature of the internal audit function provides sufficient objectivity and that the proposed amendment would not enhance the resilience of the control environment.	While the CSA recognizes the professional objectivity required of internal auditors, we are of the view that requiring independent systems reviews be conducted by a qualified external auditor at arms-length from the clearing agency both enhances and promotes confidence in the process. It is also consistent with industry best practices.
Auxiliary systems	One commenter expressed concern that the definition of “auxiliary systems” is too broad and submitted that the term should only cover systems that are part of the clearing agency ecosystem and under its control.	After careful consideration of the comments, we have modified the definition of auxiliary systems in subsection 4.6.1(1) to capture those systems operated by or on behalf of the recognized clearing agency that, if breached, would pose a security threat to the clearing agency’s critical systems i.e. systems that support the recognized clearing agency’s clearing, settlement and depository functions
Security incidents and related reporting obligations	One commenter expressed concern with the proposed change from the obligation in paragraph 4.6(c) to report material security breaches to an obligation to report material security incidents, as well as proposed new language in the CP regarding materiality. The commenter submitted that the resulting obligations would be much broader than the current requirements and would be unduly onerous without providing a clear	Given the evolving and multidimensional nature of cyber threats, a sophisticated attack on the entity’s systems and controls can have serious operational, financial or even reputational impact on the entity even if a breach has yet to happen. This is a view that is shared by regulators, organizations and stakeholders globally. The definition of incidents by the National Institute of Standards and Technology (NIST) captures this reality, which is why the CSA

	material benefit. The commenter expressed similar concerns regarding the proposed new subsection 4.6(2), which would require clearing agencies to provide a log and explanation for any system issue or security incident regardless of its impact.	has incorporated it into the proposed definition of security incident, in paragraph 4.6(c) to the CP. With regards to the issue of materiality, we find that relying on internal corporate controls for establishing the materiality threshold is a straightforward and reasonable regulatory anchor for the purpose of event reporting. We have modified paragraph 4.6(c) to clarify the guidance with respect to determining materiality. In addition, we have removed the proposed new subsection 4.6(2) in the Instrument which would have required a recognized clearing agency to file with the regulator quarterly reports of any all system issues and security incidents logs. Instead we have added language to the CP which reiterates the securities regulator's discretion to ask for any information related to system issues or securities incidents as part of its broader information access rights under section 5.1 of the Instrument.

ANNEX C

THE MANITOBA SECURITIES COMMISSION
MSC Rule No. 2020-2
(Section 149.1, *The Securities Act*)

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

1. National Instrument 24-102 Clearing Agency Requirements is amended by this Instrument.

2. Section 1.2 is amended

(a) in subsection (2),

*(i) by replacing "*company if*" with "*company if any of the following apply:*",*

(ii) by replacing "fifty percent" with "50%" wherever the expression occurs,

*(iii) by replacing "*by way of security*" with "*by way of a security interest*" in subparagraph (a)(i), and*

*(iv) by deleting "*or*" at the end of paragraph (b), and*

(b) in subsection (3),

*(i) by replacing "*company if*" with "*company if either of the following applies:*", and*

(ii) by replacing paragraph (a) with the following:

(a) it is a controlled entity of any of the following:

(i) that other;

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

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

3. Section 1.3 is replaced with the following:

Interpretation –meaning of affiliate for the purposes of the PFMI principles
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 subsequently referred to in this section as a "party", if any of the following apply:

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

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

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

4. Subparagraph 2.1(1)(b) is replaced with the following:

(b) sufficient information to demonstrate that the applicant is

(i) in compliance with applicable provincial and territorial securities legislation, or

(ii) subject to and in compliance with the regulatory requirements of the foreign jurisdiction in which the applicant's head office or principal place of business is located that are comparable to the applicable requirements under this Instrument;**.**

5. Subsection 2.1(2) is amended

*(a) by replacing "*books and records*" with "*books, records and other documents*", wherever the expression occurs, and*

*(b) in paragraph (b) by replacing "*such*" with "*the*".*

6. Subsection 2.1(3) is amended by replacing "Submission to Jurisdiction and Appointment of Agent for Service" with "Clearing Agency Submission to Jurisdiction and Appointment of Agent for Service of Process".

*7. Subsection 2.1(4) is amended by replacing "*material change to the information provided in its application*" with "*change to the information provided in its application that is material*".*

8. Subsection 2.2(1) is amended

*(a) by adding "*any of the following:*" immediately after "*in relation to a clearing agency,*" at the end of the first sentence, and*

*(b) in paragraph (h) by replacing "*recognition terms and conditions.*" with "*terms and conditions of a decision to recognize the clearing agency under securities law.*"***.**

9. Subsection 2.2(3) is replaced with the following:

2.2(3) The written notice referred to in subsection (2) must include an assessment of how the significant change is consistent with the PFMI Principles applicable to the recognized clearing agency**. .**

10. Subsection 2.3(1) is replaced with the following:

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 at least 90 days before ceasing to carry on business**. .**

*11. Subsection 2.5(2) is amended by adding "*of the recognized clearing agency's or exempt clearing agency's financial year*" immediately after "*each interim period*".*

12. Section 3.1 is amended

(a) by replacing the first paragraph with the following:

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 and 15 to 23, other than key consideration 9 of PFMI Principle 20 and the following:*, and*

*(b) by deleting "*and*" at the end of paragraph (b).*

*13. Section 4.1 is amended in paragraph (2)(b) by replacing "*not employees or executive officers of a participant or*" with "*neither employees nor officers of a participant nor*".*

14. Section 4.3 is amended

(a) in subsection (1), by deleting "or, if determined by the board of directors, to the chief executive officer",

(b) in paragraph (2)(a),

(i) by deleting "full", and

(ii) replacing "maintain, implement" with "implement, maintain",

(c) by replacing the "," with a ";" at the end of each of subparagraphs (3)(c)(i) and (ii),

(d) in subparagraph (3)(c)(iii) by replacing "non-compliance, or" with "non-compliance;", and

(e) in paragraph (3)(f) by replacing "such" with "the".

15. Section 4.4 is amended

*(a) in paragraph (4)(b) by replacing "*not employees or executive officers of a participant or*" with "*neither employees nor officers of a participant nor*", and*

(b) by adding the following subsection:

4.4(5) For the purpose of this section, an individual is independent of a clearing agency if the individual has no relationship with the agency that could, in the reasonable opinion of the clearing agency's board of directors, be expected to interfere with the exercise of the individual's independent judgment**.**

16. Section 4.6 is amended

(a) in paragraph (a)

*(i) in subparagraph (i) by replacing "*an adequate system of internal controls" *with "*adequate internal controls*", and*

*(ii) in subparagraph (ii) by adding "*cyber resilience and*" immediately before "*information technology*",*

*(b) in subparagraph (b)(ii) by replacing "*ability*" with "*processing capability*", "*process transactions*" with "*perform*" and by deleting* "and",

(c) by replacing paragraph (c) with the following:

(c) promptly notify the regulator or, in Québec, the securities regulatory authority of any systems failure, malfunction, delay or security incident that is material, and provide timely updates to the regulator or, in Québec, the securities regulatory authority regarding the following:

(i) any change in the status of the failure, malfunction, delay or security incident;

(ii) the resumption of service, if applicable;

(iii) the results of any internal review, by the clearing agency, of the failure, malfunction, delay or security incident; and, *and*

(d) by adding the following paragraph:

(d) keep a record of any systems failure, malfunction, delay or security incident and whether or not it is material**. .**

17. The Instrument is amended by adding the following section:

Auxiliary systems

4.6.1(1) In this section, "**auxiliary system**" means a system, other than a system referred to in section 4.6, operated by or on behalf of a recognized clearing agency that, if breached, poses a security threat to another system operated by or on behalf of the recognized clearing agency that supports the recognized clearing agency's clearing, settlement or depository functions.

4.6.1(2) For each auxiliary system, a recognized clearing agency must

(a) develop and maintain adequate information security controls that address the security threats posed by the auxiliary system to the system that supports the clearing, settlement or depository functions,

(b) promptly notify the regulator or, in Québec, the securities regulatory authority of any security incident that is material and provide timely updates to the regulator or, in Québec, the securities regulatory authority on

(i) any change in the status of the incident,

(ii) the resumption of service, if applicable, and

(iii) the results of any internal review, by the clearing agency, of the security incident, and

(c) keep a record of any security incident and whether or not it is material**. .**

18. Subsection 4.7(1) is replaced with the following:

4.7(1) A recognized clearing agency must

(a) on a reasonably frequent basis and, in any event, at least annually, engage a qualified external auditor to conduct an independent systems review and prepare a report, in accordance with established audit standards and best industry practices, that assesses the clearing agency's compliance with paragraphs 4.6(a) and 4.6.1(2)(a) and section 4.9, and

(b) on a reasonably frequent basis and, in any event, at least annually, engage a qualified party to perform assessments and testing to identify any security vulnerability and measure the effectiveness of

information security controls that assess the clearing agency's compliance with paragraphs 4.6(a) and 4.6.1(2)(a)**.**

*19. Subsection 4.7(2) is amended by replacing "*subsection (1)*" with "*paragraph (1)(a)*".*

*20. Paragraph 4.10(g) is amended by replacing "*an appropriate*" with "*a reasonable*".*

*21. Subsection 5.1(1) is amended by deleting "*and must keep those other books, records and documents as may otherwise be required under securities legislation*".*

22. Section 5.2 is amended

(a) by replacing subsection (1) with the following:

5.2(1) In this section, "**Global Legal Entity Identifier System**" means the system for unique identification of parties to financial transactions.

*(b) in subsection 5.2(2), by replacing "*a single*" with "*the*", and*

(c) by adding the following subsection:

5.2(2.1) During the period that a clearing agency is a recognized clearing agency or is exempt from the requirement to be recognized as a clearing agency, the clearing agency must maintain and renew the legal entity identifier referred to in subsection (2)**..**

*23. Subsection 6.1(3) is amended by adding "*Alberta and*" immediately before "*Ontario*".*

24. Form 24-102F1 is amended

(a) in paragraph 7, by replacing "[province of local jurisdiction]*" with "*[name of local jurisdiction]*",*

*(b) in paragraph 10, by replacing "*be a recognized*" with "*be recognized", *and*

(c) after the heading "AGENT CONSENT TO ACT AS AGENT FOR SERVICE" *by deleting "*insert*" wherever it occurs.*

25. Form 24-102F2 is amended

*(a) under the heading "Exhibit B" by replacing "*ceasing business*" with "*ceasing to carry on business*",*

*(b) by replacing "*the cessation of*" with "*ceasing to carry on*" in Exhibits C and D, and*

*(c) after the heading "*CERTIFICATE OF CLEARING AGENCY*"*

*(i) by deleting the round brackets immediately before and after "*Name of clearing agency*",*

(ii) by replacing "(Name of director, officer or partner – please type or print)*" with "*Name of director, officer or partner (please type or print)*",*

*(iii) by deleting the round brackets immediately before and after "*Signature of director, officer or partner*", and*

(iv) by replacing "(Official capacity – please type or print)*" with "*Official capacity (please type or print)*".*

26.(1) This Instrument comes into force on June 19, 2020.

