CANADIAN SECURITIES ADMINSTRATORS' REQUEST FOR COMMENT - DISCUSSION PAPER 24-401 ON STRAIGHT-THROUGH PROCESSING

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EXECUTIVE SUMMARY

The continued success of Canada's capital markets depends on the ability of our markets to compete with global markets. This Discussion Paper and Request for Comments (Paper) discusses the importance of straight-through processing (STP) to the securities clearing and settlement system and the efficiency and global competitiveness of Canada's capital markets. The Canadian Securities Administrators (CSA or we) raise concerns about the risks of not achieving STP objectives in Canada on an industry-wide basis at the same time as the United States (U.S.) and seek comment on regulatory approaches to address these objectives. The Paper is organized into four parts.

I. Importance of an efficient clearing and settlement system to competitiveness of Canadian capital markets: Part I discusses the importance of the securities clearing and settlement system and STP to the Canadian capital markets.

The clearing and settlement process is a critical component of the financial market infrastructure. The process involves many market participants: central securities depositories, banks, custodians, dealers, issuers, transfer agents, investment advisers, investors and service providers.

Implementing straight-through processing will enable the direct capture of trade details from order taking at the front-end of trading systems to the complete automated processing of confirmation and settlement instructions without the need for the re-keying of data. A key reason for achieving industry-wide STP is to position the industry and market participants for future growth and to maintain the global competitive position of the Canadian capital markets. STP will reduce firm and systemic risk while enhancing operational efficiency.

II. Monitoring industry efforts: Part II sets out the industry's role in addressing STP and the CSA's observations of industry efforts.

Implementing STP throughout the industry requires changing business processes, identifying common technology, setting standards, and building interfaces and utilities. The solutions to implementing industry-wide STP must accommodate the complexity of the industry, particularly the significant differences in type and size of market participants. It is appropriate for the industry to identify the issues, the solutions and the critical path to achieving those solutions. The Canadian Capital Markets Association (CCMA) was founded in 2000 by the industry to provide the necessary leadership to achieve STP in Canada. The CSA have largely been depending on the CCMA to identify what needs to be achieved to implement STP across the industry and how to implement the various steps.

The CSA have been monitoring the CCMA efforts in their observer role in the CCMA committees as well as through industry surveys. The surveys raised concerns about the degree of STP preparation and readiness of market participants. Also, the CCMA has not responded to date to staff's request for information on the critical path to implement key STP goals and how the Canadian industry's efforts compare to U.S. industry efforts. The CSA believe this raises

concerns about the industry's efforts to achieve industry-wide STP by June 2005, and increases risks to the competitiveness of the Canadian capital markets.

III. Mandating requirements – proposed institutional trade processing rule: Part III describes the CCMA's requests for regulatory action from the CSA, and the CSA's responses, in the context of the following key STP initiatives of the CCMA:

1. *Trade comparison and matching* - Improving the post-trade, pre-settlement processing of institutional trades in Canada, particularly the confirmation and affirmation process, whereby the details (including terms of settlement) of a securities trade executed on behalf of an institutional investor are agreed upon by all relevant parties on the date the trade is executed (or T).

2. *Corporate actions reporting* - Improving the process in Canada of disseminating entitlement (also known as *corporate actions*) information on publicly traded securities in a standardized or data-defined format received from issuers or offerors.

3. *Using the Large Value Transfer System for corporate entitlement payments* - Requiring issuers and offerors to make their entitlement payments (such as dividend, interest, redemption, repurchase or take-over bid payments) in funds transmitted by the *Large Value Transfer System (LVTS).*

4. *Addressing processing issues relating to client name model for investment funds* - Improving the post-trade processing of investment fund transactions in the context of the *client name* business model as compared to the *nominee name* business model.

5. *Furthering immobilization and dematerialization of securities* - Reducing the physical movement of securities certificates in connection with the settlement of transactions in publicly traded securities among market participants.

6. *Improving the processing of securities lending transactions* - Introducing electronic functionality for recalling loaned securities.

The CCMA has identified specific regulatory and legal measures that the industry believes are necessary to implement STP and improve the efficiency and soundness of the Canadian securities clearing and settlement system. In particular, the CCMA has identified the need for the CSA to mandate market participants to complete confirmation and affirmation, or matching, of institutional trades on T as the most important regulatory initiative to support the industry's STP milestones. The CSA agree that it is necessary to take regulatory action and propose to mandate a requirement that institutional trades be matched as soon as practicable after a trade is executed and in any event no later than the close of business on T. The CSA also propose to adopt general T+3 settlement cycle and *good delivery* rules.

Consequently, the CSA are publishing for comment, together with the Paper, proposed *National Instrument 24-101 — Post-Trade Matching and Settlement* (the Proposed Instrument) and Companion Policy 24-101CP — To National Instrument 24-101 — *Post-Trade Matching and*

Settlement (the Companion Policy). The Proposed Instrument mandates dealers and portfolio advisers to take all necessary steps to match trades in depository eligible securities as soon as practicable after the trade is executed and in any event no later than the close of business on T. Dealers would be required to enter into a *trade-matching compliance agreement* with their institutional clients before they can execute trades in depository eligible securities on behalf of their clients on a delivery-versus-payment (DVP) or receive-versus-payment (RVP) basis.

Today the trade confirmation and affirmation process, or trade comparison and matching process, is a sequential and largely manual process involving institutional investors, dealers and custodians. The requirement in the Proposed Instrument to complete this process before the close of business on T will mean that institutional investors, dealers and custodians must change their technology systems and business processes. While not mandatory, the Proposed Instrument contemplates the use of centralized facilities operated by a recognized clearing agency, a recognized exchange, a recognized quotation and trade reporting system, or a *matching service utility* to perform the trade comparison and matching process. To the extent a matching service utility offers its services in the Canadian capital markets, it will be required to comply with certain filing, reporting and other requirements under the Proposed Instrument. The CSA hope that the Proposed Instrument will facilitate adoption of industry best practices and standards for institutional trade comparison and matching and encourage industry-wide inter-operability. Finally, the Proposed Instrument requires dealers to take all necessary steps to settle trades in depository eligible securities no later than the end of T+3 and permits dealers to settle client trades in depository eligible securities on a DVP/RVP basis only through the facilities of a recognized clearing agency.

In addition to the above, the CSA anticipate publishing for comment in the near future proposed technical amendments to National Instrument 81-102 — *Mutual Funds* (NI 81-102) and Companion Policy 81-102CP — To National Instrument 81-102 — *Mutual Funds* (CP 81-102CP) to facilitate the processing of investment fund transactions on a STP basis. Also, concurrent with those amendments, the Ontario and Alberta securities commissions (respectively, OSC and ASC) will propose amending OSC Policies 5.3 and 5.4 and ASC Policies 4.3 and 4.4 to remove the requirement for certain unincorporated closed-end investment funds to issue certificates to their security holders.

IV. Conclusion and requests for comments: Part IV summarizes the main points of the Paper, and reproduces the specific requests for comments set forth below. Certain capitalized terms used below have been defined in the National Instrument or this Paper.

Question 1: If the CSA were to implement mandatory STP readiness certificates, what should be the subject matter of such certificates?

Question 2: Is it important to the competitiveness of the Canadian capital markets to reach STP at the same time as the U.S.? Please provide reasons for your answer. Are there any factors or challenges unique to the Canadian capital markets?

Question 3: Should it be one of the CCMA's tasks to identify the critical path to reach specific STP goals? If so, what steps and goals should be included?

Question 4: Should the CSA require market participants to match institutional trades on trade date? Would amending SRO rules to require trade matching on T be more effective than the Proposed Instrument? Is the effective date of July 1, 2005 achievable?

Question 5: Is a close of business definition required? If so, what time should be designated as close of business?

Question 6: Should the Proposed Instrument expressly identify and require matching of each trade data element, or is it sufficient for the Proposed Instrument to impose a general requirement to match on T and rely on industry best practices and standards to address the details?

Question 7: Should the CSA rely on the best practices and standards established by the CCMA ITPWG?

Question 8: The CSA seek comments on the scope of the Proposed Instrument. Have we captured the appropriate transactions and types of securities that should be governed by requirements to effect trade comparison and matching by the end of T and settlement by the end of T+3? Have we appropriately limited the rule to *public* secondary market trades?

Question 9: Is the contractual method the most feasible way to ensure that all or substantially all of the *buy side* of the industry will match their trades by the end of T?

Question 10: Should an exception to the requirement to match a trade on T be allowed when parties are unable to agree to trade details before the end of T and are required, as a result, to correct the trade data elements before matching?

Question 11: Should registrants be required to report all exceptions from matching by the close of business on T? If so, who should receive the report (e.g. recognized clearing agency, SROs, and/or securities regulatory authorities)?

Question 12: Is it necessary to mandate the use of a *matching service utility* in Canada? If so, how would the appropriate centralized trade matching system be identified? Are there institutional investors or investment managers that may not benefit from being forced into an automated centralized trade matching system? Can STP trade matching be achieved without a matching service utility?

Question 13: Should the scope of functions of a matching service utility be broader?

Question 14: Are the filing and reporting requirements set out in the Proposed Instrument for a matching service utility sufficient, or should a matching service utility be required to be recognized as a clearing agency under provincial securities legislation?

Question 15: Can the Canadian capital markets support more than one matching service utility? If so, what should be the inter-operability requirements?

Question 16: Should the CSA mandate a T+3 settlement cycle? Should the CSA mandate a T+1 settlement cycle when the U.S. moves to T+1 and the SEC amends its T+3 Rule?

Question 17: Should the CSA require the reporting of corporate actions into a centralized *hub*? If not, is it more appropriate for exchanges and other marketplaces to impose this requirement through listing or other requirements? Who should pay for the development and maintenance of the central *hub*?

Question 18: Should the CSA wait until a *hub* has been developed by the industry before it imposes any requirements?

Question 19: Should the CSA require issuers and offerors to make their entitlement payments by means of the LVTS?

Question 20: If there is a CSA requirement to make entitlement payments in LVTS funds, should the requirement apply only to payments in excess of a certain minimum value? If so, what should that minimum value be?

Question 21: Should the CSA consider implementing any additional rules to encourage and facilitate the investment funds industry to move towards an STP business model? If so, what issues should be addressed by the CSA?

Question 22: Should the CSA develop rules that require the immobilization and, to the extent permitted by corporate and other law, dematerialization of publicly traded securities in Canada?

Question 23: To the extent DRS systems operate in Canada, should a securities regulatory authority regulate transfer agents that are operating or using such DRS systems?

Question 24: Should there be separate DRS systems and should they be required to be inter-operable?

Question 25: Is it sufficient for the Canadian capital markets to rely solely on existing SRO segregation rules? Or, given the growing reliance on the indirect holding system, should the CSA consider an active role in developing comprehensive rules on segregation of customer assets?

PART I: THE CANADIAN SECURITIES CLEARING AND SETTLEMENT SYSTEM AND STRAIGHT-THROUGH PROCESSING

A. Nature and Importance of the Securities Clearing and Settlement System

1. Nature of a securities clearing and settlement system

A *securities clearing and settlement system* comprises the spectrum of arrangements and activities in the capital markets for the confirmation, clearance and settlement of securities transactions, the safeguarding of securities and certain other *back-office* and *post settlement functions*.[1] The Group of Thirty (G-30) describes securities clearing and settlement as "a core financial function on which fundamental confidence in the financial markets depends".[2]

Clearing and settlement encompasses a process which commences immediately after a trade is executed and ends with the final transfer of the property interest in securities in exchange for the payment of a price between buyer and seller.[3] While it is generally recognized that the clearing and settlement process is central to all securities market activity, it rarely receives the same amount of attention as the front-office trade execution process, because the back-office processes of the markets are generally complex and invisible to the public.[4] The institutional arrangements that comprise a securities clearing and settlement system for a domestic market or a connected

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1 The Committee on Payment and Settlement Systems (CPSS) defines *back-office* as the part of a firm that is responsible for post-trade activities. Depending upon the organizational structure of the firm, the back office can be a single department or multiple units (such as documentation, risk management, accounting or settlements). See Committee on Payment and Settlement Systems, *A glossary of terms used in payments and settlement systems*, January 2001, revised July 2001, Bank for International Settlements (the CPSS Glossary). The Canadian Capital Markets Association (CCMA) defines *post-settlement function* as the administrative functions connected with safekeeping securities, such as dividend payments; stock dividend, warrant, and bonus share processing; notification of warrants, rights and tender offers; and other corporate actions. See CCMA's *Canadian Securities Industry Glossary*, March 13, 2002, available on the CCMA's Web site at www.ccma-acma.ca (the CCMA Glossary). We note that our use of the expression *clearing and settlement system* in this Paper should not be confused with the specific definition given to this same expression in the federal *Payment Clearing and Settlement Act*, 1996 c. 6, sch. In this Paper, we use the expression in a broader context to generally describe the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities (see *securities settlement systems* in the CPSS Glossary).

2 See *Global Clearing and Settlement: A Plan of Action*, report of the G-30 released on January 23, 2003; at page 1 - Executive Summary (G-30 report).