26.(2) In Saskatchewan, despite subsection (1), if this Instrument is filed with the Registrar of Regulations after June 19, 2020, this Instrument comes into force on the day on which it is filed with the Registrar of Regulations.

27. This Instrument may be cited as MSC Rule 2020-2.

ANNEX D

CHANGES TO COMPANION POLICY 24-102CP *CLEARING AGENCY REQUIREMENTS*

1. ***Companion Policy 24-102CP Clearing Agency Requirements is changed by this Document.***

2. ***Subsection 1.1(2) is changed by replacing "***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***" with "***this section, sections 1.2 and 1.3 of this CP, and Annexes I and II***".***

3. ***Subsection 1.2(3) is changed by replacing "***Annex I to this CP includes supplementary guidance in *text boxes* that applies***" with "***Annexes I and II to this CP include supplementary guidance that applies***".***

4. ***Part 1 is changed by adding the following section:***

1.5 Section 1.5 provides clarity on the application of the different parts of the Instrument to a clearing agency that has been recognized by a securities regulatory authority, or exempted from recognition, as is further described in section 2.0 of this CP. Unless otherwise specified, Parts 1, 2, and 5 to 7 generally apply to both a recognized clearing agency and one that is exempted from recognition**..**

5. ***Subsection 2.0 is changed:***

   (a) in subsection (2) by replacing "will generally***" with "***would generally need to***", and***

   (b) in subsection (4) by replacing "certain material changes to information provided to the securities regulatory authority***" with "***certain changes to information provided to the securities regulatory authority that are material***".***

6. ***Section 2.1 is changed:***

   (a) by adding "in both substance and process, though its oversight program may differ***" immediately after "***agency is similar***",***

   (b) by adding "comprehensive and***" immediately after "***completion of***", and***

   (c) by adding "for either recognition or exemption***" immediately after "***application materials***".***

7. ***Subsection 2.2(2) is changed:***

   (a) by replacing the first sentence with the following:

   The written notice should provide a reasonably detailed description of the significant change (as defined in subsection 2.2(1)), the expected date of the implementation of the change, and an assessment of how the significant change is consistent with the PFMI Principles applicable to the clearing agency (see subsection 2.2(3))***., and***

   (b) by deleting the last sentence.

8. ***Section 2.3 is changed by deleting "***within the appropriate timelines***".***

9. ***Part 2 is changed by adding the following section:***

Financial statements

2.4 Financial statements filed under sections 2.4 and 2.5 must disclose the accounting principles used to prepare

them. For clarity, financial statements prepared either in accordance with Canadian GAAP applicable to publicly accountable enterprises or in accordance with IFRS should include:

(a) in the case of annual financial statements, an unreserved statement of compliance with IFRS;
(b) in the case of interim financial statements, an unreserved statement of compliance with International Accounting Standard 34 *Interim Financial Reporting.*

10. Part 2 is changed by adding the following section:

Filing of interim financial statements

2.5 The term "interim period" in subsection 2.5(2) means a period commencing on the first day of the recognized or exempt clearing agency's financial year and ending nine, six or three months before the end of the same financial year, or otherwise in accordance with the regulatory requirements of the jurisdiction in which the clearing agency's head office or principal place of business is located**..**

11. Part 3 is changed

(a) in section 3.1

(i) by adding "and other reports or explanatory material published by CPMI and IOSCO that provide supplementary guidance to FMIs on the application of the PFMI Principles***" immediately after "***explanatory notes in the PFMI Report***", and***

(ii) by deleting "separate *text boxes* in***",***

(b) in current section 3.2 by deleting "(see Box 5.1 in Annex I to this CP)***",***

(c) in current section 3.3 by deleting the ":" after the words "domestic cash markets because***" in the paragraph immediately after the subheading "****- Customers of IIROC dealer members****", and***

(d) by deleting the numbering of sections 3.2 and 3.3.

12. Section 4.0 is changed by adding "recognized***" immediately before "***clearing agency***".***

13. Subsection 4.1(4) is changed

(a) by replacing "reasonably***" with "***, absent exceptional circumstances,***",***

(b) by deleting "executive***" immediately before "***officer***" in paragraph (a), (b) and (e), and***

(c) by replacing "ten per cent***" with "***10%***" wherever it occurs.***

14. Section 4.2 is deleted.

15. Section 4.3 is changed by adding the following paragraph immediately after the first paragraph:

Consistent with PFMI Principle 2, Key Consideration 6, subsection 4.3(1) is not intended to prevent the CRO and the CCO from reporting to both management and the board, provided that there are adequate safeguards in place to ensure that the CRO and the CCO have sufficient independence from the other members of management in performing their functions as CRO and CCO, particularly their obligations under subsections 4.3(2) and 4.3(3)**..**

16. Subsection 4.3(3) is changed by adding "(or certain aspects of the role)***" immediately after "***role of a CCO***".***

17. Section 4.6 is changed

(a) by replacing paragraph (a) with the following:

(a) The intent of these provisions is to ensure that controls are implemented to support cyber resilience, information technology planning, acquisition, development and maintenance, computer operations, information systems support and security. Recognized guides as to what constitutes adequate information technology controls may include guidance, principles or frameworks published by the Chartered Professional Accountants - Canada (CPA Canada), American Institute of Certified Public Accountants (AICPA), Information Systems Audit and Control Association (ISACA), International Organization for Standardization (ISO), or the National Institute of Standards and Technology (U.S. Department of Commerce) (NIST). We are of the view that internal controls include controls which support the processing integrity of the models used to quantify, aggregate, and manage the clearing agency's risks.

(b) in paragraph (b), by replacing "subsection 4.6(b)***" with "***paragraph 4.6(b)***" and "***once a year***" with "***once in each 12-month period***",***

(c) by replacing paragraph (c) with the following:

(c) A security incident is considered to be any event that actually or potentially jeopardizes the confidentiality, integrity or availability of an information system or the information the system processes, stores or transmits, or that constitutes a violation or imminent threat of violation of security policies, security procedures or acceptable use policies. A failure, malfunction, delay or security 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. Such events would not generally include those that have or would have little or no impact on the clearing agency's operations or on participants, although non-material events may become material if they recur or have a cumulative effect. Any event that requires non-routine measures or resources by the clearing agency would also 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 incident it did not consider material. It is expected that, as part of the notification required under paragraph 4.6(c), the clearing agency will provide updates on the status of the event and the resumption of service. Further, the clearing agency should have comprehensive and well-documented procedures in place to record, analyze, and resolve all systems failures, malfunctions, delays and security incidents. In this regard, the clearing agency should undertake a "post-mortem" 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.[1]***, and***

(d) adding the following paragraph:

(d) Pursuant to section 5.1, a recognized clearing agency may be asked to provide the regulator or, in Quebec, the securities regulatory authority, with additional information, such as but not limited to reports, logs or other documents related to a systems failure, malfunction, delay, security incident or any other system or process related data**.**

18. Part 4 is changed by adding the following subsection:

Auxiliary systems

4.6.1(2) A recognized clearing agency should also refer to the considerations for paragraph 4.6(c) above with regards to security incidents that arise in connection with auxiliary systems. Pursuant to section 5.1, a recognized clearing agency may be asked to provide the regulator or, in Quebec, the securities regulatory authority, with additional information, such as but not limited to reports, logs or other documents related to a security incident**.**

19. Subsection 4.7(1) is replaced with the following:

4.7 (1)(a) An independent systems review must be conducted and reported on at least once in each 12-month

[1] Adapted from the NIST definition of "incident". See https://csrc.nist.gov/Glossary/?term=4730#AlphaIndexDiv.

period by a qualified external auditor in accordance with established audit standards and best industry practices. We consider that best industry practices include the 'Trust Services Criteria' developed by the American Institute of CPAs and CPA Canada. For the purposes of paragraph 4.7(1)(a), we consider a qualified external auditor to be 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. Before engaging a qualified external auditor to conduct the independent systems review, a clearing agency is expected to discuss its choice of external auditor and the scope of the systems review mandate with the regulator or, in Québec, the securities regulatory authority. We further expect that the report prepared by the external auditor include, to the extent applicable, an audit opinion that (i) the description included in the report fairly presents the systems and controls that were designed and implemented throughout the reporting period, (ii) the controls stated in the description were suitably designed, and (iii) the controls operated effectively throughout the reporting period.

(1)(b) The clearing agency must also establish and perform effective assessment and testing methodologies and practices and would be expected to implement appropriate improvements where necessary. The assessments and testing required in this section, such as vulnerability assessments and penetration tests, are to be carried out by a qualified party on a reasonably frequent basis and, in any event, at least once in each 12-month period. For the purposes of paragraph 4.7(1)(b), we consider a qualified party to be 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. We consider that qualified parties 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. The securities regulatory authority may, in accordance with securities legislation, require the clearing agency to provide a copy of any such assessment**..**

20. Section 4.9 is changed by replacing "annually***" with "***at least once in each 12-month period***".***

21. Subsection 5.2(1) is replaced with the following:

5.2 (1) The Global Legal Entity Identifier System defined in subsection 5.2(1) is a G20 endorsed system[2] that is intended to serve as a public-good utility responsible for overseeing the issuance of legal entity identifiers (LEIs) globally in order to uniquely identify parties to transactions. It was designed and implemented under the direction of the LEI Regulatory Oversight Committee, a governance body endorsed by the G20.

22. Subsection 5.2(3) is deleted.

23. Annex I is replaced with the following:

ANNEX I

TO COMPANION POLICY 24-102CP

JOINT SUPPLEMENTARY GUIDANCE

DEVELOPED BY THE BANK OF CANADA AND CANADIAN SECURITIES ADMINISTRATORS

ON THE PFMI PRINCIPLES

Joint Supplementary Guidance has been developed by the BOC and the securities regulatory authorities to provide additional clarity on certain aspects of selected PFMI Principles within the Canadian context. It is found on the BOC

[2] See http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm for more information.

website and in annexes to the Companion Policy (to the CSA National Instrument 24-102 *Clearing Agency Requirements*).

The Joint Supplementary Guidance applies in respect of recognized domestic clearing agencies that are designated as systemically important by the BOC and jointly overseen by the BOC and one or more securities regulatory authorities (referred to in this Joint Supplementary Guidance as an "FMI").

Beyond observation of the PFMI Principles, an FMI is expected to take into account the "Explanatory Notes" for each applicable PFMI Principle, other reports and explanatory materials published by CPMI and IOSCO that supplement the PFMI Report and that provide guidance to FMIs on the application of the PFMI Principles, as well as this Joint Supplementary Guidance or any future guidance published jointly by the BOC and the securities regulatory authorities.

The Joint Supplementary Guidance below appears under the relevant headings for each applicable PFMI Principle (referred to by the BOC as its "Risk-Management Standards for Designated FMIs").

PFMI Principle 3: Framework for the comprehensive management of risks

a. Joint Supplementary Guidance for PFMI Principle 3 has been developed by the BOC and CSA pertaining to FMI recovery planning. This guidance can be found separately on the BOC website and in Annex II to the Companion Policy.

PFMI Principle 5: Collateral

a. An FMI should not rely solely on external opinions to determine collateral eligibility.

b. In general, most of the FMI's collateral pools should be composed of cash and debt securities issued or guaranteed by the Government of Canada, a provincial government or the U.S. Treasury.

c. Additional asset classes may be acceptable as collateral if they are subject to conservative haircuts and concentration limits. An FMI should limit such assets to a maximum of 40% of the total collateral posted from each participant. It should also limit securities issued by a single issuer to a maximum of 5% of total collateral from each participant. Such assets are:

- Securities issued by a municipal government;
- Bankers' acceptances;
- Commercial paper;
- Corporate bonds;
- 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;
- Equity securities traded on marketplaces regulated by a member of the CSA; 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.

d. Since it is highly likely that the value of debt and equity securities issued by companies operating in the financial sector would be adversely affected by the default of an FMI participant – introducing wrong-way risk for an FMI that has accepted such securities as collateral – an FMI should:

- Limit the collateral from financial sector issuers to a maximum of 10% of total collateral pledged from each participant; and
- Not allow a participant to pledge as collateral securities issued by itself or an affiliate.

PFMI Principle 7: Liquidity risk

a. Liquidity facilities should include at least three independent liquidity providers to ensure the FMI has access to sufficient liquid resources even in the event one of its liquidity providers defaults.

b. Uncommitted liquidity facilities are considered qualifying liquid resources for liquidity exposure in Canadian dollars if they meet all of the following additional criteria:

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

PFMI Principle 15: General business risk

a. Liquid net assets funded by equity must be held at the level of the FMI legal entity to ensure they are unencumbered and can be accessed quickly.

PFMI Principle 16: Custody and investment risks

a. It is paramount that an FMI have prompt access to assets held for risk-management purposes with minimal price impact. For the purposes of PFMI Principle 16, financial instruments can be considered to have minimal credit, market and liquidity risk if they are debt instruments that are:

- Securities issued or guaranteed by the Government of Canada;
- Marketable securities issued by the U.S. Treasury;
- Securities issued or guaranteed by a provincial government;
- Securities issued by a municipal government;
- Bankers' acceptances;
- Commercial paper;
- Corporate bonds; and
- Asset-backed securities that are:
  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.

b. Investments should also, at a minimum, observe the following:

- To reduce concentration risk, no more than 20% of total investments should be invested in any combination of municipal and private sector securities. Investment in a single private sector or municipal issuer should be no more than 5% 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% of total investments. An FMI should not invest assets in the securities of its own affiliates.
- For investments that are subject to counterparty credit risk, an FMI should set clear criteria for choosing investment counterparties and setting exposure limits.

24. The Companion Policy is changed by adding the following Annex II:

ANNEX II

TO COMPANION POLICY 24-102CP

JOINT SUPPLEMENTARY GUIDANCE

DEVELOPED BY THE BANK OF CANADA AND CANADIAN SECURITIES ADMINISTRATORS

ON RECOVERY PLANS

Context

In 2012, to enhance the safety and efficiency of payment, clearing and settlement systems, CPMI and IOSCO released a set of international risk-management standards for FMIs, known as the PFMIs.[1] 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 Systemic FMIs*[2] and by the CSA as part of the Instrument.[3] In the context of recovery planning,

> *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, CPMI and IOSCO released its report, "Recovery of Financial Market Infrastructures" (the Recovery Report), providing additional guidance specific to the recovery of FMIs.[4] 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.[5,6]

Recovery planning is not intended as a substitute for robust day-to-day risk management or for business continuity planning. Rather, it serves to extend and strengthen an FMI's risk-management framework, enhancing the resilience of the FMI against financial risks 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

<u>Overview of existing risk-management and legal structures</u>

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.

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1 Available at http://www.bis.org/cpmi/publ/d101a.pdf.

2 See key consideration 4 of PFMI Principle 3 and key consideration 3 of PFMI Principle 15 which are adopted in the Instrument, section 3.1.

3 The Bank of Canada's *Risk-Management Standards for Systemic FMIs* is available at http://www.bankofcanada.ca/core-functions/financial-system/bank-canada-risk-management-standards-systemic-fmis/.

4 Available at http://www.bis.org/cpmi/publ/d121.pdf.

5 Recovery Report, Paragraph 1.1.1.

6 For a precise definition of orderly wind-down, see the Recovery Report, Paragraph 2.2.2.

FMIs should also include an overview of their existing risk-management frameworks – i.e., their **pre-recovery** risk-management frameworks and activities. As part of this overview, and to determine the relevant point(s) where standard pre-recovery risk-management frameworks are exhausted, FMIs should identify all the material risks they are exposed to and explain how they use their existing pre-recovery risk-management tools to manage these risks to a high degree of confidence.

Critical services[7]

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[8]

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 pre-recovery risk controls, thereby placing 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.[9] This includes detailing in advance their communication plans, as well as the escalation process associated with their decision-making procedures. They should

7 Recovery Report, Paragraphs 2.4.2–2.4.4.
8 Recovery Report, Paragraph 2.4.5.
9 Recovery Report, Paragraph 2.4.8.

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 described in the recovery plan. 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 should be prudent in its actions and err on the side of caution.

Selection and Application of Recovery Tools[10]

A comprehensive plan for recovery

The success of a recovery plan relies on a comprehensive set of tools that can be effectively applied 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 Recovery Report, to determine the characteristics of effective recovery tools.[11] 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 in a manner that results in participant exposures that are determinable and fixed provides better certainty of the tools' impacts on FMI participants and their 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 may include 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 be cautious in using tools that can create uncapped, unpredictable or ill-defined participant exposures, and which could create uncertainty and disincentives to participate in an FMI. Any such use would need to be carefully

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10 Recovery Report, Paragraph 2.3.6 – 2.3.7 and 2.5.6 and Paragraphs 3.4.1 – 3.4.7.

11 Recovery Report, Paragraph 3.3.1.

justified. 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 determining which recovery tools should be included in a recovery plan, and selecting and applying such tools during the recovery phase, 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), nor is this an exhaustive list of tools that may be available for recovery. Each FMI should use discretion when determining the most appropriate tools for inclusion in its recovery plan, consistent with the considerations discussed above.

❖ **Cash calls**

Cash calls are recommended for recovery plans to the extent that the exposures they generate are fixed and determinable; for example, capped and limited to a maximum number of rounds over a specified period, established in advance. In this context, participant exposures 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 through the placement of 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 because participant exposure under this tool can be measured with reasonable confidence, as it is tied to the level of risk held in the variation margin (VM) fund and the potential for gains. Where recovery plans allow for multiple rounds of VMGH, Canadian authorities will consider the impact of each successive round of haircutting with increasing focus on systemic stability.

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. FMIs should seek to minimize these negative effects to the greatest extent possible.

❖ **Voluntary contract allocation**

To recover from an unmatched book caused by a participant default, a CCP can use its powers to allocate unmatched contracts.[12] In the context of recovery, contract allocation is encouraged on a voluntary basis –for example, by

[12] A CCP "matched book" occurs when a position taken on by the CCP with one clearing member is offset by an opposite position taken on with a second clearing member. 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.

auction. Voluntary contract allocation 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 voluntary contract tear-up as a potentially effective tool for FMI recovery. To this end, FMIs may want to consider using incentives to encourage voluntary tear-up during recovery.[13] While contract tear-up undertaken on a voluntary basis is a recommended tool, the forced termination of an incomplete trade may represent a disruption of a critical FMI service, and can be intrusive to apply (see the section "Tools requiring further justification" for a discussion of forced contract tear-up).

To the extent that voluntary contract tear-up may disrupt 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 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. Canadian authorities 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.[14] Where system-specific recovery needs necessitate, FMIs can also design recovery tools not explicitly listed in this guidance. The applicability of such tools will be examined by the Canadian authorities when they review the proposed recovery plan.

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 requiring further justification

Due to their uncertain and potentially negative effects on the broader financial system, tools that are more intrusive or result in participant exposures that are difficult to measure, manage or control, must be carefully considered and justified with strong rationale by the FMI when they are included in a recovery plan. Canadian authorities will provide their views on the suitability of any such tools as part of their review of recovery plans.

For example, uncapped and unlimited cash calls and unlimited rounds of VMGH can create ambiguous participant exposures, the negative effects of which must be prudently considered when including them in a recovery plan. In addition, when applied during the recovery process, Canadian authorities will monitor the application of each successive round of cash calls and VMGH with increased focus on systemic stability.

Tools such as involuntary (forced) contract allocation and involuntary (forced) contract tear-up create exposures that are difficult to manage, measure and control. To the extent that these tools are even more intrusive, they have the ability to pose greater risk to systemic stability. Canadian authorities acknowledge that such tools have potential utility when other recovery options are ineffective, and could possibly be used by a resolution authority, but expect FMIs to carefully assess the potential impact of such tools on participants and the stability of the broader financial system.

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13 Recovery Report, Paragraph 4.5.3.

14 Recovery Report, Paragraph 3.3.1.

Canadian authorities do not encourage the use of non-defaulting participants' initial margin in FMI recovery plans considering the potential for significant negative impacts.[15] Similarly, a recovery plan should not assume any extraordinary form of public or central bank support.[16]

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.[17] 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 identify procedures detailing how to promptly detect, evaluate and address the sources of underlying structural weakness on a continuous basis (e.g., unprofitable business lines, investment losses).

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)[18] and 7 (liquidity risk)[19] of the PFMIs require that FMIs should specify rules and procedures to fully allocate both uncovered losses and liquidity shortfalls caused by stress events. To be consistent with this requirement, **Canadian FMIs should consider various stress scenarios and have rules and procedures that allow them to fully allocate any losses or liquidity shortfalls arising from these stress scenarios, in excess of the capacity of existing pre-recovery risk controls.** Tools used to address full allocation should reflect the Recovery Report's characteristics of effective recovery tools, including the need to have them measurable, manageable and controllable to those who will bear the losses and liquidity shortfalls in recovery, and for their negative impacts to be minimized to the greatest extent possible.

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.[20] 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.[21]

FMIs should consider whether it is appropriate to involve indirect participants in the allocation of losses and shortfalls during recovery. To the extent that it is permitted, such arrangements should have a strong legal and regulatory basis; respect the FMI's frameworks for tiered participation, segregation and portability; 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.

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15 Recovery Report, Paragraph 4.2.26.
16 Recovery Report, Paragraph 2.3.1.
17 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.
18 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.
19 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.
20 PFMI Report, Paragraph 3.1.10.
21 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.

Additional Considerations in Recovery Planning

Transparency and coherence[22]

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 application 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[23]

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 of Recovery Plan[24]

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 applying recovery tools effectively and strategies to address them; and
- ❖ the impact of a major operational disruption.[25]

This information is important to strengthen a recovery plan's resilience to shocks and ensure that the recovery tools are actionable.

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22 Recovery Report, Section 2.3
23 Recovery Report, Section 2.3.
24 Recovery Report, Paragraph 2.3.9.
25 This is also related to the FMI's backup and contingency planning, which are distinct from recovery plans.

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 application of recovery tools and other recovery actions. To the extent an FMI intends to use a tool or take a recovery action that might have significant impact on its participants (e.g. tools requiring further justification), the FMI should consult Canadian authorities before using such tools or taking such actions to demonstrate how it has taken into account potential financial stability implications and other relevant public interest considerations. Authorities include those 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.

Relevant Canadian authorities should be informed (or consulted as appropriate) early on and interaction with authorities 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[26]

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 application. 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 applying recovery tools on financial stability and other relevant public interest considerations.[27] 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.[28] 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[29]

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26 Recovery Report, Paragraph 2.3.8.