3 A *trade* executed on the facilities of a marketplace is merely the entering into a contract for the purchase and sale of securities. It is not the exchange of property for other property or money. The rules and customs of the marketplace will generally set the terms of the contracts that are formed through the trading of securities. For example, settlement of trades in most equity and long-term debt securities will usually occur on the third day after the date of the trade or *T+3*. See Rule 5-103 of the Toronto Stock Exchange (TSX) and Regulation 800.27 of the Investment Dealers Association of Canada (IDA). *Clearance* or *clearing* means the process of calculating the mutual obligations of market participants, usually on a net basis, for the exchange of securities and money. *Clearing* or *clearance* is also given a broader meaning to include the process of transmitting, reconciling and confirming payment orders or security transfer instructions prior to settlement, including the netting of instructions and the establishment of final positions for settlement. *Settlement* is the process by which the property right or entitlement to the securities is transferred finally and irrevocably from one investor to another, usually in exchange for a corresponding transfer of money.

4 G-30 report, at 2.

group of markets involve many players: central securities depositories, central counterparties, banks, custodians, dealers, issuers, transfer agents, investment advisors, investors and service providers.

2. Importance of the securities clearing and settlement process to efficiency and financial safety of market

The broad spectrum of functions and activities that comprise a securities clearing and settlement system are a "critical component of the infrastructure of global financial markets".[5] They have become increasingly important to the efficiency and financial safety of the capital markets.

According to the Committee on Payment and Settlement Systems of the Group of Ten central banks (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), weaknesses in securities clearing and settlement systems can be a source of systemic disturbances to securities markets and to other components of a financial system.[6] Indeed, a major reason why clearance and settlement has become an important global public policy topic in recent years is that inadequacies in the securities clearing and settlement system can be one of the main vehicles by which the consequences of the failure of a market participant, no matter where situated, spread to others around the globe.[7] Therefore, improvements in the clearance and settlement process, including improvements to operational systems and processes and reforms to applicable laws and regulations, are an important component in a larger general initiative to reduce systemic risk.[8]

B. What is Straight-through Processing?

STP is defined as the passing of information seamlessly and electronically among all participants involved in a securities transaction process.[9] Implementing STP will enable the direct capture of trade details from order taking at the front-end of trading systems and complete automated processing of confirmations and settlement instructions without the need for the re-keying or re-formatting of data.[10] STP implies electronic rather than manual interfaces between market participants, market infrastructure entities and service providers.[11] Achieving STP can affect the entire life cycle of a trade, and will largely involve changes to processes and systems from the front offices to the back offices of market participants.

Achieving STP also means achieving *inter-operability* in the marketplace. Inter-operability in the marketplace means the ability of entities along the clearing and settlement chain to communicate

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5 See *Recommendations for securities settlement systems - Report of the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (Joint Task Force) on securities settlement systems*, dated November 2001, at para. 1.1 (the CPSS-IOSCO report).

6 CPSS-IOSCO report, at para. 1.2.

7 See J.S. Rogers, "Policy Perspectives on Revised U.C.C. Article 8", (1996) 43 U.C.L.A. Rev. 1431, at page 1437.

8 *Ibid*.

9 CCMA, *Straight-through Processing (STP) is Everyone's Business*, November 2002, (STP is Everyone's Business), at 2, available on the CCMA's Web site at www.ccma-acma.ca.

10 See CPSS Glossary.

11 STP is Everyone's Business, at 2.

and work with other entities without special effort on the part of users.[12] Inter-operability involves ensuring throughout the industry technical compatibility of systems (such as standardized communication, messaging, data, and timing) and compatible processes, business practices, controls, technologies, products, fee structures, and the like.[13]

C. Why is STP Important to the Canadian Capital Markets?

1. Competitiveness of the Canadian capital markets

A key reason for achieving industry-wide STP is to position the industry and market participants for future growth and maintain the global competitiveness of the Canadian capital markets.[14] The same conditions leading to the 1989 G-30 recommendations[15] and implementation in 1995 of a North American settlement cycle period of three days after the date of trade (T+3) were noted in 2000—that is, significantly increasing securities trading volumes, market volatility, and cross-border trading activity.[16] Although the decision to move to a settlement cycle period of one day after the date of trade (T+1) has been deferred, and T+1 initiatives have been generally replaced with STP initiatives,[17] we expect that the move to a T+1 settlement cycle period will again become the main focal point for efforts to reduce systemic risk in the financial system and improve the overall soundness of the securities clearing and settlement system.

In 2000, Charles River Associates released an economic analysis of the consequences for Canada of not moving to T+1 in a coordinated manner with the United States. The analysis demonstrated that, if Canada were to remain at T+3 while the U.S. moves to T+1, our markets would become uncompetitive vis-à-vis the U.S. markets and would suffer harm.[18] Canadian T+1 and STP initiatives have attempted to follow similar U.S. industry efforts because market practices in both countries are generally the same, and the securities clearing and settlement systems in both

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12 G-30 report, at 27.

13 *Ibid.*

14 See *Canadian Securities Marketplace Best Practices and Standards: Institutional Trade Processing, Entitlements and Securities Lending*; June 9, 2003, Canadian Capital Markets Association, at p. i (the CCMA Best Practices and Standards White Paper). On December 12, 2003, the CCMA released the final version of the CCMA Best Practices and Standards White Paper. The proposed best practices and standards are minimum requirements that Canadian participants must meet to achieve cross-industry STP in the areas of institutional trade processing, entitlements/corporate actions, and securities lending activities. A final version of the CCMA Best Practices and Standards White Paper dated December 2003 is available on the CCMA Web site at www.ccma-acmc.ca.

15 Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (New York: Group of Thirty, March 1989) (1989 G-30 report).

16 See CCMA Institutional Trade Processing Working Committee, *Institutional Trade Processing T+1 White Paper*, March 8, 2001 (the ITPWG White Paper) at 3.

17 In July 2002, the securities industries in the United States and Canada announced that they would focus on straight-through processing in 2003 and 2004, rather than move to a T+1 trade settlement period in 2005.

18 Charles River Associates, *Free Riding, Under-investment and Competition: the Economic Case for Canada to Move to T+1: Executive Summary*, November 10, 2000, available on the Web site of the CCMA (www.ccma-acmc.ca). See also letter from David Brown, Q.C., Chair, Ontario Securities Commission, dated July 27, 2001, to Ontario registrant firms in connection with the need to move to T+1, available at http://www.osc.gov.on.ca/en/HotTopics/currentinfo/tplus1_nlttrfaq_011105.html.

countries are closely integrated.[19] The Securities and Exchange Commission (SEC) has recently sought comment on the current operation of its T+3 rule and the costs and benefits of implementing a settlement cycle shorter than T+3.[20]

2. Reducing risk and enhancing operational efficiency

More importantly, however, is the fact that STP will achieve the key objectives of reducing firm and systemic risk as well as enhancing the operational efficiency of our securities clearing and settlement system.

Systemic risk is defined as the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due.[21]

A key to managing risk in the securities trading business is the effort to reduce the inevitable lag between contract formation and contract performance. A longer period between trade date and settlement means a greater volume and value of unsettled transactions.[22] A shorter period will reduce the risks inherent in settling securities transactions because it will reduce the number of unsettled trades in the clearance and settlement system at any give time.[23]

Another critical objective of STP and shortening trade settlement periods is to ensure that details of a trade are verified as soon as possible after the trade is executed (this objective is a subset of the broader objective to reduce risk in the securities clearing and settlement system). Mismatched trades or trades with incorrect or missing information result in human remediation. In high volume or market stress circumstances, this increases the probability of settlement risk because firms have only a limited number of staff who can remediate unmatched trades. Moreover, firms without effective STP processing are at higher risk for multiple trade settlement fails.

3. International efforts to reduce risk in clearing and settlement

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19 The links between the Canadian and U.S. clearing agencies for processing cross-border transactions are the most extensive bilateral links among clearing agencies in the world. See Canadian Securities Administrators' Uniform Securities Transfer Act Task Force *Proposal for a Modernized Uniform Law in Canada Governing the Holding, Transfer and Pledging of Securities*, August 1, 2003, (CSA USTA Consultation Paper), at 22-23. The CSA USTA Consultation Paper is available on the Web site of the Ontario Securities Commission at http://www.osc.gov.on.ca/en/HotTopics/usta.html#open.

20 Concept Release: Securities Transactions Settlement; Securities and Exchange Commission; 17 CFR Part 240 [Release No. 33-8398; 3449405; IC-26384; File No. s7-13-04] (SEC Concept Release). We briefly discuss the SEC Concept Release below.

21 See CPSS Glossary.

22 See Bachmann Task Force, *Report of the Bachmann Task Force on Clearance and Settlement Reform in U.S. Securities Markets*, U.S. Securities and Exchange Commission, File No. S7-14-92, Release No. 34-30802, 17 CFR Part 240, June 15, 1992. The report stated: "The equation TIME = RISK became an inescapable truth as we processed the information".

23 Although T+1 is often the norm for transactions in government securities and commercial paper, T+3 remains largely the standard today in North America for equity and long-term corporate debt securities.

Global efforts to reduce risk and increase efficiency in securities clearing and settlement systems, including concerns about the adequacy of the legal and regulatory frameworks that support such systems, have spawned a number of important international reports and industry and governmental initiatives.[24] A joint task force of the CPSS and IOSCO issued a report in November 2001 containing 19 recommendations that establish minimum standards for securities settlement systems operating in all markets.[25] The CPSS-IOSCO report was supplemented by a follow-up report of the CPSS-IOSCO joint task force in November 2002,[26] which provides a methodology for assessing whether jurisdictions are in compliance with the standards set out in the first report. These reports were soon followed by another important report released by the G-30 in January 2003, entitled *Global Clearing and Settlement: A Plan of Action.*[27] The G-30 report makes 20 wide-ranging recommendations that establish best practices for clearing and settlement in the major mature markets, including creation of global standards in technological and operational areas, improvements in risk management practices, further harmonization of global legal and regulatory environments, and improved corporate governance for providers of clearing and settlement services. Within the European Union (EU), the problems with securities clearing and settlement have been described and addressed by two reports of the Giovannini Group.[28] A report issued in 2001 identified 15 barriers to efficient cross-border clearing and settlement in the EU, while a report released in 2003 recommends the actions to be taken to resolve those barriers. The 2003 report advocates harmonization in this area consistent with the G-30 and CPSS-IOSCO recommendations.

In the United States, the SEC released last month a Concept Release entitled *Securities Transactions Settlement* that seeks comment on methods to improve the safety and operational efficiency of the U.S. clearance and settlement system and to help the U.S. securities industry

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[24] Efforts in Canada to improve the legal and regulatory frameworks that underpin the clearing and settlement process include the federal *Payment Clearing and Settlement Act*, 1996 c. 6, sch., which gives the Bank of Canada regulatory authority over designated clearing and settlement systems; the proposed provincial *Uniform Securities Transfer Act* (USTA), modeled on Revised Article 8 of the U.S. Uniform Commercial Code (see the discussion of the USTA in Part III of this Paper); and the Proposed Instrument discussed in Part III of this Paper. International efforts to improve and harmonize legal frameworks on a global scale include the completion and signing in December 2002 of the Hague Conference on Private International Law, Convention #36—*Convention On The Law Applicable To Certain Rights In Respect Of Securities Held With An Intermediary* and a UNIDROIT Study Group proposal to develop harmonised substantive rules regarding indirectly held securities. See the Web sites of the Hague Conference (http://www.hcch.net/e/conventions/text36e.html) and UNIDROIT (http://www.unidroit.org/english/workprogramme/study078/item1/studygroup/poisitionpaper-2003-08.pdf).

[25] See the CPSS-IOSCO report.

[26] See *Assessment methodology for "Recommendations for securities settlement systems"*, November 2002. Both the CPSS-IOSCO report and the follow-up assessment methodology report are available on the IOSCO Web site at www.iosco.org and on the Web site of the Bank for International Settlements at www.bis.org.

[27] See the G-30 report. The G-30 is a private organization sponsored by central banks and major commercial and investment banks that, over the years, has assembled a number of international task forces to study and report on the state of global clearing and settlement. For information on how to order G-30 reports and papers, see the G-30's Web site at www.group30.org.

[28] See The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements in the European Union*, (2001 Report), Brussels, November 2001; The Giovannini Group, *Second Report on EU Clearing and Settlement Arrangements*, (2003 Report), Brussels, April 2003. Both these reports are available at http://www.europa.eu.int/comm/economy_finance/giovannini/clearing_settlement_en.htm. The Giovannini Group was formed in 1996 to advise the European Commission on issues relating to EU financial integration and the efficiency of euro-denominated financial markets.

achieve STP.[29] In particular, the SEC is seeking comment on whether it should adopt a new rule or U.S. self-regulatory organizations should be required to amend existing rules to require the completion of the confirmation and affirmation process on T when a broker-dealer provides DVP or RVP privileges to a customer. It is also seeking input on the benefits and costs associated with implementing a settlement cycle for most broker-dealer transactions that is shorter than T+3. Finally, the SEC is seeking comment on methods to reduce the use of physical securities.

[29] SEC Concept release, at 1. The release is available on the SEC Web site at: http://www.sec.gov/rules/concept/33-8398.htm.