27 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.

28 Recovery Report, Paragraph 2.3.3.

29 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.

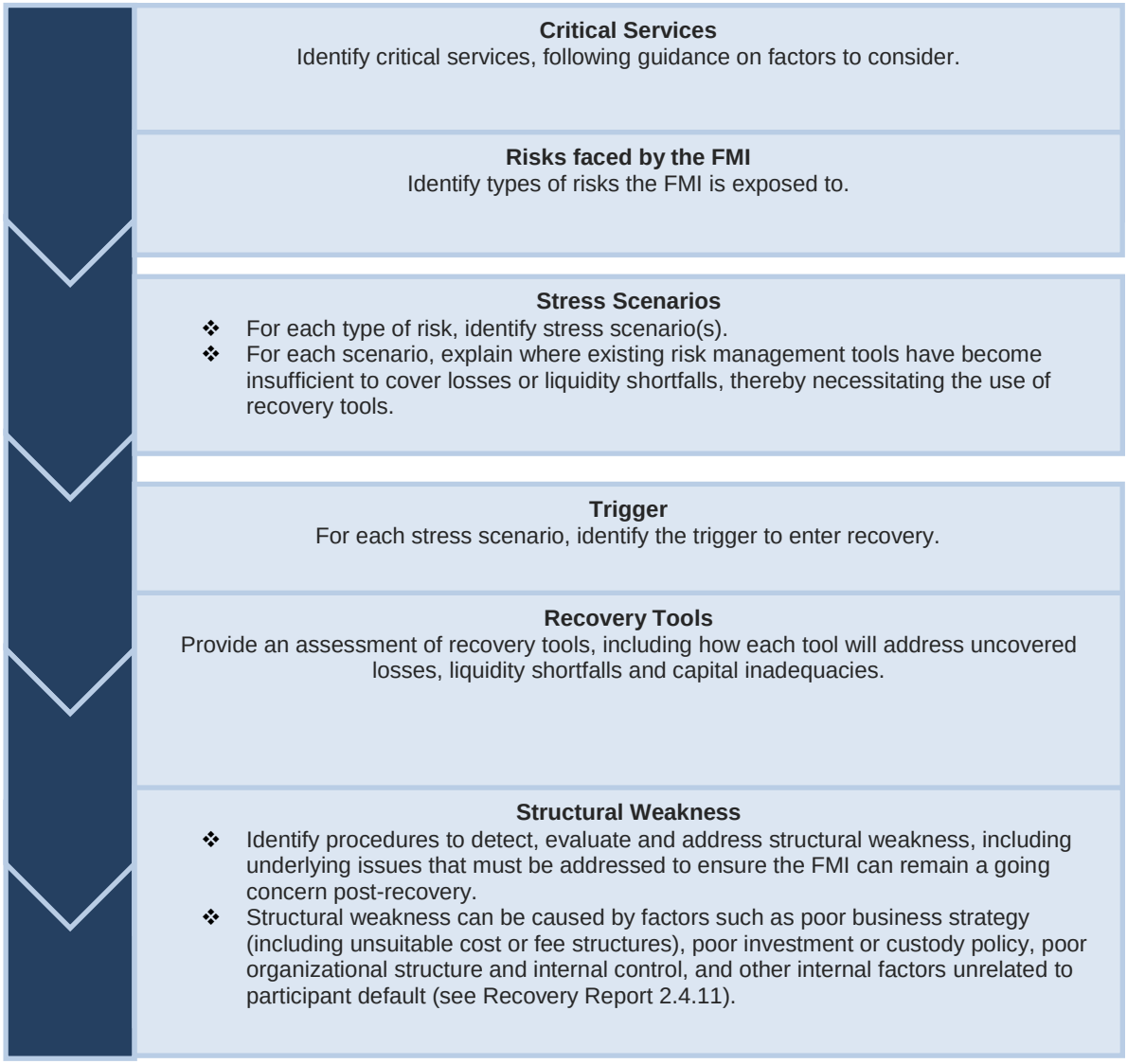
Disclosure of recovery and orderly wind-down plans

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 applying 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 apply 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.

Appendix: Guidelines on the Practical Aspects of FMI Recovery Plans

The following example provides suggestions on how an FMI recovery plan could be organized.



25. These changes become effective on June 19, 2020.

ANNEX E
BLACKLINED AMENDMENTS TO NATIONAL INSTRUMENT 24-102 *CLEARING AGENCY REQUIREMENTS*

NATIONAL INSTRUMENT 24-102 *CLEARING AGENCY REQUIREMENTS*

~~**Part 1**~~

PART 1
DEFINITIONS, INTERPRETATION AND APPLICATION

Definitions

~~1.1~~ **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~~**1.2 (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)~~ **(2)** In this Instrument, a person or company is considered to be controlled by a person or company if any of the following apply:

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

~~(i)~~ (i) voting securities of the first-mentioned person or company carrying more than ~~fifty percent~~50% of the votes for the election of directors are held, otherwise than by way of a security interest only, by or for the benefit of the other person or company, and

~~(ii)~~ (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)~~ (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~~50% of the interests in the partnership; ~~or~~

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

~~(3)~~ **(3)** In this Instrument, a person or company is considered to be a subsidiary entity of another person or company if either of the following applies:

~~(a)~~ (a) it is a controlled entity of any of the following:

~~(i)~~ (i) that other~~,~~;

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

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

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

Interpretation – ~~Extended Meaning of Affiliated Entity~~meaning of affiliate for the purposes of PFMI Principles

~~1.3~~ **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~~subsequently referred to in this section as a "party", ~~where,~~ if any of the following apply:

~~(a)~~ (a) a party holds, otherwise than by way of a security interest 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,~~ of the other party;

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

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

Interpretation – Clearing Agency

~~1.4~~ **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~~1.5 (1)** Part 3 applies to a recognized clearing agency that operates as any of the following:

~~(a)~~ (a) a central counterparty;

~~(b)~~ (b) a central securities depository;

~~(c)~~ (c) a securities settlement system.

~~(2)~~ **(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)~~ **(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)~~ **(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~~
PART 2
CLEARING AGENCY RECOGNITION OR EXEMPTION FROM RECOGNITION

Application and initial filing of information

~~2~~ **~~.1~~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)~~ (a) if applicable, the applicant's most recently completed PFMI Disclosure Framework Document;

~~(b)~~ (b) sufficient information to demonstrate that the applicant is

(i) in compliance with~~(i)~~ applicable provincial and territorial securities legislation, or

~~(ii)~~ (ii) subject to and in compliance with the regulatory ~~regime~~requirements of ~~a~~the foreign jurisdiction in which the applicant's head office or principal place of business is located~~;~~ that are comparable to the applicable requirements under this Instrument;

~~(c)~~ (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)~~ **(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)~~ (a) certify that it will assist the securities regulatory authority in accessing the applicant's books ~~and~~, records and other documents and in undertaking an onsite inspection and examination at the applicant's premises, and

~~(b)~~ (b) certify that it will provide the securities regulatory authority, if requested by ~~such~~the authority, with an opinion of legal counsel that the applicant has, as a matter of law, the power and authority to

~~(i)~~ (i) provide the securities regulatory authority with prompt access to its books ~~and~~, records and other documents, and

~~(ii)~~ (ii) submit to onsite inspection and examination by the securities regulatory authority.

~~(3)~~ **(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 *Clearing Agency Submission to Jurisdiction and Appointment of Agent for Service of Process*.

~~(4)~~ **(4)** An applicant must inform the securities regulatory authority in writing of any ~~material~~ change to the information provided in its application that is material, 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~~**2.2** **(1)** In this section, for greater certainty, a "significant change" includes, in relation to a clearing agency, any of the following:

~~(a)~~ (a) any change to the clearing agency's constating documents or by-laws;

~~(b)~~ (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)~~ (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)~~ (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)~~ (e) any material change to the design, operation or functionality of any of the clearing agency's operations and services;

~~(f)~~ (f) the establishment or removal of a link or any material change to an existing link;

~~(g)~~ (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)~~ (h) any other matter identified as a significant change in the ~~recognition~~ terms and conditions of a decision to recognize the clearing agency under securities law.

~~(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.

~~(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~~**(3)** The written notice referred to in subsection (2) must include an assessment of how the significant change is consistent with the PFMI Principles applicable to the 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)~~ **(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)~~ **(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~~**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)~~ **(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~~**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)~~ **(2)** The financial statements referred to in subsection (1) must

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

~~(c)~~ (c) disclose the presentation currency, and

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

~~(a)~~ (a) expresses an unmodified or unqualified opinion,

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

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

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

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

~~(f)~~ (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~~**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)~~ **(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 of the recognized clearing agency's or exempt clearing agency's financial year.

~~**Part 3**~~

PART 3

PFMI PRINCIPLES APPLICABLE TO RECOGNIZED CLEARING AGENCIES

PFMI Principles

~~3.1~~ **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,~~13 and 15 to ~~19, 20~~23, other than key consideration ~~9, 21 to 23~~9 of PFMI Principle 20 and the following:

~~(a)~~ (a) if the clearing agency operates as a central counterparty, PFMI Principles 4 to 9, 12 and 14;

~~(b)~~ (b) if the clearing agency operates as a securities settlement system, PFMI Principles 4, 5, 7 to 9 and12; ~~and~~

~~(c)~~ (c) if the clearing agency operates as a central securities depository, PFMI Principle 11.

~~**Part 4**~~

PART 4

OTHER REQUIREMENTS OF RECOGNIZED CLEARING AGENCIES

~~Division 1~~ ***Division 1*** ***– Governance:***

Board of directors

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

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

~~(a)~~ (a) independent of the clearing agency, and

~~(b) not~~(b) neither employees ~~or executive~~nor officers of a participant ~~or~~nor their immediate family members.

~~(3)~~ **(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)~~ **(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~~ **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~~**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)~~ **(2)** The chief risk officer must

~~(a)~~ (a) have ~~full~~ responsibility and authority to ~~maintain,~~ implement, maintain and enforce the risk management framework established by the clearing agency,

~~(b)~~ (b) make recommendations to the clearing agency's board of directors regarding the clearing agency's risk management framework,

~~(c)~~ (c) monitor the effectiveness of the clearing agency's risk management framework, and

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

~~(a)~~ (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)~~ (b) monitor compliance with the policies and procedures described in paragraph (a),

~~(c)~~ (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)~~ (i) the non-compliance creates a risk of harm to a participant~~,~~;

~~(ii)~~ (ii) the non-compliance creates a risk of harm to the broader financial system~~,~~;

~~(iii)~~ (iii) the non-compliance is part of a pattern of non-compliance~~, or~~;

~~(iv)~~ (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)~~ (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)~~ (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)~~ (f) concurrently with submitting a report under paragraphs (c), (d) or (e), file a copy of ~~such~~the report with the securities regulatory authority.

Board or advisory committees

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

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

~~(a)~~ (a) independent of the clearing agency, and

~~(b) not~~(b) neither employees ~~or executive~~nor officers of a participant ~~or~~nor their immediate family members.

(5) . For the purpose of this section, an individual is independent of a clearing agency if the individual has no relationship with the agency that could, in the reasonable opinion of the clearing agency's board of directors, be expected to interfere with the exercise of the individual's independent judgment.