PART II: THE CANADIAN INDUSTRY'S ROLE IN ADDRESSING STP AND CSA OBSERVATIONS ON INDUSTRY EFFORTS

Each of the CSA jurisdictions has a mandate to promote investor protection and efficient capital markets. The clearance and settlement process is one of the core processes that underlies a securities market and determines, to a large extent, its efficiency and effectiveness.[30] The regulation of clearing and settlement processes, including the implementation of STP, is directly related to our mandate. With that in mind, the CSA established a staff committee (CSA STP Committee) to monitor industry STP efforts and make recommendations to the CSA jurisdictions on initiatives that would facilitate implementation of STP, remove any regulatory barriers, and develop rules where appropriate. We describe in this Part the industry's STP efforts and our observations of industry achievements as a result of our monitoring.

A. The Canadian Industry's Commitment to and Role in Addressing Straight-through Processing

Since the early 1970's, many initiatives have been implemented by the Canadian securities industry to enhance the efficiency of the securities clearing and settlement process and reduce risk in our capital markets. These initiatives include developing and requiring the use of a central securities depository and central counterparty (CSD/CCP) utility,[31] encouraging the immobilization of securities and the use of *book-based* systems, and requiring that trades be settled within T+3. These initiatives have rendered the process of clearing and settlement of securities trades in Canada one of the most efficient and safest in the world. However, some aspects of securities clearing and settlement need to be improved, particularly outside the scope of operations of a CSD/CCP utility.

In the past decade, trade volumes and dollar values of securities traded in Canada and globally have grown substantially. The increasing volumes mean existing back-office systems and procedures of market participants are challenged to meet post-trade processing demands, exacerbating the risk that a transaction may not be completed or that one of the parties to a transaction may fail.

Implementing industry-wide STP will largely resolve these processing problems. However market participants are reluctant to invest in upgrading systems and improving processes without industry coordination because it is difficult to justify the investment solely on an individual return-on-investment basis. The decision to invest will only make sense if all market participants make a concerted effort to act together. As noted by the G-30:

> The amount of change needed to achieve consistently safe and efficient performance on a global basis is substantial: the problem is extremely

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30 See *Towards a Legal Framework for Clearing and Settlement in Emerging Markets*, Emerging Markets of the International Organization of Securities Commissions; IOSCO paper November 1997, at 1.

31 Canada's CSD/CCP utility for debt and equity securities is The Canadian Depository for Securities Limited (CDS). CDS is subject to extensive regulation and oversight by the Bank of Canada, OSC and Autorité des marchés financiers (Québec). A CSD/CCP utility is generally known as a *clearing agency*, a defined term in certain provincial securities legislation.

> complicated, and there are no simple fixes. Because change in one system or market segment will not yield the promised benefits unless all systems and segments change as well, the proposed changes must be pursued comprehensively.[32]

A coordinated and comprehensive effort to achieve STP on a market-wide basis has become a necessity.

B. Leadership Role of Industry in Identifying Issues, Solutions and Critical Path for Implementation

Implementing STP throughout the industry requires changing business processes, identifying common technology, setting standards, and building interfaces and utilities. Although much of this work is done on an individual firm level, co-ordination is required because of the nature of the securities industry—a high level of integration and interaction is essential among different parties such as dealers, marketplaces, clearing agencies, banks, custodians, investors, investment advisers, issuers, transfer agents, and service providers.

The level of co-ordination must be balanced with the fact that market participants need to implement solutions tailored to their specific business needs. Due to wide differences in size and type of market participants, scope of business activities, and back office structures, it is unrealistic to suggest that there exists a one-size-fits-all solution to the issues. Because of this complexity, the industry as a whole agreed that it should take the lead in implementing STP. The CSA agree that it is appropriate for the industry to identify the issues, the solutions and the critical path to achieving those solutions.

C. Formation of the Canadian Capital Markets Association

Industry leadership was established through the formation of the CCMA. The CCMA was founded in 2000 by industry groups and participants in the financial services industries to promote and lead STP initiatives. The CCMA's primary objectives in the STP initiatives are to lower operational, market and settlement risks and maintain the global competitiveness of the Canadian capital markets.

The CCMA has a wide range of industry members, including representatives of dealers, custodians, transfer agents, banks, credit unions, investment managers, clearing agencies, insurance companies and industry associations and self-regulatory organizations (SROs). The CCMA operates through a Steering Committee and has created a number of subcommittees or *working groups*. The working groups consist of (1) an Institutional Trade Processing Working Group; (2) a Corporate Actions Working Group; (3) a Retail Trade Processing Working Group; (4) a Dematerialization Working Group; (5) a Securities Lending Working Group; (6) a Legal and Regulatory Working Group; and (7) a Communications and Education Working Group. The CSA, Bank of Canada, Office of the Superintendent of Financial Institutions, Canadian Payments Association (CPA), and federal and Quebec ministries of finance participate as observers on the CCMA Steering Committee and some of its working groups.

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[32] G-30 report, at 15.

D. CCMA's Work

The CCMA and its working groups have prepared numerous white papers, newsletters, and other publications, made a number of submissions, and organized various conferences to alert the industry, government and government agencies to the STP efforts in Canada.[33]

1. ITPWG White Papers

The CCMA released on June 9, 2003 for public comment a document entitled *Canadian Securities Marketplace Best Practices and Standards: Institutional Trade Processing, Entitlements and Securities Lending* (CCMA Best Practices and Standards White Paper) that sets out, among other things, best practices and standards for the processing for settlement of institutional trades. The document states that the ultimate goal is to achieve by June 2005 one hundred per-cent industry-wide electronic trade delivery rate for domestic trades and 99 per-cent industry-wide matching of domestic trades on T.[34] The institutional trade processing standards and best practices contained in the CCMA Best Practices and Standards White Paper are derived from a white paper and an addendum to the white paper published in 2001 and 2002, respectively, by the Institutional Trade Processing Working Group (ITPWG).[35]

2. LRWG White Paper

On December 19, 2002, the CCMA Legal and Regulatory Working Group (LRWG) released for public comment a list of proposed legal and regulatory measures, including amendments to existing CSA and SRO rules, required to facilitate STP in Canada.[36] The LRWG identified 107 specific amendments to or new measures for provincial and federal laws, regulations and policies and the by-laws, rules, standards and conventions of SROs, marketplaces and clearing agencies.[37]

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[33] All CCMA publications and other material referred to in this Paper are available on the CCMA Web site at www.ccma-acmc.ca.

[34] See CCMA Best Practices and Standards White Paper at 1.

[35] See the ITPWG White Paper and *Addendum to Institutional Trade Processing White Paper*, November 5, 2002 (the ITPWG White Paper Addendum). The ITPWG White Paper and ITPWG White Paper Addendum are available on the Web site of the CCMA at www.ccma-acmc.ca. See also CSA Notice 33-401 *Canadian Capital Markets Association T+1 White Paper*, (March 2001) 24 OSCB 2069. The CSA Notice is also available at http://www.osc.gov.on.ca/en/HotTopics/currentinfo/tplus1.

[36] The LRWG originally released the *Legal/Regulatory White Paper: General Issues List – Legal* (GILL) and *Detailed Required Amendments List* (DRAL) on November 7, 2001. On December 19, 2002, the LRWG released a revised GILL, listing functional changes required to support STP; a revised DRAL, listing legal and regulatory changes required to support STP; and a list of DRAL Inactive/Deleted Items, listing legal and regulatory issues specific to T+1, items believed at this time to require no change and deleted items. The CSA assisted the LRWG in developing the DRAL and GILL. In 2002, the CSA provided a preliminary list of potential securities regulatory amendments to remove barriers to and facilitate the implementation of STP in Canada.

[37] Proposed measures or amendments in the DRAL are listed by type of statute or regulation, and include rules or regulations of the CSA, IDA, Mutual Fund Dealers Association (MFDA), Toronto Stock Exchange/TSX Venture Exchange, Market Regulation Services Inc., Canadian Payments Association (CPA), and CDS.

3. CAWG White Paper

The CCMA Corporate Actions Working Group (CAWG) published a white paper in 2002 and issued best practices and standards in 2003 in the CCMA Best Practices and Standards White Paper.[38] A major goal of the CAWG's best practices and standards is to facilitate the electronic distribution of entitlement and corporate action information from issuers to beneficial security holders, through the multi-tier level of securities intermediaries of the indirect holding system, by way of a *central hub*.[39] Another important goal of the CAWG best practices and standards is to require all entitlement payments on securities immobilized with a central securities depository to be made in LVTS funds.[40]

4. DWG White Paper

The Dematerialization Working Group (DWG) released for public comment on January 31, 2003 an addendum to a 2001 white paper (the DWG White Paper Addendum).[41] The DWG White Paper Addendum describes the need to reduce the physical movement of securities to achieve STP and sets out the following assumptions and objectives about securities ownership:

- The *immobilization* of securities, and consequential use of the *indirect holding system* and central securities depositories, continues to be the main choice of financial intermediaries and their clients for holding securities;[42]

- The *dematerialization* of securities, and proposed use of Direct Registration Systems (DRS systems), are effective alternatives for investors wishing to hold their securities in a *direct book-entry* uncertificated form; and

- The right of an individual to request and receive a physical certificate should continue.[43]

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[38] The CAWG released on October 22, 2002 the *Corporate Actions White Paper to Reduce Risk, Errors and Costs for Intermediaries and Investors.* See also *CSA Notice 51-305 Canadian Capital Markets Association – Corporate Actions and Other Entitlements White Paper* (October 2002) 25 OSCB 7971. The CSA Notice is also available on the OSC Web site at http://www/osc.gov.on.ca/en/Regulation/Rulemaking/Notices/csanotices/2002/csan_51-305_20021129_ccma.htm. The CAWG also participated in the drafting of the CCMA Best Practices and Standards White Paper.

[39] See CCMA Best Practices and Standards White Paper at 35.

[40] *Ibid*. at 35.

[41] The Dematerialization Working Group (DWG) (formerly Elimination of Certificates Working Group) released their *Dematerialization White Paper* on November 5, 2001(the DWG White Paper). This was followed by the release of *comments* from stakeholders on June 14, 2002 and later by an *Addendum* on January 31, 2003 (the DWG White Paper Addendum).

[42] For a discussion of the *direct* and *indirect* holding systems, see the CSA USTA Consultation Paper, at 13-20. In the context of the indirect holding system, the expression *holding* of securities should be given a broad meaning to include an intermediary maintaining for an investor a securities account to which securities and other financial assets are credited, and which are backed by securities accounts maintained by a higher-tier intermediary on behalf of the lower-tier intermediary, and so on up the chain of the indirect holding system until some intermediary (usually a clearing agency) is the direct holder of the securities or financial assets. See the CSA USTA Consultation Paper at 13-20.

[43] CCMA News Release, *CCMA Recommendations for Certificateless Securities Endorsed by Public* (February 13, 2003).

5. RTPWG White Papers

On September 16, 2003 the CCMA's Retail Trade Processing Working Group (RTPWG) published an addendum to a 2002 white paper.[44] The addendum focuses primarily on retail post-trade processing issues relating to investment funds rather than other typical retail products, such as debt and equity, because a significant portion of investment fund securities in Canada are held in *client name*.[45] The RTPWG suggests retail transactions in debt and equity securities are processed mostly in the *nominee name* model, which is essentially already an STP model.[46] The *nominee name* model generally refers to the holding of securities in the *indirect holding system*, that is, through a securities account maintained with a securities intermediary. In contrast to this model, the *client name* model refers to holding securities in the *direct holding system*, where the security holder has a direct legal relationship with the issuer (whether holding securities in certificated or uncertificated form).

The addendum makes a number of recommendations to increase efficiency, minimize risks, reduce trade processing costs and improve customer service through STP in the context of *client name* business model. It outlines the following goals by June 2005:

- 100 per-cent industry participant compliance with industry best practices and standards
- 99 per-cent STP (electronic transaction processing)

The RTPWG has defined STP for retail investment fund products as the electronic processing of an investment fund transaction among the parties involved from the time a transaction is initiated with a dealer through to settlement, meeting industry timelines and data quality standards for completeness and accuracy. Like the other STP initiatives, the successful achievement of STP for investment fund transactions is considered a necessary prerequisite to moving to a T+1 settlement cycle period.

6. SLWG White Paper

The CCMA Securities Lending Working Group (SLWG) released on January 31, 2003 a white paper recommending ways to allow for the STP of securities lending transactions[47] and proposed a number of best practices and standards in the CCMA Best Practices and Standards White Paper. The goal of the SLWG is to have all securities lending and borrowing transactions (specifically recalls and acknowledgements) processed electronically between the borrower, lender and central securities depository.[48]

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[44] See CCMA *Retail Trade Processing Working Group White Paper*, April 16, 2002 (the RTPWG White Paper) and *Retail Trade Processing Working Group White Paper Addendum-Investment Funds and Other Products*, September 16, 2003 (the RTPWG White Paper Addendum).

[45] See the RTPWG White Paper Addendum, at 5.

[46] RTPWG White Paper Addendum (Executive Summary) at i.

[47] See CCMA *Securities Lending Working Group, Securities Lending White Paper*, January 31, 2003 (the SLWG White Paper).

[48] See CCMA Best Practices and Standards White Paper at 48.