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

Use of own capital

~~4.5~~ **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~~ ***Division 3*** ***– Operational risk:***

Systems requirements

~~4.6~~ **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)~~ (a) develop and maintain

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

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

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

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

(c) promptly notify the regulator or, in Québec, the securities regulatory authority of any systems failure, malfunction, delay or security incident that is material, and provide timely updates to the regulator or, in Québec, the securities regulatory authority -regarding the following:

(i) any change in the status of the failure, malfunction, delay or security incident;

(ii) the resumption of service, if applicable;

(iii) the results of any internal review, by the clearing agency, of the failure, malfunction, delay or security incident; and

(d) keep a record of any systems failure, malfunction, delay or security incident and whether or not it is material.

Auxiliary systems

4.6.1 (1) In this section "**auxiliary system**" means a system, other than a system referred to in section 4.6, operated by or on behalf of a recognized clearing agency that, if breached, poses a security threat to another system operated by or on behalf of the recognized clearing agency that supports the recognized clearing agency's clearing, settlement or depository functions.

(2) For each auxiliary system, a recognized clearing agency must

(a) develop and maintain adequate information security controls that address the security threats posed by the auxiliary system to the system that supports the clearing, settlement or depository functions,

(b) ~~(c)~~ promptly notify the regulator or, in Québec, the securities regulatory authority of any ~~material systems failure, malfunction, delay or~~ security ~~breach,~~incident that is material and provide timely updates to the regulator or, in Québec, the securities regulatory authority on

(i) any change in the status of the ~~failure, malfunction, delay or security breach,~~ incident,

(ii) the resumption of service, if applicable, and

(iii) the results of any internal review, by the clearing agency~~'s internal review,~~ of the ~~failure, malfunction, delay or~~ security ~~breach.~~incident, and

(c) keep a record of any security incident and whether or not it is material.

Systems reviews

~~4.7~~**4.7 (1)** A recognized clearing agency must

(a) on a reasonably frequent basis and, in any event, at least annually, engage a qualified ~~party~~external auditor 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 assesses the clearing agency ~~is in~~'s compliance with ~~paragraph~~paragraphs 4.6(a) and 4.6.1(2)(a) and section ~~4.9.~~4.9, and

(b) on a reasonably frequent basis and, in any event, at least annually, engage a qualified party to perform assessments and testing to identify any security vulnerability and measure the effectiveness of information security controls that assess the clearing agency's compliance with paragraphs 4.6(a) and 4.6.1(2)(a).

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

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

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

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

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

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

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

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

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

Testing of business continuity plans

~~4.9~~ **4.9** A recognized clearing agency must

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

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

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

~~(ii)~~ (ii) includes service level provisions, and

~~(iii)~~ (iii) provides for adequate termination procedures;

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

~~(e)~~ (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)~~ (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)~~ (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~~a reasonable business continuity plan, including a disaster recovery plan;

~~(h)~~ (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)~~ (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~~ ***Division 4*** ***– Participation requirements:***

Access requirements and due process

~~4.11~~4.11 **(1)** A recognized clearing agency must not

~~(a)~~ (a) unreasonably prohibit, condition or limit access by a person or company to the services offered by the clearing agency,

~~(b)~~ (b) unreasonably discriminate among its participants or indirect participants,

~~(c)~~ (c) impose any burden on competition that is not reasonably necessary and appropriate,

~~(d)~~ (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)~~ (e) impose fees or other material costs on its participants that are unfairly or inequitably allocated among the participants.

~~(2)~~ **(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)~~ (a) the participant or applicant is given an opportunity to be heard or make representations, and

~~(b)~~ (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)~~ **(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**~~

PART 5
BOOKS AND RECORDS AND LEGAL ENTITY IDENTIFIER

Books and records

~~5.1~~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)~~ **(2)** The clearing agency must retain the books and records maintained under this section

~~(a)~~ (a) for a period of seven years from the date the record was made or received, whichever is later,

~~(b)~~ (b) in a safe location and a durable form, and

~~(c)~~ (c) in a manner that permits them to be provided promptly to the securities regulatory authority.

Legal Entity Identifier

~~5.2~~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)~~ **(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~~the 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~~

(2.1) During the period that a clearing agency is a recognized clearing agency or is exempt from the requirement to be recognized as a clearing agency, the clearing agency must maintain and renew the legal entity identifier referred to in subsection (2).

(3) LAPSED.

~~**Part 6**~~

PART 6
EXEMPTIONS

Exemption

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

~~(3)~~ **(3)** Except in Alberta and 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**~~

PART 7
EFFECTIVE DATE ~~AND TRANSITION~~

Effective date ~~and transition~~

~~7 .1 (1) This Instrument comes into force on February 17, 2016.~~**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.~~

(2) LAPSED.

(3) LAPSED.

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 _____ [name 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 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 _____ [name of Clearing Agency] and hereby consent to act as agent for service pursuant to the terms of the appointment executed by _____ [name of Clearing Agency] on _____ [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 to carry on 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 ceasing to carry on business as a clearing agency.

Exhibit D

A description of all links the clearing agency had immediately before ceasing to carry on 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 CHANGES TO COMPANION POLICY 24-102CP
TO NATIONAL INSTRUMENT 24-102 *CLEARING AGENCY REQUIREMENTS*

~~**Companion Policy 24-102CP**~~

COMPANION POLICY 24-102CP
TO
NATIONAL INSTRUMENT 24-102
CLEARING AGENCY REQUIREMENTS

TABLE OF CONTENTS

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COMPANION POLICY 24-102CP
TO
NATIONAL INSTRUMENT 24-102

Part 1 **GENERAL COMMENTS**

Part 1
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)~~ **(2)** Except for this ~~Part 1 of the CP,~~ section ~~3.2~~, sections 1.2 and ~~3.3 of Part 3~~1.3 of this CP, and ~~the *text boxes* in Annex I~~Annexes I and II 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)~~ **(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 PFMIs 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.[1] 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)~~ **(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)[2] and the International Organization of Securities Commissions (IOSCO).[3] The PFMI Principles harmonize and strengthen previous international standards for financial market infrastructures (FMIs).[4]

~~(3) Annex~~**(3)** Annexes I and II to this CP ~~includes~~include 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)~~ **(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. 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.[5] 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)~~ **(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.

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

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

3 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) and the IOSCO website (www.iosco.org).

4 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). The CPMI-IOSCO reports are also available on IOSCO website (www.iosco.org).

5 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*.

~~(4)~~ **(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.

1.5 Section 1.5 provides clarity on the application of the different parts of the Instrument to a clearing agency that has been recognized by a securities regulatory authority, or exempted from recognition, as is further described in section 2.0 of this CP. Unless otherwise specified, Parts 1, 2, and 5 to 7 generally apply to both a recognized clearing agency and one that is exempted from recognition.

~~Part 2~~

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)~~ **(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~~would generally need to be recognized by a securities regulatory authority.[6] 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;[7] risk exposures (particularly credit and liquidity) of the clearing agency to its participants; complexity of the clearing agency;[8] and centrality of the clearing agency with respect to its role in the market, including its substitutability, relationships, interdependencies and interactions.[9] 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.[10]

~~(3)~~ **(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)~~ **(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~~.~~ that are material.

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6 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.

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

8 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.

9 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.

10 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.

Application and initial filing of information

~~2.1~~ **2.1** The application process for both recognition and exemption from recognition as a clearing agency is similar in both substance and process, though its oversight program may differ. 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 comprehensive and appropriate documentation. This will include the items listed in subsection 2.1(1). Together, the application materials for either recognition or exemption 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~~ **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)~~ **(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, and an assessment of how the significant change is consistent with the PFMI Principles applicable to the clearing agency (see subsection 2.2(3)). 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~~ **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.[11]

Financial statements

2.4 Financial statements filed under sections 2.4 and 2.5 must disclose the accounting principles used to prepare them. For clarity, financial statements prepared either in accordance with Canadian GAAP applicable to publicly accountable enterprises or in accordance with IFRS should include:

(a) in the case of annual financial statements, an unreserved statement of compliance with IFRS;
(b) in the case of interim financial statements, an unreserved statement of compliance with International Accounting Standard 34 *Interim Financial Reporting*.

Filing of interim financial statements

2.5 The term "interim period" in subsection 2.5(2) means a period commencing on the first day of the recognized or exempt clearing agency's financial year and ending nine, six or three months before the end of the same financial year, or otherwise in accordance

[11] See, for example, section 21.4 of the *Securities Act* (Ontario).

with the regulatory requirements of the jurisdiction in which the clearing agency's head office or principal place of business is located.

~~Part 3~~
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.[12]

~~(2)~~ **(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~~ **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 and other reports or explanatory material published by CPMI and IOSCO that provide supplementary guidance to FMIs on the application of the PFMI Principles, as appropriate, unless otherwise indicated in section 3.1 or this Part 3 of the CP.[13] 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[14] 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.[15] The features of the alternate approach are described in the PFMI Report.[16]

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

13 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*.

14 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.

15 See paragraph 3.14.6 of the PFMI Report, at p. 83.

16 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 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

- *Customers of IIROC dealer members*:

Currently, most participants of domestic cash market CCPs that clear for customers are investment dealers.[17] They are required to be members of the Investment Industry Regulatory Organization of Canada (IIROC)[18] and to contribute to the Canadian Investor Protection Fund (CIPF).[19] 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,[20] provides protection to eligible customers for losses up to $1 million per account.[21]

- *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.

~~Part 4~~
PART 4
OTHER REQUIREMENTS OF RECOGNIZED CLEARING AGENCIES

Introduction

~~4.6~~ **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 recognized clearing agency whether or not it operates as a CCP, SSS or CSD.

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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.

17 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*.

18 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.

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

20 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.

21 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.

~~Division 1 –~~***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~~, absent exceptional circumstances, be expected to interfere with the exercise of the individual~~'~~'s independent judgment:

~~(a)~~ (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)~~ (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)~~ (c) an individual who beneficially owns, directly or indirectly, voting securities carrying more than ~~ten per cent~~10% 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)~~ (d) an individual whose immediate family member beneficially owns, directly or indirectly, voting securities carrying more than ~~ten per cent~~10% 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)~~ (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~~10% 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)~~ (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~~ **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.

Consistent with PFMI Principle 2, Key Consideration 6, subsection 4.3(1) is not intended to prevent the CRO and the CCO from reporting to both management and the board, provided that there are adequate safeguards in place to ensure that the CRO and the CCO have sufficient independence from the other members of management in performing their functions as CRO and CCO, particularly their obligations under subsections 4.3(2) and 4.3(3).

~~**(3)**~~ **(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 (or certain aspects of the role) 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~~ **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)~~ (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)~~ (b) ensuring adequate processes and controls are in place over the models used to quantify, aggregate, and manage the clearing agency's risks;

~~(c)~~ (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)~~ (d) implementing policies and processes to identify, address, and manage potential conflicts of interest of board members; and

~~(e)~~ (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 –~~ ***Division 2 –*** ***Default management:***

Use of own capital

~~4.5~~ **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 –~~ ***Division 3 –*** ***Operational risk:***

~~4.6~~ **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 cyber resilience, 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~~may include guidance, principles or frameworks published by the Chartered Professional Accountants ~~(CICA) and 'COBIT' from the IT Governance Institute~~- Canada (CPA Canada), American Institute of Certified Public Accountants (AICPA), Information Systems Audit and Control Association (ISACA), International Organization for Standardization (ISO), or the National Institute of Standards and Technology (U.S. Department of Commerce) (NIST). We are of the view that internal controls include controls which support the processing integrity of the models used to quantify, aggregate, and manage the clearing agency's risks.