E. CSA Surveys of Market Participants

In May 2003, the CSA asked approximately one thousand Canadian registrant firms and certain other market participants to complete a *STP Readiness Assessment Survey* to assess the preparedness of the industry in Canada for STP.[49] Of these, 732 responded to and completed the survey. While some 52 per cent of survey respondents reported that they feel their organization is prepared or somewhat prepared for STP, their assessment is not supported by the responses to many of the specific quantitative *progress* questions. In other words, a large number of organizations believe they are further ahead than they actually are. There is some concern with the apparent disconnect between firms' self-assessments of their readiness, and the actual amount of preparations they have underway. Achieving industry-wide STP by mid 2005 is a lengthy and complex undertaking that will likely be unsuccessful unless firms are already expending time and effort.

The CSA will undertake a second survey later this year of the same group to determine the progress made by market participants towards achieving STP.

The CSA also conducted a separate survey with twenty key *infrastructure* participants, consisting of custodians, transfer agents, exchanges, third party service providers and clearing agencies. The objectives of the survey were to identify the relative significance of the issues from the perspective of the infrastructure of the Canadian capital markets that need to be addressed to achieve STP, and assess the current commitment of the infrastructure resources to STP. The results of the infrastructure survey show that infrastructure participants are well ahead of the overall industry in achieving STP compliance. However, this gap is significantly reduced if only large industry respondents are considered.[50] We also conducted follow-up interviews with ten infrastructure companies. These participants said that their current internal operations and systems are either compliant or almost compliant, or they have major projects underway to become compliant.

During the late 1990's, the Canadian securities industry went through a similar effort as it prepared technology systems for the transition to Year 2000. In order to monitor progress and encourage firms to commit resources to preparing for Y2K, the CSA implemented a requirement for all registrant firms to file a certificate of preparedness for the Year 2000.[51] Those certificates were mandatory and required the signature of the chief executive officer of the registrant firm. The CSA are considering whether a similar approach should be used for STP.

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[49] See OSC Staff Notice 33-371-*CSA/OSC STP Readiness Assessment Survey*, (February 21, 2003) 26 OSCB 1568; CSA News Release-*Regulators Survey Industry's Straight-through Processing Readiness*, (May 16, 2003) 26 OSCB 3717; CSA Staff Notice 33-307-*List of Canadian Registrant and Non-Registrant Firms that Completed the CSA STP Readiness Assessment Survey*, (July 18, 2003) 26 OSCB 5473; CSA Staff Notice 33-308-*the CSA STP Readiness Assessment Survey Report (Survey Report) is Now Available on the OSC Web Site*, (September 19, 2003) 26 OSCB 6429; CSA News Release –*Regulators Report on Industry's Straight-through Processing Readiness*, (September 19, 2003) 26 OSCB 6575; and CSA Staff Notice 33-309-*the CSA STP Infrastructure Survey Report is Now Available on the OSC Web Site*, (December 19, 2003) 26 OSCB 8149. The notices, news releases and survey reports are available at http://www.osc.gov.on.ca/en/HotTopics/marketplace.html#stptdp1.

[50] Large industry participants are those with 100 or more employees.

[51] See Statement of National Instrument 33-106—*Year 2000 Preparation Reporting* and National Instrument 33-106—*Year 2000 Preparation Reporting* (1998) 21 OSCB 6595.

Question 1: If the CSA were to implement mandatory STP readiness certificates, what should be the subject matter of such certificates?

F. Benchmarking the Canadian Industry's Efforts

As part of our monitoring, we believe it is necessary to evaluate the industry's efforts to achieve STP and how it compares to the U.S. industry's similar efforts. The CSA STP Committee sent a letter on November 7, 2003 asking the CCMA to identify the key tasks in the critical path to STP, the goals for 2003 and 2004, and how they compare to the industry efforts of the U.S. The CCMA has indicated it will not be able to respond to the letter until the second quarter of 2004. The CSA believe that it is essential for the CCMA to identify a critical path, monitor its progress against the steps identified in the critical path, and compare its progress to the U.S. industry progress. The U.S. industry has indicated they will reconsider later this year whether to move to T+1. If the CCMA is unable to determine its progress, or if it determines that Canada is at least twelve months behind the U.S, the Canadian capital markets are unlikely to reach their STP goals at the same time as the U.S. markets.

Question 2: Is it important to the competitiveness of the Canadian capital markets to reach STP at the same time as the U.S.? Please provide reasons for your answer. Are there any factors or challenges unique to the Canadian capital markets?

Question 3: Should it be one of the CCMA's tasks to identify the critical path to reach specific STP goals? If so, what steps and goals should be included?

PART III: MANDATING REQUIREMENTS – CSA RESPONSE TO INDUSTRY

A. Introduction—Legal and Regulatory Barriers to STP

The CCMA has made numerous submissions to the CSA, governments, government agencies, and other groups identifying key legal and regulatory measures that the industry believes are necessary to implement key STP goals and improve the efficiency and soundness of the Canadian securities clearing and settlement system.[52] Although some of these measures are proposed new rules, many are amendments to existing rules, such as proposed amendments to NI 81-102 relating to investment funds, and to the definition of *security* in the Ontario, Alberta and British Columbia *Securities Acts*. These new measures and amendments are intended to facilitate the following six key STP initiatives in Canada:

1. Institutional trade matching - Improving the post-trade, pre-settlement processing of institutional trades, particularly the *confirmation and affirmation* process, whereby the details of a securities trade executed on behalf of an institutional investor are agreed upon by all relevant parties on the date the trade is executed (or T). This is also known as trade *comparison and matching* on T.

2. Corporate action reporting - Improving the process of disseminating *entitlement* (also known as *corporate actions*) *information* on publicly traded securities in a standardized or data-defined format received from issuers or offerors,[53] through intermediaries, to beneficial security owners.

3. LVTS for entitlement payments - Requiring issuers and offerors to make their *entitlement payments* (such as dividend, interest, redemption, repurchase or take-over bid payments) in funds transmitted by the Large Value Transfer System (LVTS), whenever such entitlement payments are being made to a clearing agency (or a nominee of the clearing agency) as a registered or bearer holder of publicly traded securities.

4. Improving client-name processing for investment funds - Improving the post-trade processing of investment fund transactions in the context of the *client name* business model as compared to the *nominee name* business model.

5. Dematerialization and immobilization – Furthering the *immobilization* and moving towards the *dematerialization* of publicly traded securities to reduce the physical

[52] Since 2000, the CCMA has written to many governments, governmental agencies, regulators, committees and other organizations, including the following: the CSA, and separately to each of the OSC, British Columbia Securities Commission, Commission des valeurs mobilières du Québec (now known as the Autorité des marchés financiers), Alberta Securities Commission, Manitoba Securities Commission, Nova Scotia Securities Commission, Prince Edward Island Securities Commission and Saskatchewan Securities Commission; the CPA; the Toronto Stock Exchange; the Wise Persons' Committee appointed by the Federal Government; the Five Year Review Committee appointed by the Ontario Ministry of Finance; the First Ministers' Inter-Provincial Securities Framework Initiative; the B.C. Provincial Treasury; the House of Commons Standing Committee on Finance; the Prince Edward Island Government; the New Brunswick Government; the Nova Scotia Government; and the Quebec Ministry of Finance. The CCMA and the CSA have also had several meetings since 2000 to discuss the STP and T+1 initiatives.

[53] The term *offeror* is presumed to be within the meaning of s. 89(1) of the *Securities Act* (Ontario) (OSA).

movement of securities certificates in connection with the settlement of transactions in such securities among market participants.

6. Securities lending - Improving the processing of securities lending transactions, in particular, introducing electronic functionality for recalling loaned securities.

We discuss in the following sections of the Paper the CCMA's requests for regulatory or legal measures in the context of these six key initiatives.

B. Institutional Trade Matching on Trade Date

Improving the post-trade, pre-settlement processing of institutional trades, particularly the *confirmation*[54] and *affirmation*[55] process, is critical to facilitating STP in Canada. In the confirmation and affirmation process, or *comparison and matching* process, the trade details (including terms of settlement) of a securities trade executed on behalf of an institutional investor are compared and agreed upon by all relevant parties before the trade is submitted for clearing and settlement at the CSD/CCP. The CCMA is suggesting that the confirmation and affirmation process be completed on T.

1. Current problems with institutional trade processing

Institutional trades are much more complicated than retail transactions since they involve far larger amounts of money and securities, more parties, and more processing steps between the initiation of the order and final settlement. The CCMA's ITPWG has analyzed the current post-execution and pre-settlement activities of investment managers,[56] dealers, custodians and the Canadian Depository of Securities Limited (CDS), the primary parties involved in institutional trade processing. The ITPWG identified four key problem areas that result in delayed transaction processing and inefficiencies and contribute to increased settlement risk:

- inadequate technology;
- timing of activities (e.g., missing or late allocations, missing or late notices of execution);
- data integrity; and
- accounting (e.g., settlement by underlying allocations rather than by block).[57]

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[54] Confirmation is generally considered to be the process by which a dealer notifies its institutional customer (e.g. an investment manager) of the details of a trade and allows the customer to agree with or question the trade. See CCMA Glossary.

[55] Affirmation is generally considered to be the process following confirmation of trade details between the dealer and institutional customer by which a trade is submitted, reviewed and corrected (if necessary) before it is submitted for settlement. See CCMA Glossary.

[56] Investment managers is a term used by the industry to generally describe the *buy side* of the industry. Investment managers are also sometimes referred to as money managers. They provide investment advice to their clients and generally have discretionary authority over their clients' accounts. Some investment managers are registrants under provincial securities legislation.

[57] See ITPWG White Paper at 18 to 22.

(i) inadequate technology

According to the ITPWG, inadequate technology is the leading cause of the problems relating to institutional trade processing in Canada. Inadequate technology means too much reliance on manual processing, lack of real-time functionality, lack of standard interfaces and inter-operability, and poor communication mechanisms. Many messages sent by investment managers and dealers are sent manually by telephone or fax.[58] Moreover, the recipient of these messages must manually re-key the information, which increases the likelihood of error, which in turn requires manual intervention to repair the error. Thus, the entire process to clear and settle a trade is delayed. Lack of real-time functionality is an issue that must be resolved. Most messages between the parties to an institutional trade are largely processed in batch, at the end of the day, rather than real-time or near real-time.

Currently, many of the parties use different communication protocols, which have different message standards and may not be inter-operable. Consequently, messages received by incompatible protocols have to be processed manually, resulting in a greater chance of error and processing delay. Further, the means of communication between many institutional parties are ineffective. For example, an investment manager does not have online access to CDS to monitor the status of his or her trade nor the ability to prevent a failed trade by correcting the settlement details online.[59] The investment manager must rely on the dealer or custodian, who has online access to CDS, to notify him or her of the failed trade verbally or by fax before he or she can correct the details.[60]

(ii) timing of activities

The second cause of problems in institutional trade processing relates to the timing of different steps in the trade process, specifically, missing or late notices of execution and missing or late allocations. According to the ITPWG, five per-cent of trades fail to settle in a timely fashion because the investment manager provides the allocations or block instructions to the broker relatively late.[61] This delay by the investment manager results in delaying the entire processing and settlement of the trade since the custodian will not process the trade until the custodian receives instructions from the investment manager.[62]

(iii) data integrity and accounting issues

As noted by the ITPWG, data integrity related issues and accounting issues are also problems in the current institutional processing environment. Incorrect data is the leading cause of all failed trades in the Canadian marketplace. In order for an institutional trade to be processed and settled

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58 Specifically, almost all notices of execution are sent by telephone, approximately 20% of allocations are sent by telephone or fax, and most dealer confirmations, especially by smaller-sized dealers, are sent by mail (10 to 15%) or fax (40 to 60%). See ITPWG White Paper at 18.

59 ITPWG White Paper, at 19.

60 *Ibid*, at 19.

61 *Ibid*, at 19.

62 *Ibid*, at 20.

by T+3, all trade details or *trade data elements*[63] must be agreed to by all relevant parties involved in the post-trade processing of the trade. The relevant parties must take ownership of the data elements for which they are responsible. According to the ITPWG, the investment manager sometimes will not provide certain data elements, such as security identifiers, making settlement virtually impossible unless the dealer or custodian commits the necessary time and resources required to telephone the investment manager to retrieve the missing data elements.[64] Further, there are no industry-wide tolerance standards on how to resolve incorrect or incomplete data. In addition, settlement by *allocations* rather than by *block* results in processing delays since the investment manager usually breaks down the block trade into client account allocations, which the dealer must input into CDS as separate trades, each with its own identifiers. The dealer must then cross reference these identifiers with the data provided by the investment manager. This step causes processing delays and increases the possibility that an incorrect identifier (data element) will be used, resulting in a manual intervention to correct this error.[65]

2. CCMA request to mandate matching on T

The CCMA identified the need for the CSA to mandate market participants to complete confirmation and affirmation, or matching, on T as the most important regulatory initiative required to support the institutional trade processing milestones. According to the CCMA Best Practices and Standards White Paper, the ultimate goal of the CCMA is to achieve 99 per-cent industry-wide trade matching of domestic trades on trade date by June 2005. Currently, on average only 4.6 per-cent of domestic trades are confirmed and affirmed, or matched, on trade date as opposed to 23 per-cent in the United States.[66]

The CCMA has argued that a CSA rule is required for three reasons. First, there are currently no CSA rules or regulations that govern post-trade matching between all three parties to an institutional trade. Second, institutional trades have no formal mechanism or system that would facilitate trade comparison or matching. (This is in contrast to the different systems and processing and settlement practices that have evolved in Canada's capital markets for non-institutional trades, such as: (1) *broker-to-broker* trades, frequently associated with retail trades of exchange-listed securities which are generally matched or *locked-in* at a stock exchange or other marketplace; (2) direct trades between two participants of CDS of non-exchange traded securities which are effectively matched through the facilities of CDS' trade confirmation and

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63 Essential trade details or data elements include security identifiers, dealer identifiers (e.g. executing dealer as opposed to clearing dealer), price, commission and client account number. Often these details do not match between what the dealer inputs to CDS and the instructions received by the custodian from the investment manager.