~~(b)~~ (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~~paragraph 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 each 12-month period. 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~~(c). A security incident is considered to be any event that actually or potentially jeopardizes the confidentiality, integrity or availability of an information system or the information the system processes, stores or transmits, or that constitutes a violation or imminent threat of violation of security policies, security procedures or acceptable use policies. A failure, malfunction, delay or ~~other~~security 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. Such events would not generally include those that have or would have little or no impact on the clearing agency's operations or on participants, although non-material events may become material if they recur or have a cumulative effect. Any event that requires non-routine measures or resources by the clearing agency would also 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 incident it did not consider material. It is ~~also~~ expected that, as part of ~~this~~the notification required under paragraph 4.6(c), the clearing agency will provide updates on the status of the ~~failure~~event 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~~systems failures, malfunctions, delays and security incidents. In this regard, the clearing agency should undertake a "post-~~incident~~mortem" 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.~~[22]

(d) Pursuant to s. 5.1, a recognized clearing agency may be asked to provide the regulator or, in Quebec, the securities regulatory authority, with additional information, such as but not limited to reports, logs or other documents related to a systems failure, malfunction, delay, security incident or any other system or process related data.

Auxiliary systems

4.6.1(2) A recognized clearing agency should also refer to the considerations for paragraph 4.6(c) above with regards to security incidents that arise in connection with auxiliary systems. Pursuant to section 5.1, a recognized clearing agency may be asked to provide the regulator or, in Quebec, the securities regulatory authority, with additional information, such as but not limited to reports, logs or other documents related to a security incident.

Systems reviews

4.7 (1) ~~A qualified party is~~(a) An independent systems review must be conducted and reported on at least once in each 12-month period by a qualified external auditor in accordance with established audit standards and best industry practices. We consider that best industry practices include the 'Trust Services Criteria' developed by the American Institute of CPAs and CPA Canada. For the purposes of paragraph 4.7(1)(a), we consider a qualified external auditor to be 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. Before engaging a qualified external auditor to conduct the independent systems review, a clearing agency is expected to discuss its choice of external auditor and the scope of the systems review mandate with the regulator or, in Québec, the securities regulatory authority. We further expect that the report prepared by the external auditor include, to the extent applicable, an audit opinion that (i) the description included in the report fairly presents the systems and controls that were designed and implemented throughout the reporting period, (ii) the controls stated in the description were suitably designed, and (iii) the controls operated effectively throughout the reporting period.

(1)(b) The clearing agency must also establish and perform effective assessment and testing methodologies and practices and would be expected to implement appropriate improvements where necessary. The assessments and testing required in this section, such as vulnerability assessments and penetration tests, are to be carried out by a qualified party on a reasonably frequent basis and, in any event, at least once in each 12-month period. For the purposes of paragraph 4.7(1)(b), we consider a qualified party to be 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~~We consider that qualified parties 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~~The securities regulatory authority may, in accordance with securities legislation, require the clearing agency to provide a copy of any such assessment.

Clearing agency technology requirements and testing facilities

[22] Adapted from the NIST definition of "incident". See https://csrc.nist.gov/Glossary/?term=4730#AlphaIndexDiv.

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

~~(5)~~ **(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~~ **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~~at least once in each 12-month period. 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~~ **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 –~~

Division 4 – Participation requirements:

Access requirements and due process

~~4.11~~ **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~~

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[~~22~~23] that ~~will~~is intended to 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~~was 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.~~

~~Part 6~~

PART 6
EXEMPTIONS

Exemptions

~~6.1~~ **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**~~

ANNEX I
~~**to Companion Policy 24-102 Clearing Agency Requirements**~~

~~**Joint Supplementary Guidance**~~
~~**Developed by the Bank of Canada and Canadian Securities Administrators**~~

TO COMPANION POLICY 24-102CP

~~***PFMI Principle 2: Governance***~~

~~**Box 2.1:**~~
~~**Joint Supplementary Guidance – Governance**~~

JOINT SUPPLEMENTARY GUIDANCE
DEVELOPED BY THE BANK OF CANADA AND CANADIAN SECURITIES ADMINISTRATORS
ON THE PFMI PRINCIPLES

~~***Context***~~

Joint Supplementary Guidance has been developed by the BOC and the securities regulatory authorities to provide additional clarity on certain aspects of selected PFMI Principles within the Canadian context. It is found on the BOC website and in annexes to the Companion Policy (to the CSA National Instrument 24-102 *Clearing Agency Requirements*).

The ~~PFMIs 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.~~Joint Supplementary Guidance applies in respect of recognized domestic clearing agencies that are designated as

[~~22~~] [23] See http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm for more information.

systemically important by the BOC and jointly overseen by the BOC and one or more securities regulatory authorities (referred to in this Joint Supplementary Guidance as an "FMI").

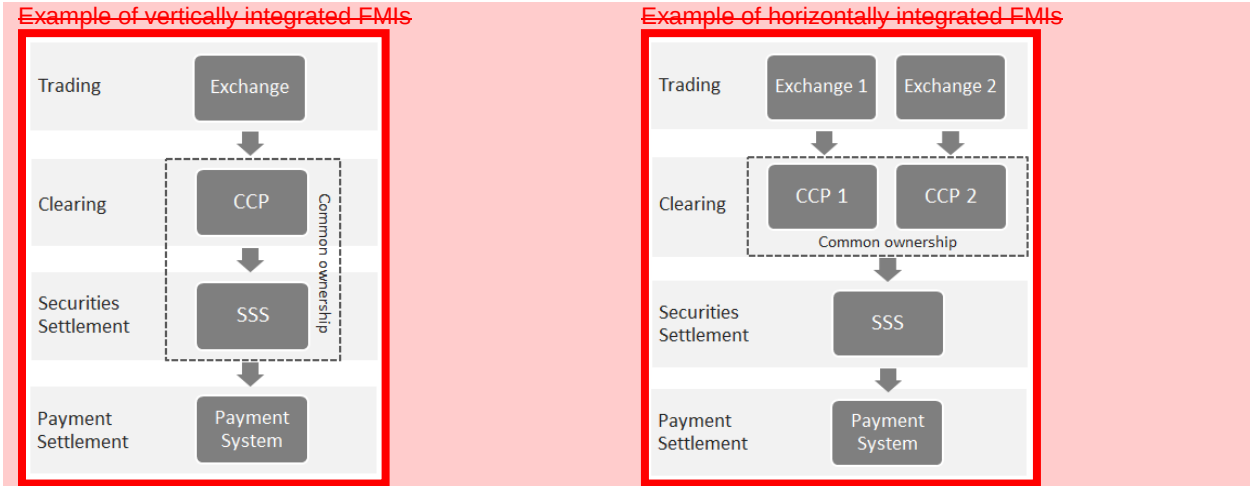
~~This note provides supplementary regulatory guidance for Canadian FMIs that either belong to an integrated entity or are considering consolidating with another entity to form one. It also provides additional context and clarity for Canadian FMIs on certain aspects of the PFMIs expectations pertaining to how their governance arrangements are expected to support relevant public interest considerations.~~

~~***(i) Vertical and horizontal integration in the context of FMIs***~~

Beyond observation of the PFMI Principles, an FMI is expected to take into account the "Explanatory Notes" for each applicable PFMI Principle, other reports and explanatory materials published by CPMI and IOSCO that supplement the PFMI Report and that provide guidance to FMIs on the application of the PFMI Principles, as well as this Joint Supplementary Guidance or any future guidance published jointly by the BOC and the securities regulatory authorities.

The ~~PFMIs 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).[1] Examples are shown in Figure 1.~~Joint Supplementary Guidance below appears under the relevant headings for each applicable PFMI Principle (referred to by the BOC as its "Risk-Management Standards for Designated FMIs").

~~**(a) Figure 1: Examples of FMI integration in the value chain**~~



~~Consolidation, or integration, of FMI services may bring about benefits for merging FMIs; however it may also create new governance challenges. The PFMIs contain some general guidance regarding how FMIs should manage governance issues that arise in integrated entities.~~

~~**(b) Guidance within the PFMIs**~~

~~The following text has been extracted directly from the PFMIs. The pertinent information is in bold.~~

~~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.[2] 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.***~~

~~[1] Committee on Payments and Market Infrastructure (CPMI) and International Organization of Securities Commissions (IOSCO) 2010. "Market structure developments in the clearing industry: implications for financial stability." CPMI-IOSCO Paper No 92. Available at: http://www.bis.org/cpmi/publ/d92.htm~~

~~[2] 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.~~

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.*

(c) 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
- 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-IOSCO, "Market structure developments in the clearing industry: implications for financial stability" (2010).

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.

Measures to protect critical FMI functions

FMIs may be part of a larger consolidated entity. These FMIs must either:

- legally separate FMI-related functions[3] 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.

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

[3] 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).

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 PFMI Principle on governance.

Comprehensive management of risks

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

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.[4]

(ii) Public interest considerations in the context of the PFMIs

The PFMIs 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.

(a) Guidance within the PFMIs

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

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:

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[4] Liquid assets held for general business losses must be funded by equity (such as common stock, disclosed reserves, or retained earnings) rather than debt

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 PFMIs. 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.

(b) Supplementary Guidance for designated Canadian FMIs

By definition the PFMIs 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?

PFMI Principle 3: Framework for the comprehensive management of risks

Box 3.1:

a. Joint Supplementary Guidance for PFMI Principle 3 has been developed by the BOC and CSA pertaining to FMI recovery planning. This guidance can be found separately on the BOC website and in Annex II to the Companion Policy.

Recovery Plans

PFMI Principle 5: Collateral

a. An FMI should not rely solely on external opinions to determine collateral eligibility.

b. In general, most of the FMI's collateral pools should be composed of cash and debt securities issued or guaranteed by the Government of Canada, a provincial government or the U.S. Treasury.

c. Additional asset classes may be acceptable as collateral if they are subject to conservative haircuts and concentration limits. An FMI should limit such assets to a maximum of 40% of the total collateral posted from each participant. It should also limit securities issued by a single issuer to a maximum of 5% of total collateral from each participant. Such assets are:

- Securities issued by a municipal government;
- Bankers' acceptances;
- Commercial paper;
- Corporate bonds;
- 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;
- Equity securities traded on marketplaces regulated by a member of the CSA; 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.

d. Since it is highly likely that the value of debt and equity securities issued by companies operating in the financial sector would be adversely affected by the default of an FMI participant – introducing wrong-way risk for an FMI that has accepted such securities as collateral – an FMI should:

- Limit the collateral from financial sector issuers to a maximum of 10% of total collateral pledged from each participant; and
- Not allow a participant to pledge as collateral securities issued by itself or an affiliate.