64 ITPWG White Paper, at 21.

65 *Ibid*, at 22.

66 *CCMA June 2003 Report Card: Affirmation of Domestic Institutional Transactions.* The data excludes same-day-settled trades that settle through CDS (money market securities, etc.). It is intended that equities will be included in future report cards. Approximately 90 per-cent of institutional trades in the U.S. are currently affirmed on the date following trade date (T+1). This contrasts with Canada, where an estimated 45 per-cent of trades are affirmed on T+1. See letter dated May 27, 2003 from CCMA Chair Tom MacMillan to CSA Chair Stephen Sibold (letter explaining why the CCMA believes that there should be securities commission rules requiring matching of trade details on trade date); available on the CCMA Website at www.ccma-acmc.ca.

affirmation system;[67] and (3) mutual and segregated fund transactions, where FundSERV[68] facilities provide a mechanism for matching, leading to the settlement of investment fund units for retail clients.) Third, the U.S. marketplace is further ahead in achieving the matching of institutional trades because of available trade comparison and matching systems such as the DTCC ID system.[69]

The CCMA has looked at the role of a utility that would provide centralized facilities for the confirmation and affirmation of institutional trades in the Canadian marketplace. The CCMA has concluded that a *Matching Utility* or *MU*[70] is optional. Consequently, the CCMA has not requested a rule requiring the use of a MU. This view is reflected in the CCMA Best Practices and Standards White Paper, where the CCMA has identified best practices and standards under two alternative future state scenarios: one without connectivity to a MU and the other with connectivity to a MU.

3. CSA response: proposed National Instrument

The CSA share the CCMA's view that the institutional post-trade processing inefficiencies are the most pressing operational efficiency concerns facing the Canadian capital markets today. The CSA are also concerned that insufficient progress has been made due to the lack of explicit objectives, implementation guidelines, regulatory direction, and business incentives to encourage market participants to adopt STP. Agreement of trade details or *trade data elements* must occur as soon as possible so that errors and discrepancies in the trades can be discovered early in the clearing and settlement process. Errors in recording trade details could result in inaccurate books and records, increased costs, and increased market risk and credit risk, which in turn could lead to systemic disturbances in the market. The CPSS-IOSCO report suggests that accurate verification of trades and matching settlement instructions is an essential precondition for avoiding settlement failures, especially when the settlement cycle is relatively short.[71] The CSA are proposing a rule that would require dealers and advisers involved in an institutional trade to ensure the details of the trade are confirmed and affirmed, or matched, no later than the close of business on T. The Proposed Instrument and Companion Policy are being published together with this Paper and are summarized below.

(i) Mandating trade matching

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67 The IDA is proposing a rule that will require their members to confirm and affirm *broker-to-broker* trades in non-exchange traded securities within one hour of the execution of the trade through CDS' confirmation and affirmation system. See proposed IDA Regulation 800.49 (February 13, 2004) 27 OSCB 2038.

68 For more information on FundSERV, see www.fundserv.ca.

69 The DTCC ID system in the U.S. generally facilitated trade matching between investment manager, broker-dealer and custodian. The DTCC ID system was operated by the Depository Trust and Clearing Corporation (DTCC), which wholly owns the Depository Trust Company and National Securities Clearing Corporation, both registered clearing agencies in the U.S. The system, now known as the Omgeo OASYS TradeMatch system, is currently operated by Omgeo, a joint venture entity formed by DTCC and Thomson Financial in 2001. See Global Joint Venture Matching Services – US, LLC; Order Granting Exemption from Registration as a Clearing Agency, SEC Release No. 34-44188; File No. 600-32, April 17, 2001.

70 The CCMA has defined a MU as a software model that allows for seamless real-time matching of trade data from post-execution to transmission of a matched trade to settlement at a CSD/CCP. See CCMA Glossary.

71 CPSS-IOSCO report, at para. 3.10.

The Proposed Instrument requires dealers and portfolio advisers (that is, advisers that have discretionary trading authority over client accounts) to take all necessary steps to match a trade as soon as practicable after the trade has been executed and in any event no later than the close of business on T.[72] The *close of business* is not defined in the Proposed Instrument, but could be defined to provide greater certainty, such as 5:00 p.m. or 8:00 p.m. (the latest time at which CDS accepts end-of-day trade affirmations for the last batch settlement cycle of the day). To enable matching of trades executed on behalf of institutional clients on T, dealers, advisers and custodians will need to compare the trade data elements as soon as practicable after the trade is executed. We are recommending that the Proposed Instrument become effective on July 1, 2005.

The CSA have noted that certain existing SRO rules impose obligations on dealers to ensure prompt confirmation and affirmation of trades executed on behalf of institutional clients, including a requirement that dealers obtain agreement from their clients to facilitate prompt confirmation and affirmation of trades.[73] Since the SROs perform the lead compliance function for their members, they may be in a better position to monitor compliance with a trade matching rule.

Question 4: Should the CSA require market participants to match institutional trades on trade date? Would amending SRO rules to require trade matching on T be more effective than the Proposed Instrument? Is the effective date of July 1, 2005 achievable?

Question 5: Is a close of business definition required? Is so, what time should be designated as close of business?

The Proposed Instrument and Companion Policy provide guidance on what we mean by the process of *comparing trade data*.[74] The Companion Policy states that the trade data elements are those identified in best practices and standards established by the industry, and include those trade data elements required to be included in customer trade confirmations pursuant to securities legislation[75] and the rules of the marketplace or SRO.[76] Many of these items are also part of the CSA electronic audit trail requirements set out in National Instrument 23-101— *Trading Rules*.[77]

Question 6: Should the Proposed Instrument expressly identify and require matching of each trade data element, or is it sufficient for the Proposed Instrument to impose a general requirement to match on T and rely on industry best practices and standards to address the details?

Question 7: Should the CSA rely on the best practices and standards established by the CCMA ITPWG?

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72 Sections 3.1 and 3.3 of the Proposed Instrument.
73 See, for example, IDA regulation 800.31.
74 Section 1.2 of the Proposed Instrument and Section 1.5 of the Companion Policy.
75 See, for example, section 36 of the OSA.
76 See, for example, TSX Rule 2-405 and IDA Regulation 200.1(h).
77 See Part 11 of National Instrument 23-101.

The application of the Proposed Instrument is limited to depository eligible securities and excludes special terms trades, trades involving the distribution of a security, trades in mutual fund securities, and trades in securities settled outside of Canada.[78]

Question 8: The CSA seek comments on the scope of the Proposed Instrument. Have we captured the appropriate transactions and types of securities that should be governed by requirements to effect trade comparison and matching by the end of T and settlement by the end of T+3 (see the discussion below)? Have we appropriately limited the rule to *public* secondary market trades?

(ii) Trade-matching compliance agreement

Dealers are required to enter into a *trade-matching compliance agreement* with each institutional client before they can open an account or execute trades on behalf of the institutional client on a delivery-versus-payment (DVP) or receive-versus-payment (RVP) basis.[79] The trade-matching compliance agreement is intended to require all institutional investors to match trades by the close of business on T.

Registered portfolio advisors are affected by the Proposed Instrument. Pursuant to the Proposed Instrument, a portfolio adviser who gives an order to a dealer to trade in a depository eligible security on behalf of one or more clients of the portfolio adviser must take all necessary steps to match the trade as soon as practicable after the trade has been executed and in any event no later than the close of business on T.[80] The Proposed Instrument prohibits a portfolio adviser from opening an account with or giving an order to a dealer to trade in a depository eligible security on behalf of one or more underlying clients pursuant to a DVP/RVP arrangement unless the portfolio adviser has entered into a trade-matching compliance agreement with the dealer.[81] These requirements of portfolio advisers are the mirror image of the requirements in relation to dealers. Because the Canadian securities regulatory authorities regulate portfolio advisers, the provisions directly require portfolio advisers to take all necessary steps to enable trades to be matched no later than the close of business on T. It is not necessary, in this case, to rely only on the terms of a trade-matching compliance agreement and the enforcement of contract law by a dealer. Institutional investors that are not registered or otherwise regulated by the securities regulatory authorities (such as pension funds and insurance companies) will be bound only by contract law through the trade-matching compliance agreement.

Question 9: Is the contractual method the most feasible way to ensure that all or substantially all of the *buy side* of the industry will match their trades by the end of T?

The Proposed Instrument provides an exception to trade matching on T where corrections to trade data elements are required, provided the match takes place no later than the close of business on T+1.[82]

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78 Section 2.1 and definition of *depository eligible security* in Section 1.1 of the Proposed Instrument.
79 Section 3.2 of the Proposed Instrument.
80 Section 3.3 of the Proposed Instrument.
81 Section 3.4 of the Proposed Instrument.
82 Section 3.5 of the Proposed Instrument. See also subsection 1.4(3) of the Proposed Instrument.

Question 10: Should an exception to the requirement to match a trade on T be allowed when parties are unable to agree to trade details before the end of T and are required, as a result, to correct the trade data elements before matching?

Question 11: Should registrants be required to report all exceptions from matching by the close of business on T? If so, who should receive the report (e.g. recognized clearing agency, SROs, and/or securities regulatory authorities)?

(iii) Matching service utility

The Proposed Instrument allows for trade comparison and matching to be undertaken through facilities or services operated by a recognized clearing agency, a recognized exchange, a recognized quotation and trade reporting system, or a matching service utility.[83] A matching service utility or MU is defined in the Proposed Instrument as a person or company that provides centralized facilities for the process of comparing trade data and has filed required information, but does not include a recognized clearing agency, a recognized exchange, or a recognized quotation and trade reporting system.[84] A matching service utility is not meant to include a dealer who offers *local* matching services to its institutional clients.

Although we believe many institutional investors will want to use the central facilities of a matching service utility as a business necessity because they will find it difficult to operate in a STP environment in any other way, some institutional investors, particularly small ones, may be able to operate more efficiently using their existing or enhanced proprietary communication links. We believe that the mandatory use of a matching service utility remains an open issue.

Question 12: Is it necessary to mandate the use of a *matching service utility* in Canada? If so, how would the appropriate centralized trade matching system be identified? Are there institutional investors or investment managers that may not benefit from being forced into a centralized trade matching system? Can STP trade matching be achieved without a matching service utility?

Commitment to participate in matching utility development and use is needed from all market participants and types of organizations involved in institutional trade processing.[85] The G-30 suggests that, with the adoption of standards for matching, complete inter-operability between matching utilities needs to be achieved to maximize the potential efficiency gains and encourage adoption and use of such utilities, particularly on the *buy side* where otherwise there will be continued reluctance to use a matching utility whose model may in time become redundant or not provide access to a full range of other market participants.[86]

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83 Section 3.6 of the Proposed Instrument.
84 Section 1.1 of the Proposed Instrument.
85 G-30 report, at 81.
86 *Ibid.*

The CCMA has identified the optional need for using a matching service utility. The CSA are of the view that matching service utilities should have the following characteristics:

- provide electronic connectivity among investment managers/portfolio advisers, dealers and custodians;

- provide an electronic means for each of these parties to enter trade details (including settlement instructions), correct details of trades and ultimately match trades in an entirely synchronous manner;

- when there is agreement on these details, they should submit the matched trade and trade details to a CSD/CCP;

- provide the ability to perform operations in real-time and near-real time via interactive and possibly batch means;

- inter-operate with other matching service providers in terms of connectivity (protocols - e.g., ISO 15022), trade information details (messages, fields and format as defined in the CCMA Best Practices and Standards White Paper), and billing;[87]

- provide reporting of statistics on matching effectiveness to allow participants and regulators to determine bottlenecks by security type and by participant for possible enforcement measures and other regulatory purposes; and

- provide fair access to, and fair pricing for, their facilities and services for both their clients and non-clients who use central matching facilities of another entity.

Question 13: Should the scope of functions of a matching service utility be broader?

(iv) Regulating matching service utilities

To the extent that a matching service utility offers its services to the Canadian capital markets, we propose that the matching service utility be required to comply with filing and reporting requirements that will allow the CSA to determine whether it would be contrary to the public interest for a person or company who has filed the information to act as a matching service utility. Ongoing filing and reporting requirements will allow the CSA to monitor the operational performance and management of risk, progress of inter-operability in the market, and any negative impact on access to the markets. Further, the matching service utility will report information relating to systems and operations (means of access, description of current and future capacity estimates, reasonable contingency plans, etc). We believe the filing and reporting requirements are appropriate to ensure minimal oversight, including (i) compliance with the

[87] In practical terms, a firm should only need to belong to one matching service utility to process all Canadian trades, each participant should only be charged for one match per trade, and one matching service utility need ultimately transmit the final matched trade to the CSD/CPP.

Automation Review Program (ARP) of the Ontario Securities Commission (OSC)[88] and (ii) ensuring inter-operability with other matching service utilities.[89]

As a critical infrastructure system involved in the clearing and settlement of securities transactions, the CSA believe a matching service utility operating in the Canadian markets raises certain regulatory concerns. Matching is a complex process that is inextricably linked to the clearance and settlement process. A central trade matching utility concentrates processing risk in the entity that performs matching instead of dispersing that risk among the dealers and their institutional customers. The CSA believe that the breakdown of a matching service utility's ability to accurately compare trade information from multiple market participants involving large numbers of securities transactions and sums of money could have adverse consequences for the efficiency of the Canadian securities clearing and settlement system. Accordingly, we believe that regulatory oversight of the operational risks inherent in the use of a matching service utility is necessary.

Question 14: Are the filing and reporting requirements set out in the Proposed Instrument for a matching service utility sufficient, or should a matching service utility be required to be recognized as a clearing agency under provincial securities legislation?

Question 15: Can the Canadian capital markets support more than one matching service utility? If so, what should be the inter-operability requirements?

C. Trade Settlement

1. Mandating T+3

In the U.S., a general requirement to settle transactions by T+3 is set out in SEC Rule 15c6-1 (SEC T+3 Rule).[90] Similar measures were adopted by the SROs in Canada in 1995, when the SEC T+3 Rule was implemented.[91] The Proposed Instrument sets out a basic rule that will complement the SRO rules. A dealer who executes a trade in depository eligible securities must

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88 The OSC Capital Markets Branch published its *Automation Review Program For Market Infrastructure Entities in the Canadian Capital Markets* (ARP) on October 18, 2002. See (2002) 25 OSCB 6789 and 6941. The OSC's ARP is intended to apply to *specified market infrastructure entities* that operate key technology systems in the Canadian securities markets. The ARP provides a framework for compliance with the general *systems capacity and integrity* requirements of certain regulated marketplaces, including Alternative Trading Systems, found in the various recognition orders and Part 12 of National Instrument 21-101 *Marketplace Operation* (2001) 24 OSCB 11.

89 In the U.S., section 17A of the *Securities Exchange Act of 1934* (the 34 Act) requires matching service utilities to obtain registration as a clearing agency or request an exemption from registration as a clearing agency. Under the 34 Act, the scope of the definition of *clearing agency* is wide and includes anyone "…who provides facilities for comparison of data respecting the terms of settlement of securities transactions…". The SEC has confirmed that these words include the trade matching function and that any person performing such functions must apply to be registered, or to be granted an exemption from registration, as a clearing agency. The SEC notes that an entity that provides only *central matching services* would be eligible to apply for an appropriate exemption. See Securities Exchange Act Release No. 34-39829, '*Interpretation: Confirmation and Affirmation of Securities Trades; Matching*', April 6, 1998.

90 17 C.F.R. §240.15c6-1 (1995).

91 See, for example, IDA Regulation 800.27.

take all necessary steps to settle the trade no later than the end of T+3.[92] This requirement is not necessarily limited to trades executed on behalf of institutional clients. Although current SRO rules already mandate a minimum T+3 settlement cycle period for most equity and long term debt securities, we believe a general T+3 settlement cycle rule in provincial securities legislation will strengthen the clearing and settlement system in Canada. The CPSS-IOSCO report recommends that, as a minimum standard applicable to all markets, final settlement of trades in securities should occur no later than T+3.[93]

The CCMA and the U.S. securities industry will be reconsidering the move to T+1 later this year. Such a move will depend on a number of factors, and in particular the extent to which the industries have become STP compliant. The CSA anticipate that, if the U.S. securities industry is prepared to move to T+1, the SEC will amend the SEC T+3 Rule to mandate a standard T+1 settlement cycle period. The SEC is currently seeking comment on the scope of the SEC T+3 Rule and the impact that a shorter settlement cycle would have on the operations and costs to market participants in the United States. The SEC Concept Release asks 14 specific questions on this important topic.[94]

Question 16: Should the CSA mandate a T+3 settlement cycle? Should the CSA mandate a T+1 settlement cycle when the U.S. moves to T+1 and the SEC amends its T+3 Rule?

2. Mandating good delivery

The Proposed Instrument sets out a general *good delivery* rule that exists to some extent in current SRO rules.[95] The rule provides that a dealer is not permitted to grant DVP or RVP trading privileges to a client in respect of trades in depository eligible securities unless settlement of the trade is effected through the facilities of a recognized clearing agency.[96] Like the proposed T+3 rule, we believe a *good delivery* rule enshrined in provincial securities legislation will strengthen the clearing and settlement system in Canada.

D. Reporting of Entitlement Events (Corporate Actions) Into a Central Hub

1. CCMA request for regulatory action

The CCMA notes that the extensive use of manual and paper-based processes for entitlements leads to errors and delays. It highlights the lack of industry processing standards and best practices, and the challenges in communicating with numerous stakeholders in the entitlements processing chain within the indirect holding system, i.e., from issuer through intermediaries to investor and back.[97] Currently, there is no central *hub* that a dealer or other intermediary can access to obtain complete, accurate and timely entitlement information on all securities in Canada. A dealer or other intermediary may need to search for an obscure notice in a newspaper

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92 Section 5.1 of the Proposed Instrument.
93 See CPSS-IOSCO report Recommendation 3: Settlement cycles. See also CPSS-IOSCO report, at para. 3.14.
94 SEC Concept Release, at 15-17.
95 See IDA Regulations 800.30C and 800.31.
96 Section 5.2 of the Proposed Instrument.
97 CCMA News Release, *CCMA Issues for Public Comment Corporate Actions White Paper to Reduce Risk, Error and Costs for Intermediaries and Investors*, October 22, 2002, at 1.

in order to obtain entitlement information on a given security. Indeed, market participants in Canada must look to a range of sources in order to find entitlement information on a given security including: mailings from an issuer or their agent; announcements in newspapers; vendor data feeds; stock exchanges and the CSA System for Electronic Document Analysis and Retrieval (SEDAR) and System for Electronic Disclosure for Insiders (SEDI). According to the CCMA, the SEDAR and SEDI systems contain data on only 22 entitlement events out of a total of 65. To complicate the process even further, once entitlement information is received it must be interpreted and disseminated, received, understood and acted upon in a timely manner.[98]

The CCMA has requested that the CSA mandate the reporting of entitlement events by issuers or offerors in a standard format into a centralized hub.[99] The CCMA gave three reasons for this request. First, informed trading cannot occur without the parties to a trade being fully aware of impending corporate actions that may impact the price (e.g., when a security is subject to a call). Second, an entitlement hub will be critical if the U.S. and Canada decide to shorten the settlement cycle period to T+1. Third, Canada's global competitiveness may be compromised if entitlement processing is not improved.

The CCMA envisions entitlement reporting to a central *hub* in a field based format with reference numbers, supplemented by the ability of information providers to extract and disseminate the entitlement information from the field based format in the hub.[100] The creation of the hub would result in the electronic dissemination of all entitlement and corporate action information from issuers or offerors to beneficial holders, through intermediaries, via a central hub. Where elections from security holders are required, the hub would facilitate electronic communication of the election through intermediaries to the issuer's or offeror's transfer agent.[101]

2. CSA response

Current CSA rules governing continuous disclosure obligations and general requirements to communicate information to beneficial security holders[102] do not cover the entire scope of entitlement events that should be reported. We recognize that entitlement processing in Canada must be improved. However, there are a number of outstanding questions with respect to the CCMA's request that remain largely unanswered.[103] The CSA raised concerns about how compliance with the rule would be accomplished and at what cost. For example, what infrastructure is required to implement this proposal and who will be responsible for the start-up

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98 See letter from Tom MacMillan, Chair of the CCMA, dated July 18, 2003 to Stephen Sibold, Chair of the CSA; available on the CCMA Web site.

99 *Ibid.*

100 *Ibid.*

101 CCMA Best Practices and Standards White Paper, at 35.

102 Some corporate action events are subject to continuous disclosure and informational requirements under securities law, including the security holder communication procedures in National Instrument 54-101 *Communication with Beneficial Owners of Securities of a Reporting Issuer* and related Companion Policy. See (2002) 25 OSCB 3361.

103 See letter from Doug Hyndman, CSA Chair, dated November 28, 2002 to Tom MacMillan, Chair of the CCMA (available at http://www.osc.gov.on.ca/en/HotTopics/currentinfo/tplus1_csa-ccma-letter_20021220.html); and reply letter from Mr. MacMillan dated July 18, 2003 to Stephen Sibold, Chair of the CSA, available on the CCMA Web site.

costs and ongoing costs of this infrastructure? At this time, the CSA are not proposing to implement a rule to mandate the reporting of corporate actions, but will continue their dialogue with the CCMA to explore the options.[104] The CSA believe that the industry should provide a meaningful cost-benefit analysis to support the need for a rule and the development of a central hub.

Question 17: Should the CSA require the reporting of corporate actions into a centralized *hub*? If not, is it more appropriate for exchanges and other marketplaces to impose this requirement through listing or other requirements?
Who should pay for the development and maintenance of the central *hub*?

Question 18: Should the CSA wait until a *hub* has been developed by the industry before it imposes any requirements?

E. Payment of Entitlements Through the Large Value Transfer System

1. CCMA request for regulatory action

An entitlement payment is a payment made in respect of issued and outstanding securities to holders of such securities. Entitlement payments include interest payments made on debt securities, cash dividend payments or other similar distributions made on equity securities, payments made upon redemptions, repurchases, or maturities of securities, and payments made by offerors to take up securities under a take-over bid or other offer to purchase to a group of holders of securities.

According to the CCMA, the current method of payment of entitlements is inefficient, costly and poses a risk to CDS. Many issuers pay their entitlements by uncertified cheque or other forms of paper-based payment items. The problem with such payments is that there is no finality of payment, as they can be reversed if there are insufficient funds in the account on which the cheque or other paper-based item is drawn. If an entitlement payment is reversed, this could have a domino effect on other participants where the payment has already been used by the recipient to fund further investments or payments.

The CCMA believes that, in order to have finality of payment, issuers and offerors must make their entitlement payments in funds transmitted by the *Large Value Transfer System* or LVTS. LVTS, launched in 1999 by the CPA, is an electronic wire payment system that allows financial institutions and their customers to send large payments securely in real time, with complete

[104] In certain CSA jurisdictions, the authority to make a rule to require issuers and offerors to report entitlement events is not very clear. In December 2003, the CSA published in the context of its Uniform Securities Legislation (USL) Project a consultation draft of a *Uniform Securities Act* (USA). The USA expressly provides for rule-making authority to prescribe requirements to disseminate continuous disclosure and *other information* for security holders, including requirements in respect of *entitlement events*. See proposed s. 11.3(7)(ix) of the consultative draft USA (*CSA Notice and Request for Comment 11-404 Consultation Drafts of the Uniform Securities Act and the Model Administration Act* at (2004) 27 OSCB (Supp-1) and available on the OSC Web site at www.osc.gov.on.ca).

certainty that payment will settle.[105] The CPA has recently taken steps to migrate more large-value Canadian dollar payments to the LVTS in order to enhance the safety and soundness of Canada's payment system. A CPA rule change that became effective in August 2003 places a $25 million ceiling on cheques, bank drafts and other paper-based payments that can be processed through the Automated Clearing Settlement System (ACSS), effectively moving a significant number of large-value payments to the LVTS.

The CCMA requested that the CSA mandate the payment of corporate entitlements to depositories by using final irrevocable LVTS funds.[106] Essentially, the CCMA is requesting that a rule or regulation be adopted by securities regulators that would govern the method of cash payments made by an issuer or offeror, or any agent of an issuer or offeror, in respect of issued and outstanding securities. The rule would be limited to payments made to a *clearing agency* (or a nominee of the clearing agency[107]) as a registered or bearer holder of such securities. Payments made to other registered or bearer holders of such securities would presumably not be covered by the rule. The rule would require that payments to the clearing agency (or nominee) be made in funds transmitted by the CPA's LVTS by noon, Eastern Time, on payment date. In reality, such payments would be made through the payor's banker, who would likely be a direct LVTS clearer.

Although it is unclear from the CCMA's proposal, it is assumed that the scope of the rule would be limited to entitlement payments made in respect of securities issued by a *reporting issuer*.[108]

2. CSA response

We recognize the importance of using same-day, irrevocable final funds for payments into the CSD/CCP utility in Canada.[109] However, the securities regulatory authorities of most CSA jurisdictions may not have the authority to make a rule under current securities legislation to mandate the payment of corporate entitlements to clearing agencies in LVTS funds. For jurisdictions that do not have the rulemaking authority, it may be necessary to request from their applicable Ministry of Finance or other responsible ministry the enactment of a regulation, or

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[105] By 2001, the LVTS was processing an average of more than 14,000 payments a day totalling more than $100 billion. For more information on LVTS, see the Bank of Canada Web site at www.bank-banque-canada.ca/ and the CPA Web site at www.cdnpay.ca.

[106] Letter from Tom MacMillan, Chair of the CCMA, dated May 12, 2003, to Stephen Sibold, CSA Chair (the letter was in response to the questions on this matter in our November 28, 2002 letter to the CCMA), available on the CCMA Web site at www.ccma-acmc.ca.

[107] The bulk of registered securities deposited with CDS are registered in the name of CDS' nominee, CDS & Co.