PFMI Principle 7: Liquidity risk

a. Liquidity facilities should include at least three independent liquidity providers to ensure the FMI has access to sufficient liquid resources even in the event one of its liquidity providers defaults.

b. Uncommitted liquidity facilities are considered qualifying liquid resources for liquidity exposure in Canadian dollars if they meet all of the following additional criteria:

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

PFMI Principle 15: General business risk

a. Liquid net assets funded by equity must be held at the level of the FMI legal entity to ensure they are unencumbered and can be accessed quickly.

PFMI Principle 16: Custody and investment risks

a. It is paramount that an FMI have prompt access to assets held for risk-management purposes with minimal price impact. For the purposes of PFMI Principle 16, financial instruments can be considered to have minimal credit, market and liquidity risk if they are debt instruments that are:

- Securities issued or guaranteed by the Government of Canada;
- Marketable securities issued by the U.S. Treasury;
- Securities issued or guaranteed by a provincial government;
- Securities issued by a municipal government;

- Bankers' acceptances;
- Commercial paper;
- Corporate bonds; and
- Asset-backed securities that are:
  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.

b. Investments should also, at a minimum, observe the following:

- To reduce concentration risk, no more than 20% of total investments should be invested in any combination of municipal and private sector securities. Investment in a single private sector or municipal issuer should be no more than 5% 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% of total investments. An FMI should not invest assets in the securities of its own affiliates.
- For investments that are subject to counterparty credit risk, an FMI should set clear criteria for choosing investment counterparties and setting exposure limits.

ANNEX II
TO COMPANION POLICY 24-102CP

JOINT SUPPLEMENTARY GUIDANCE
DEVELOPED BY THE BANK OF CANADA AND CANADIAN SECURITIES ADMINISTRATORS
ON 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)~~CPMI and IOSCO released a set of international risk-management standards for FMIs, known as the ~~Principles for Financial Market Infrastructures (PFMIs)~~PFMIs.[1] 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 Systemic FMIs*[2] and by the CSA as part of ~~National~~the Instrument ~~24-102. (NI 24-102)~~.[3] In the context of recovery planning~~.~~.

> *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~~-~~ and IOSCO released its report, "Recovery of Financial Market Infrastructures" (the Recovery Report), providing additional guidance specific to the recovery of FMIs.[4] 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.[5,6]

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1 Available at ~~http://www.bis.org/cpmi/publ/d101a.pdf.~~http://www.bis.org/cpmi/publ/d101a.pdf.

2 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.

3 The Bank of Canada's *Risk-Management Standards for Systemic FMIs* is available at http://www.bankofcanada.ca/core-functions/financial-system/bank-canada-risk-management-standards-systemic-fmis/.

4 Available at ~~http://www.bis.org/cpmi/publ/d121.pdf.~~http://www.bis.org/cpmi/publ/d121.pdf.

5 Recovery Report, Paragraph ~~1.1.1~~1.1.1.

6 For a precise definition of orderly wind-down, see the Recovery Report, Paragraph 2.2.2.

Recovery planning is not intended as a substitute for robust day-to-day risk management or for business continuity planning. Rather, it serves to extend and strengthen an FMI's risk-management framework, enhancing the resilience of the FMI against financial risks 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 frameworks and activities. As part of this overview, and to determine the relevant point(s) where standard pre-recovery risk-management frameworks are exhausted, FMIs should identify all the material risks they are exposed to and explain how they use their existing pre-recovery risk-management tools to manage these risks to a high degree of confidence.

Critical services[7]

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

- ~~□ □he~~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~~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~~.~~

~~□ 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.~~

Stress scenarios[8]

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 pre-recovery risk controls, thereby placing 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

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7 Recovery Report, Paragraphs 2.4.2~~–2.4.4~~–2.4.4.

8 Recovery Report, Paragraph ~~2.4.5~~2.4.5.

their recovery plans how they will make decisions.[9] 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 described in the recovery plan. 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 should be prudent in its actions and err on the side of caution.

Selection and Application of Recovery Tools[10]

A comprehensive plan for recovery

The success of a recovery plan relies on a comprehensive set of tools that can be effectively applied 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 Recovery Report, to determine the characteristics of effective recovery tools.[11] 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 in a manner that results in participant exposures that are determinable and fixed provides better certainty of the tools' impacts on FMI participants and their 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 may include 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 be cautious in using tools that can create uncapped, unpredictable or ill-defined participant exposures, and which could create uncertainty and disincentives to participate in an FMI. Any such use would need to be carefully justified. 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 determining which recovery tools should be included in a recovery plan, and selecting and applying such tools during the recovery phase, 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), nor is this an exhaustive list of tools that may be available for

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9 Recovery Report, Paragraph ~~2.4.8~~2.4.8.

10 Recovery Report, Paragraph 2.3.6 ~~–~~ 2.3.7 and 2.5.6 and Paragraphs 3.4.1 ~~– 3.4.7~~ 3.4.7.

11 Recovery Report, Paragraph ~~3.3.1~~3.3.1.

recovery. Each FMI should use discretion when determining the most appropriate tools for inclusion in its recovery plan, consistent with the considerations discussed above.

~~-~~Cash calls

Cash calls are recommended for recovery plans to the extent that the exposures they generate are fixed and determinable; for example, capped and limited to a maximum number of rounds over a specified period, established in advance. In this context, participant exposures 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 through the placement of 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 because participant exposure under this tool can be measured with reasonable confidence, as it is tied to the level of risk held in the variation margin (VM) fund and the potential for gains. Where recovery plans allow for multiple rounds of VMGH, Canadian authorities will consider the impact of each successive round of haircutting with increasing focus on systemic stability.

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. FMIs should seek to minimize these negative effects to the greatest extent possible.

~~-~~ Voluntary contract allocation

To recover from an unmatched book caused by a participant default, a CCP can use its powers to allocate unmatched contracts.[12] In the context of recovery, contract allocation is encouraged on a voluntary basis ~~–~~for example, by auction. Voluntary contract allocation 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 voluntary contract tear-up as a potentially effective tool for FMI recovery. To this end, FMIs may want to consider using incentives to encourage voluntary tear-up during recovery.[13] While contract tear-up undertaken on a voluntary basis is a recommended tool, the forced termination of an incomplete trade may represent a disruption of a critical FMI service, and can be intrusive to apply (see the section "Tools requiring further justification" for a discussion of forced contract tear-up).

To the extent that voluntary contract tear-up may disrupt 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

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12 A CCP "matched book" occurs when a position taken on by the CCP with one clearing member is offset by an opposite position taken on with a second clearing member. 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.

13 Recovery Report, Paragraph ~~4.5.3~~4.5.3.

FMIs. Canadian authorities 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.[14] Where system-specific recovery needs necessitate, FMIs can also design recovery tools not explicitly listed in this guidance. The applicability of such tools will be examined by the Canadian authorities when they review the proposed recovery plan.

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 requiring further justification

Due to their uncertain and potentially negative effects on the broader financial system, tools that are more intrusive or result in participant exposures that are difficult to measure, manage or control, must be carefully considered and justified with strong rationale by the FMI when they are included in a recovery plan. Canadian authorities will provide their views on the suitability of any such tools as part of their review of recovery plans.

For example, uncapped and unlimited cash calls and unlimited rounds of VMGH can create ambiguous participant exposures, the negative effects of which must be prudently considered when including them in a recovery plan. In addition, when applied during the recovery process, Canadian authorities will monitor the application of each successive round of cash calls and VMGH with increased focus on systemic stability.

Tools such as involuntary (forced) contract allocation and involuntary (forced) contract tear-up create exposures that are difficult to manage, measure and control. To the extent that these tools are even more intrusive, they have the ability to pose greater risk to systemic stability. Canadian authorities acknowledge that such tools have potential utility when other recovery options are ineffective, and could possibly be used by a resolution authority, but expect FMIs to carefully assess the potential impact of such tools on participants and the stability of the broader financial system.

Canadian authorities do not encourage the use of non-defaulting participants' initial margin in FMI recovery plans considering the potential for significant negative impacts.[15] Similarly, a recovery plan should not assume any extraordinary form of public or central bank support.[16]

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.[17] 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 identify procedures detailing how to promptly detect, evaluate and address the sources of underlying structural weakness on a continuous basis (e.g., unprofitable business lines, investment losses).

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)[18] and 7 (liquidity risk)[19] of the PFMIs require that FMIs should specify rules and procedures to fully allocate both uncovered losses and liquidity shortfalls caused by stress events. To be consistent with this requirement, **Canadian FMIs should consider various stress scenarios and have rules and procedures that allow them to fully allocate any losses or liquidity shortfalls arising from these stress scenarios, in excess of the capacity of existing pre-recovery risk controls.** Tools used to address full allocation should reflect the Recovery Report's characteristics of effective recovery tools, including the

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14 Recovery Report, Paragraph ~~3.3.1~~3.3.1.

15 Recovery Report, Paragraph ~~4.2.26~~4.2.26.

16 Recovery Report, Paragraph ~~2.3.1~~2.3.1.

17 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.

18 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.

19 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.

need to have them ~~measureable~~measurable, manageable and controllable to those who will bear the losses and liquidity shortfalls in recovery, and for their negative impacts to be minimized to the greatest extent possible.

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.[20] 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.[21]

FMIs should consider whether it is appropriate to involve indirect participants in the allocation of losses and shortfalls during recovery. To the extent that it is permitted, such arrangements should have a strong legal and regulatory basis; respect the FMI's frameworks for tiered participation, segregation and portability; 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[22]

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 application 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[23]

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 of Recovery Plan[24]

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20 ~~CPMI-IOSCO Principles for Financial Market Infrastructures~~ PFMI Report, Paragraph ~~3.1.10~~3.1.10.

21 The Bank Act, Section ~~414.1~~414(1) and IIROC Rule 100.14 prohibit banks and securities dealers, respectively, from providing unlimited guarantees to an FMI or a financial institution.

22 Recovery Report, Section ~~2.3.~~2.3

23 Recovery Report, Section 2.3.

24 Recovery Report, Paragraph ~~2.3.9~~2.3.9.

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 applying recovery tools effectively and strategies to address them; and
- the impact of a major operational disruption.[25]

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 application of recovery tools and other recovery actions. To the extent an FMI intends to use a tool or take a recovery action that might have significant impact on its participants (e.g. tools requiring further justification), the FMI should consult Canadian authorities before using such tools or taking such actions to demonstrate how it has taken into account potential financial stability implications and other relevant public interest considerations. Authorities include those 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.

Relevant Canadian authorities should be informed (or consulted as appropriate) early on and interaction with authorities 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[26]

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 application. 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 applying recovery tools on financial stability and other relevant public interest considerations.[27] 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.[28] 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.

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25 This is also related to the FMI's backup and contingency planning, which are distinct from recovery plans.

26 Recovery Report, Paragraph ~~2.3.8~~2.3.8.

27 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.

28 Recovery Report, Paragraph ~~2.3.3~~2.3.3.

Orderly Wind-Down Plan as Part of a Recovery Plan[29]

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 applying 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 apply 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.

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29 Recovery Report, Paragraph ~~2.2.2~~2.2.2.

~~Annex~~Appendix: Guidelines on the Practical Aspects of FMI Recovery Plans

The following example provides suggestions on how an FMI recovery plan could be organized.