[108] In fact, it would be unnecessary for the rule to apply in other cases. Most entitlement payments in respect of government securities or commercial paper are required to be processed by an *Entitlements Processor*, who must be a CDS participant appointed by the issuer as fiscal agent. See CDS rules 2.5.1 and 2.5.5. Since CDS participants are bound by the CDS rules, the Entitlements Processor is obliged to make such entitlement payments in LVTS funds.

[109] See CPSS-IOSCO report, at paras. 3.47 to 3.52. Recommendation 10: *Cash settlement assets* in the report states: "Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose."

cause a legislative amendment to the rule-making authority of the securities regulatory authority to address this area.[110]

Other options to address this area may include the following: (i) CDS could implement a rule or procedure that would effectively force all reporting issuers to agree to make their entitlement payments to CDS in LVTS funds before their securities are made eligible for deposit with CDS[111] and (ii) the CPA could amend its rules that currently restrict large value payments of $25 million or more through the ACSS by lowering the $25 million ceiling to, say, $5 or 1 million.

Question 19: Should the CSA require issuers and offerors to make their entitlement payments by means of the LVTS?

Question 20: If there is a CSA requirement to make entitlement payments in LVTS funds, should the requirement apply only to payments in excess of a certain minimum value? If so, what should that minimum value be?

F. Modifying Investment Fund Transaction Processing Rules

1. CCMA request for regulatory action

The CCMA believes several issues need to be addressed to fully transfer processing of investment fund transactions from a manual environment to an electronic environment. They relate to: (1) the *client name* model that generally prevails in the investment fund industry; (2) electronic standards; (3) and money movements. The CCMA RTPWG's key recommendations are to:

- automate the processing of client name accounts through the use of *Documentation Agreements* and electronic trades;

- increase the use of the *FundSERV Net Settlement Messaging* (N$M) service to transfer funds to settle investment fund transactions; and

- initiate transaction orders and rejects electronically on order date.[112]

These recommendations will streamline the processing and settlement of investment fund transactions among industry participants. To implement these recommendations, the CCMA is seeking specific legislative and regulatory changes, including amendments to the *Securities Act* of all the provinces, NI 81-102, OSC Policies 5.3 and 5.4 and ASC Policies 4.3 and 4.4.

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[110] The proposed USA expressly addresses this uncertainty. The USA permits the making of rules to prescribe "the methods by which cash entitlement payments may be made to a recognized clearing agency or nominee of it as registered or bearer holder of securities issued by a reporting issuer". See proposed s. 11.3(18) of the consultation draft USA.

[111] CDS has suggested that this option is undesirable because it may have the unintended effect of discouraging immobilization of securities and increasing risk in the clearing and settlement system.

[112] See RTPWG White Paper Addendum, at ii-iv.

(i) Client name issues

Today, it is estimated that 25 to 40 per cent of Canadian investment fund accounts are held in client name.[113] There are three major impediments to the processing of client name business in an STP environment:

1. *Reliance on receipt of documentation by fund companies to initiate or complete processing for the majority of transactions.* The documentation signed by the client is required because the securities are recorded as being held directly by the investor on the fund company records (client name).

2. *The practice of sending transactions directly to the fund company for processing as direct trades.* This is done because the distributor of a particular fund company does not support the placement of the order electronically or the distributor chooses to place the order manually simply because it is their business practice.

3. *Distributors send physical cheques to the fund companies for settlement.* The main reason for this is that some distributors do not have trust accounts or do not transmit funds electronically.

The RTPWG suggests that client name processing must become electronic[114] and that documentation exchanged between dealer and fund company must be minimized and, where possible, eliminated through the development and implementation of so called *Documentation Agreements*. According to the RTPWG, Documentation Agreements would allow the distributor to maintain the documentation on behalf of the fund company for transactions involving minimum liability and risk to the fund company, the fund or the client. However, this raises questions about the liability of the fund issuer in case of errors or fraudulent transactions, and its reluctance to rely on dealer indemnifications. The RTPWG suggests that under current provincial securities legislation, it is unclear *who owns the client*. At present, an advisor on a *front load* purchase acts as an agent for an investor. In contrast to *front load*, in *deferred load* purchases the advisor acts as an agent for the company. The RTPWG proposes that the advisor should always be seen as acting as the agent for the investor.

(ii) Electronic standards

The CCMA believes all transaction orders and rejects should take place electronically on the date the order takes place at the distributor in order to facilitate STP requirements. Fund companies

[113] The prevalence of the *client name* model in the mutual fund industry may be partially due to the fact that most mutual fund dealers in Canada are currently not participating in an adequate investor protection coverage plan, similar to the Canadian Investor Protection Fund (CIPF). CIPF covers investors holding securities and cash through an investment dealer up to a maximum of $1,000,000 per account for any combination of cash and securities. We understand that the MFDA is presently considering various alternatives for establishing a similar investor protection fund company. It is anticipated that it will cover customer's losses of mutual fund securities and cash balances that result from the insolvency of a MFDA member, up to a coverage limit of $100,000 per customer or customer account or accounts.

[114] RTPWG White Paper Addendum, at 25.

must use the correct error code to reject a transaction to support timely correction and processing of the trade.

Most of the legislative or regulatory amendments in this area deal with such practical matters as altering the definition of *security* in securities legislation (to include references to the intangible *interest* in securities and not just the physical embodiments of securities, such as certificates, instruments and other title documents), avoiding the reliance on physical securities certificates, and removing the delivery requirements of originating trade documents from distributor to fund company.

(a) altering the definition of *security*

The definition of *security* in the Ontario, Alberta and British Columbia *Securities Acts* may need to be amended since the structure and terminology in the various Acts focus more on the form of evidence of a security ("document, instrument or writing commonly known as a security") than on the underlying interest itself. The focus of the definition would need to be shifted equally towards the underlying interest itself.[115]

(b) avoiding reliance on physical certificates

In Ontario and Alberta, holders of units of non-redeemable income investment trusts and partnerships have a right to receive certificates evidencing their holdings. In order to achieve the *elimination of paper* objective, this right to receive the physical certificates would have to be altered. This would require an amendment to OSC Policies 5.3 and 5.4 and ASC Policies 4.3 and 4.4 by eliminating the requirement that the holders of units of *closed end* income investment trusts and partnerships are entitled to receive certificates evidencing their holdings. [116]

(c) removing delivery requirements

As stated above, in order to move to an STP environment, all transaction orders and rejects should take place electronically on the date the order takes place to facilitate STP.

Under NI 81-102, purchase orders may be sent to the dealers by same or next day courier or priority mail. Purchase orders would need to be made electronically in order to eliminate this reliance on paper. Similarly, redemption orders would need to be made by electronic means.

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[115] The USA defines *security* to include an "*interest,* record, share, unit or writing commonly known as a security." See proposed s. 1.2 of the consultation draft USA.

[116] In addition, the CCMA identified the previous version of Multilateral Instrument 45-102 *Resale of Securities* as a barrier to STP because its legend requirements in effect required certification, thus forcing the use of paper certificates. The CSA subsequently released for public comment a revised Multilateral Instrument 45-102 *Resale of Securities* (New MI 45-102) on March 30, 2003, but did not address the legend issue. During the comment process, the CCMA suggested in a letter dated May 2, 2003 that the certification requirements in New MI 45-102, as initially published for comment, would create severe problems for STP and moving to a shorter settlement cycle should the Canadian industry decide to move to T+1. The CCMA suggested that DRS systems and nominee name book-entry options are an effective alternative to certification. In response to the comments received from the CCMA and other industry participants, the CSA broadened the language in section 2.5(2) of New MI-45-102 to accommodate electronic alternatives (including DRS or other electronic book-entry systems) to a paper certificate with a legend. New MI 45-102 was implemented on March 30, 2004 as a rule in British Columbia, Alberta, Manitoba, Ontario, Prince Edward Island, Nova Scotia, Newfoundland and Labrador; a commission regulation in Saskatchewan; and a policy or code in New Brunswick, the Northwest Territories, Nunavut and the Yukon. New MI 45-102 was not adopted in Quebec.

Sections 9.1(1), 9.1(2), 10.2(1) and 10.2 (2) of NI 81-102 need to be amended to remove all references to same or next day courier or priority post. It may also be necessary to eventually amend sections 9.4(1) and 9.4(2) of NI 81-102 to shorten the current processing cycle of an investment fund transaction.[117]

(iii) Money movement

According to the CCMA, the use of physical cheques in retail transactions must be greatly reduced and ultimately eliminated in order to move to an STP environment. FundSERV's N$M service is seen as the most effective means to transmit funds supporting mutual fund trades. The RTPWG recommends consideration of the following two options to address those dealers unable to meet the minimum N$M participation requirements (both designs are based on the dealer's acceptance, verification and keying of an investor's banking information at point-of-sale):

1. Send the transaction order directly to the fund company for complete processing.

2. Send the transaction order to FundSERV, where banking information is routed to the financial institution for confirmation, the order (without banking information) is sent to the fund company for processing, and funds are netted at FundSERV and forwarded to the fund company.

Unless prohibited under SRO rules and provincial securities regulation, the use of trust accounts by dealers as set out in section 11.3 of NI 81-102 may also facilitate the money movement process.

2. CSA response

The CSA generally support the CCMA's STP initiatives for investment fund transaction processing, and will publish for comment in the near future proposed technical amendments to NI 81-102 and CP 81-102CP to facilitate the processing of investment fund transactions on a STP basis.[118] In addition, the OSC and ASC propose to amend OSC Policies 5.3 and 5.4 and ASC Policies 4.3 and 4.4 to remove the requirement for certain unincorporated closed-end investment funds to issue certificates to their security holders.

We agree with the CCMA that the retail securities market, specifically investment funds, must move towards STP to reduce risk and complexity of this market and avoid a loss of business while other segments of the market are settling transactions more rapidly. However, institutional trade processing is the current focus of regulatory action because it involves issues of a systemic nature. For the most part, the investment fund industry in Canada operates in a closed market. With a few exceptions, such as exchange traded funds, Canadian investors may

[117] We may also need to consider amending section 9.2 of NI 81-102 relating to initial trade rejections and section 7.2 of National Instrument 81-104 (Calculation of net asset value (NAV)).

[118] The Autorité des marchés financiers (Québec) emphasizes that, in Quebec, it may not be possible to impose a requirement that all transaction orders and rejects take place electronically under the current *Act to establish a legal framework for information technology* (Quebec).

only purchase Canadian funds that meet Canadian regulatory standards. There is less impetus for the investment fund industry to move to STP since it does not interact with other markets. The failure of a distributor or a mutual fund company would not necessarily spread to other market participants or market segments.

The investment funds industry in Canada also does not operate using a CSD/CCP. The distributors of non-exchange traded investment funds deal directly with the investment fund managers. With this business model, and the fact that approximately 40 per-cent of all transactions are manual, there remains a significant gap in achieving STP in the investment funds industry.

We support the industry's preference to maintain the client name model as an option for investors to hold their investment fund securities. Even in the equity and debt securities markets, where a vast majority of investors hold their securities in nominee name, investors have the option to hold or own their securities directly in client name with the issuer, whether in certificated or uncertificated form. Removing the ability of investors to hold or own their securities in a direct legal relationship with the fund issuer, and forcing them to hold or own their securities in nominee name only, would remove the investor's freedom to choose how to hold his or her personal investments.

The CSA propose to carefully review whether the use of Documentation Agreements and electronic payment processes will cause any investor protection or market efficiency concerns under securities regulatory law. We urge the industry to also carefully consider any implications under commercial, insolvency and privacy law with the use of Documentation Agreements and electronic alternatives for all market participants, particularly investors and fund companies.

Question 21: Should the CSA consider implementing any additional rules to encourage and facilitate the investment funds industry to move towards an STP business model? If so, what issues should be addressed by the CSA?

G. Immobilization and Dematerialization of Physical Securities

Ownership of securities has traditionally been evidenced by the possession of physical certificates. Physical certificates have also been used to record restrictions on trading of securities. Gradually, over the past several decades, there has been a movement towards using the electronic medium, particularly the *immobilization* of securities and the use of the indirect holding system, as a substitute to holding physical certificates. The DWG has identified a number of problems with the continued use of physical securities, including unnecessary costs resulting from the issuance, safekeeping, transfer and delivery of physical securities, and the costs associated with fraud and forgery.[119] The U.S. Securities Industry Association (SIA) has concluded that, in the U.S., the complete elimination of physical certificates for securities could save market participants more than U.S.$200 million annually.[120]

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[119] DWG White Paper Addendum, at i.

[120] See SIA letters dated March 24 and August 20, 2003 to the SEC's Division of Market Regulation regarding the immobilization and dematerialization of physical securities (SIA Letters to SEC re: Certificates); available on the Web site of the SIA at www.sia.com/stp/pdf/PhysSecCostAnalysis.pdf.

As noted above, most problems associated with physical certificates in Canada have been alleviated through immobilization of securities with a central securities depository, such that they are transferred electronically by book-entries on the records of the central securities depository, the participants of the central securities depository, and other intermediaries further down the chain of the indirect holding system.[121] The majority of trades in Canada today do not involve physical certificates—less than 0.03 per-cent of the value of trades originates with physical securities.[122] Despite that, according to the DWG "there are approximately 20 to 30 million certificates held by over five million investors holding in excess of $200 billion that are still held in physical form".[123]

The concept of the complete elimination of physical certificates is referred to as *dematerialization*. It is important to emphasize the distinction between dematerialization and immobilization.[124] While immobilization merely reduces the physical *movement* of certificates, dematerialization refers to the *elimination* of physical certificates entirely. Dematerialization is claimed by its proponents to be one of the main ways in which efficiency in the industry can be increased. This is a particularly relevant and important consideration within the context of STP in Canada.