~~Critical Services~~

~~Identify critical services, following guidance on factors to consider.~~

~~Risks faced by the FMI~~

~~Identify types of risks the FMI is exposed to.~~

~~Stress Scenarios~~

- ~~For each type of risk, identify stress scenario(s).~~
- ~~For each scenario, explain where existing risk management tools have become insufficient to cover losses or liquidity shortfalls, thereby necessitating the use of recovery tools.~~

~~Trigger~~

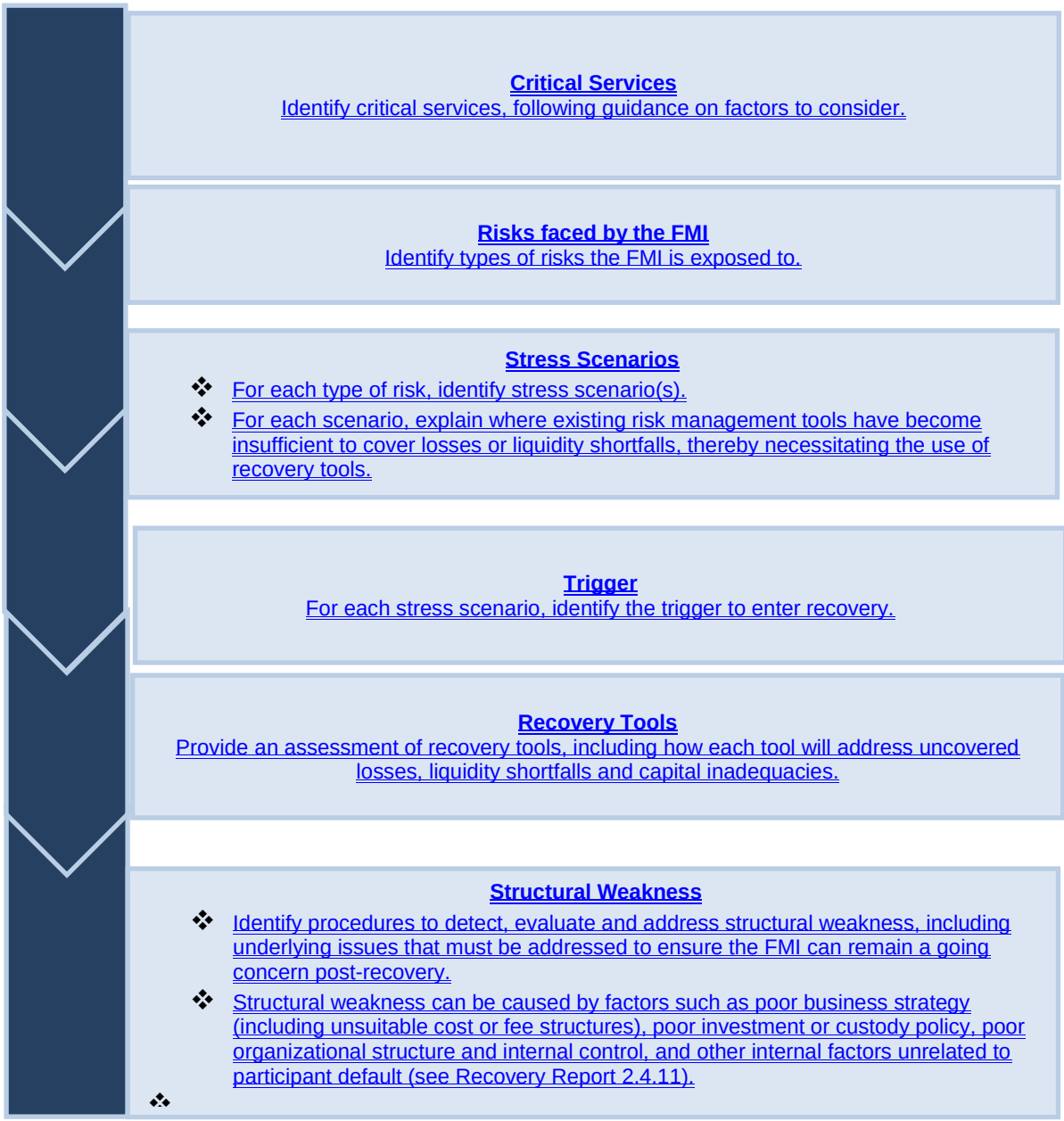
~~For each stress scenario, identify the trigger to enter recovery.~~

~~Recovery Tools~~

~~Provide an assessment of recovery tools, including how each tool will address uncovered losses, liquidity shortfalls and capital inadequacies.~~

~~Structural Weakness~~

- ~~Identify procedures to detect, evaluate and address structural weakness, including underlying issues that must be addressed to ensure the FMI can remain a going concern post-recovery.~~
- ~~Structural weakness can be caused by factors such as poor business strategy (including unsuitable cost or fee structures), poor investment or custody policy, poor organizational structure and internal control, and other internal factors unrelated to participant default (see Recovery Report 2.4.11).~~



~~***PFMI Principle 5: Collateral***~~

~~**Box 5.1:**~~
~~**Joint Supplementary Guidance – Collateral**~~

Context

The PFMIs 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.[1]

The following clarifies regulators' expectations on what is acceptable collateral.

Minimum requirements for acceptable collateral

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:

- **be freely transferable without legal, regulatory, contractual or any other constraints that would impair liquidation in a default;**
- **be marketable securities that have an active outright sale market even in stressed market conditions;**
- **have reliable price data published on a regular basis;**
- **be settled over a securities settlement system compliant with the Principles; and**
- **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.

Accepted asset categories

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

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[1] See PFMI Principle 5, key considerations 1 and 4.

- **cash;**
- **securities issued or guaranteed[2] by the Government of Canada;**
- **securities issued or guaranteed by a provincial government; and**
- **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.

Additional asset categories

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:

- **securities issued by a municipal government;**
- **bankers' acceptances;**
- **commercial paper;**
- **corporate bonds;**
- **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;**
- **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

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[2] 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.

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.[3]

(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.[4]

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

Concentration risk limits

An FMI should limit assets from the broader range of acceptable assets identified in the previous section ("Additional asset categories") 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 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 the previous section ("Additional asset categories") for accepting a broader range of assets as collateral apply equally to the decision over whether more stringent concentration limits should be implemented.

Specific wrong-way risk limits

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

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[3] 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.

[4] See Principle 5, key considerations 1 and 4.

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.

Collateral monitoring

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.[5]

The following points clarify regulators' expectations regarding the calculation and testing of haircuts.

Calculating haircuts

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

Verifying the adequacy of haircuts and overall collateral accepted

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.

FMIs 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

[5] See PFMI Principle 5, key considerations 2 and 3.

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 PFMIs 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 FMIs 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.[1]

The information provided in this section clarifies regulators' expectations of sufficient qualifying liquid resources.

Liquidity exposure coverage

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.[2] 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, changes in the way transactions settle or other relevant market- risk factors.

Total liquid resources

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

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[1] See PFMI Principle 7, key considerations 3, 5, 6 and 9.

[2] 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. FMIs should consider potential liquidity exposures over a rolling one-year time frame.

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.

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.

Verifying sufficiency of liquid resources

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.[3]

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

Assets in the possession, custody or control of the FMI

Cash and treasury bills[4] in the possession, custody or control of an FMI are qualifying liquid resources for liquidity exposures denominated in the same currency.[5]

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.[6] 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.

Liquidity facilities

Committed liquidity facilities are qualifying liquid resources for liquidity exposures denominated in the same currency if the following criteria are met:

- **facilities are pre-arranged and fully collateralized;**
- **there is a minimum of three independent liquidity providers;[7] and**
- **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,

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[3] See PFMI Principle 7, key considerations 4, 5 and 6

[4] "Treasury bills" refers to bonds issued by the Government of Canada and the U.S. Treasury with a maturity of one year or less.

[5] 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.

[6] "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.

[7] The Liquidity providers should not be affiliates to be considered independent.

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 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.

Uncommitted liquidity facilities are considered qualifying liquid resources for liquidity exposures in Canadian dollars if they meet the following additional criteria:

- **the liquidity provider has access to the Bank of Canada's Standing Liquidity Facility (SLF);**
- **the facility is fully collateralized with SLF-eligible collateral; and**
- **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 PFMIs.

PFMI Principle 15: General business risk

Box 15.1:
Joint Supplementary Guidance – General Business Risk

Context

The PFMIs 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 PFMI Principles. To manage these risks, the PFMIs 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 PFMIs 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 PFMIs, 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 PFMIs 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 PFMIs 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:

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 PFMI 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 PFMIs 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 PFMIs 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 PFMIs 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[1] 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.

[1] 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.

FMIs may need to accumulate liquid net assets for purposes other than to meet the General Business Risk PFMI 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 PFMIs 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.

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.

FMIs 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.

FMIs should review their methodology for calculating the required level of liquid net assets at least once every five years, or as major developments occur.[2]

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

[2] 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.

The PFMIs 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 PFMIs: 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 PFMIs (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.[1]

(i) Governance

The PFMIs 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.
- 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.[2]

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.[3]

(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

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[1] 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.

[2] 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.

[3] 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).

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 PFMIs 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.[4]

Link to risk management

FMIs 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.

[4] 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.

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 PFMIs.

- *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 PFMIs state that FMIs 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 FMIs to meet the components of the disclosure principle related to: (i) public qualitative disclosure and (ii) public quantitative disclosure.

(i) Requirements included in the PFMIs

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 PFMIs, PFMI 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),[1] and the Public quantitative disclosure standards for central counterparties (the Quantitative Disclosure Standards).[2] 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.

(ii) 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[3] 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,

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[1] Committee on Payments and Market Infrastructures and Technical Committee of the International Organization of Securities Commissions (CPMI-IOSCO), "Principles for financial market infrastructures: disclosure framework and assessment methodology" (December 2012)

[2] Committee on Payments and Market Infrastructures and Technical Committee of the International Organization of Securities Commissions (CPMI-IOSCO), "Public quantitative disclosure standards for central counterparties" (February 2015)

[3] 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 constating 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.

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 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.[4] 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.[5] 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.[6] 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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[4] 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.

[5] 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.

[6] 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

ADOPTION OF THE INSTRUMENT

The Amendments will be implemented as:

- a rule in each of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Ontario, Prince Edward Island and Yukon
- a regulation in Québec
- a commission regulation in Saskatchewan

In Ontario, the Amendments, as well as other required materials, were delivered to the Minister of Finance on March 17, 2020. The Minister may approve or reject the Amendments or return them for further consideration. If the Minister approves the Amendments or does not take any further action, the Amendments will come into force on June 19, 2020.

In Québec, the Amendments are adopted as a regulation made under section 331.1 of the *Securities Act* (Québec) and must be approved, with or without amendment, by the Minister of Finance. The regulation will come into force on the date of its publication in the *Gazette officielle du Québec* or on any later date specified in the regulation. It is also published in the Bulletin of the Autorité des marchés financiers.

In British Columbia, some of these changes, specifically changes that do not have a legal effect, have been made by way of revision instead of amendment. Despite this, the intended effect of the changes in the Instrument is consistent across all jurisdictions.

In Saskatchewan, the implementation of the Amendments is subject to ministerial approval. If all necessary approvals are obtained, the Amendments will come into force on June 19, 2020 or, if after June 19, 2020, on the day on which they are filed with the Registrar of Regulations.