1. CCMA request

As noted in Part II, the SIA and the CCMA announced in 2002 that they would focus on implementing STP before trying to implement T+1. In response to this shift in focus, the CCMA stated:

> While dematerialization of certificates was not critical to achieving T+1 settlement of institutional and retail transactions, it is critical to truly achieving straight-through processing as the handling of paper securities is by its nature manual, with the associated risks and costs that manual handling implies. Moreover, dematerialization of securities supports industry-wide STP of trading and settlement and contributes to the competitiveness of Canadian capital markets.[125]

Both the CCMA and SIA are promoting the advantages of dematerialization. However, the SIA appears to be pushing towards *complete* dematerialization[126] of securities issued by public corporations incorporated in those U.S. states that currently do not permit it (e.g. Delaware),[127] while the CCMA's recommendations to reform provincial company legislation do not go so far

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121 In Canada, physical certificates would be held by or on behalf of, or uncertificated securities would be registered in the name of, CDS & Co., a nominee of CDS. See the CSA USTA Consultation Paper, at 16.

122 DWG White Paper, at 2.

123 DWG White Paper Addendum, at 9.

124 For a description of the distinction between the *immobilization* and *dematerialization* of securities, see CSA USTA Consultation Paper, at 19-20.

125 DWG White Paper Addendum, at ii.

126 Complete dematerialization means that a security holder would not be entitled to request a certificate to evidence his or her securities of the issuer.

127 See the SIA Letters to SEC re: Certificates.

as to recommend removing the right of an individual to request a physical certificate from a corporate issuer.[128]

The DWG is advocating the creation of DRS systems in Canada. A DRS is a system that enables an investor to electronically move its securities held in direct registration and uncertificated form back and forth between the issuer (or transfer agent) and the investor's dealer. A DRS provides an investor with a third alternative method of holding or owning securities.[129] Essentially, Canadian DRS systems operated by transfer agents would allow investors to register eligible securities electronically directly with the transfer agent.[130] In the DWG White Paper Addendum, the CCMA states that the DRS is a suitable solution for efficient electronic *alternative to nominee registration*.[131]

2. CSA response

Greater immobilization and the move to dematerialization of publicly traded securities are consistent with international standards[132] and should be encouraged. We believe the Proposed Instrument will encourage market participants to further immobilize physical securities,[133] although at this time we do not propose to require all new issues of publicly traded securities to be made depository eligible.[134] The CPSS-IOSCO report suggests that investors that insist on holding certificates should bear the costs of their decisions.[135]

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[128] Not all provinces have corporate law provisions similar to section 54 of the *Business Corporations Act* (Ontario) and section 49 of the *Canada Business Corporations Act*, which expressly allow corporations to issue to a security holder a *non-transferable written acknowledgement* of the holder's ownership of securities of the company (the holder always has the right to obtain a certificate upon request). The CCMA is lobbying to reform certain provincial company law statutes that currently do not expressly permit security holders to own their securities in *uncertificated* form. In late 2003, the Province of British Columbia passed a new provincial *Business Corporations Act* to replace the existing B.C. *Company Act*. Section 107 of the new Act allows a B.C. incorporated company to issue *non-transferable written acknowledgements* instead of certificates. The new legislation came into force on March 29, 2004. With respect to reform of company law statutes in Quebec, Prince Edward Island and New Brunswick, see CCMA letters, respectively, to (i) the Minister of Finance, Government of Quebec, dated December 12, 2003, (ii) the Director, Consumer, Corporate and Insurance Division, Government of P.E.I., dated October 28, 2003, and (iii) the Director, Corporate Affairs, Government of New Brunswick, dated October 16, 2003; available on the CCMA Web site.

[129] The other two methods are (i) holding a physical certificate or (i) holding securities in *street name* or nominee name book-entry form through an account maintained on the investor's behalf by a securities intermediary—the indirect holding system.

[130] In the U.S, DTCC would expand its central DRS, while in Canada, each transfer agent proposes to operate an independent DRS.

[131] DWG White Paper Addendum, at 26.

[132] See CPSS-IOSCO report, at paras. 3.27 to 3.31. Recommendation 6: *Central securities depositories (CSDs)* in the report states: "Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible".

[133] See Section 5.2 of the Proposed Instrument.

[134] All new issues of publicly traded securities in the U.S. must be made depository eligible. See SEC Order Approving on an Accelerated Basis Changes Regarding Depository Eligibility Requirements, Exchange Act Release No. 34,35798, 60 Fed. Reg. 30909 (1995) (order approving self-regulatory organization rules on new issue depository eligibility), as cited in J.S. Rogers, "Policy Perspectives on Revised U.C.C. Article 8", (1996) 43 U.C.L.A. Rev. 1431, at 1445.

[135] CPSS-IOSCO report, at para. 3.31.

Question 22: Should the CSA develop rules that require the immobilization and, to the extent permitted by corporate and other law, dematerialization of publicly traded securities in Canada?

Like other critical infrastructure systems involved in the clearing and settlement of securities transactions and the safeguarding of securities, the CSA believe DRS systems operating in Canada raise certain regulatory concerns. Transfer agent operated book-entry systems, including DRS systems, pose different and potentially increased risks to investors. For example, increased reliance on the records of transfer agents may place additional burdens on transfer agents and could increase the risks to investors arising from substandard transfer agent systems and performance. The evidence of legal ownership of uncertificated securities for a wide spectrum of investors who wish to hold their securities directly from the issuer (the direct holding system) would rest largely on the systems operated or used by transfer agents. To the extent that transfer agents in Canada operate or use DRS systems or other transfer agent operated systems in the Canadian capital markets, the CSA propose that such systems be subject to minimal oversight by the regulators.[136] We propose to require such transfer agent-operated systems to be approved by the regulators and subject to oversight, including compliance with the OSC's ARP.[137]

Question 23: To the extent DRS systems operate in Canada, should a securities regulatory authority regulate transfer agents that are operating or using such DRS systems?

Question 24: Should there be separate DRS systems and should they be required to be inter-operable?

3. CSA USTA project

A critical factor in supporting further immobilization and dematerialization of securities in the marketplace is the need to modernize in Canada the commercial law rules that govern the property rights that exist whenever securities are bought, sold, or used as collateral. Current Canadian law is out of date and fundamentally flawed in several ways. First, it fails to deal adequately with modern securities market practices, particularly the holding and transfer of securities through the indirect holding system.[138] Second, it is found in a confusing array of

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[136] The USA expressly provides for rule-making authority to regulate "... any person that operates a system or network of systems used by market participants for the clearance and settlement of securities transactions, the maintenance of securities accounts, and the safeguarding of securities, including, without limitation, any system or network of systems operated or used by, (i) a transfer agent and registrar for securities of a reporting issuer for the registration of transfer of uncertificated securities and the recording of ownership and safeguarding of those securities, and (ii) a dealer, adviser and custodian for the clearance and settlement of securities transactions, the maintenance of securities accounts, and the safeguarding of securities." See proposed s. 11.3(17) of the consultative draft USA.

[137] In the U.S., section 17A of the 34 Act requires a transfer agent to register with the SEC or a bank regulatory agency. Transfer agents also must comply with detailed SEC regulations. See SEC Rules 17Ab2-1 to 17Ad-21T. The SEC rules address such matters as the timely issuance and cancellation of certificates, record-keeping practices, and the safeguarding of securities and cash. In addition, the SEC regulates the DRS operated by DTCC for some 600 issuers and their transfer agents as part of its mandate to promote an efficient and safe national securities settlement system.

[138] It is also ill prepared to support full dematerialization of securities and DRS systems because current rules are inadequate to govern the direct holding, transfer and pledging of uncertificated securities.

provincial and federal statutes that do not cover the entire scope of securities traded in the markets. Third, in stark contrast to the United States where all 50 states have enacted commercial law on a uniform word-for-word basis, it is non-uniform throughout Canada.

On August 1, 2003 the CSA released for public comment a comprehensive proposal to modernize Canadian commercial and property-transfer law governing the holding, transfer, and pledging of securities. The proposal consists of several documents, including a consultative draft of a provincial *Uniform Securities Transfer Act* (USTA) with detailed Comments,[139] modeled on Revised Article 8 of the U.S. Uniform Commercial Code. The CCMA and the industry in general are seeking the implementation in Canada of modern uniform legislation like the USTA to improve the legal framework supporting the Canadian securities clearing and settlement system. The USTA proposal was developed by a Task Force of the CSA as a joint project with the Uniform Law Conference of Canada.

H. Securities Lending

1. CCMA's request

The SLWG defines securities lending as the temporary loan of securities for cash, or other near-cash assets of an equivalent or greater value, for collateral purposes, with a contractual obligation to re-deliver a like quantity of the same securities at a future date.[140]

The SLWG identified significant challenges in their white paper with current securities lending market practices, including the use of manual processes and reliance on paper (e.g., currently approximately 99 per-cent of loans recalled by lenders are communicated by fax and phone—an error prone and inefficient process)[141]. The SLWG also identified as problems, incomplete standards and best market practices, the lack of incentives and compliance mechanisms, and inconsistent rules and regulations among Canadian jurisdictions. Furthermore, no single body brings borrowers and lenders together to facilitate improvements in securities lending transactions.[142]

The SLWG recommended a number of solutions to improve securities lending processing. They suggest removing manual and paper-based steps, identifying and agreeing on desirable standards and market practices, ensuring an effective legal regulatory framework, promoting communications among industry stakeholders, and working to harmonize where possible with the U.S.[143]

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139 The USTA proposal also includes proposed conforming amendments to Ontario and Alberta Business Corporation Acts and Personal Property Security Acts, a Consultation Paper, and tables of concordance. For more information on the USTA proposal, see *Canadian Securities Administrators' Uniform Securities Transfer Act Task Force-Invitation for Comments Notice*, (2003) 26 OSCB 5819. The notice and materials are available on the OSC Website at http://www.osc.gov.on.ca/en/HotTopics/usta.html#open.

140 SLWG White Paper, at iv.

141 *Ibid*., at v.

142 *Ibid.*, at v and vi.

143 *Ibid*., at vi.

2. CSA response

At this time no regulatory action is being requested, so the CSA will focus its role on monitoring developments in this area. We note, however, that international minimum standards suggest that impediments to the development and functioning of securities lending markets should, as far as possible, be removed.[144] We believe this includes the need to promote the automation of the processing of securities lending transactions, possibly even encouraging the development of centralized lending facilities in the Canadian capital markets.[145]

I. Protection of Customer Assets in the Indirect Holding System

Dealers and custodians holding securities in custody for investors must have appropriate accounting and safekeeping procedures and robust systems to safeguard securities.[146] While not directly addressed by the industry's STP initiatives, we highlight this issue because of the growing reliance on book-entry ownership systems to evidence property interests in securities and the emphasis on furthering the immobilization and dematerialization of securities. We have already discussed our concerns with unregulated DRS systems operating in Canada in the context of the direct holding system.

While certain regulations exist under current Canadian securities legislation governing the segregation of funds and securities held by dealers,[147] there are no comprehensive CSA rules that are substantively comparable to the SEC rules in the U.S. on segregation of customer assets.[148] Comparable Canadian regulatory provisions dealing with the segregation of fully paid or excess margin securities and the segregation of funds are found in SRO rules.[149] The basic element of an appropriate segregation rule is that a dealer or other securities intermediary must promptly obtain and thereafter maintain all fully-paid and excess margin securities carried for the account of customers.[150] Dealers and other intermediaries should be required to verify on a daily basis the securities required to be segregated according to established procedures. In the event that a segregation deficiency exists, including securities purchased but not delivered within a certain period of time, then the dealer must promptly take steps to obtain such securities through a buy-in procedure or otherwise.[151]

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144 CPSS-IOSCO report, at para. 3.24.

145 *Ibid*.

146 See CPSS-IOSCO report Recommendation 12: Protection of customers' securities: "Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors."

147 See, for example, Regulations 116 to 122, R.R.O. 1990, Reg. 1015, enacted under the OSA. However, pursuant to Regulation 122, these provisions may not be applicable to SRO members.

148 For example, see SEC Rule 15c3-3 (also known as the *Customer Protection Rule*).

149 See, for example, IDA By-Law 17.3, Regulation 1200 *Clients' Free Credit Balances*, and Regulation 2000 *Segregation Requirements.*

150 See, in the U.S., § (b)(1) of 17 CFR 240.15c3-3 and, in Canada, IDA By-laws 17.3, 17.3A and 17.3B. This obligation is met by holding securities either directly (physical possession or direct registration on the issuer's register) or indirectly (through securities accounts maintained with upper-tier intermediaries, including a clearing agency).

151 See, in the U.S., § (d)(2) of 17 CFR 240.15c3-3 and, in Canada, IDA Regulation 2000.9.

Generally, in view of the greater reliance on securities intermediaries to hold securities, we believe it may be appropriate at this time to consider the role of the CSA to develop comprehensive rules governing the segregation of funds and securities by dealers and custodians involved in holding securities in the clearing and settlement system. Such rules would form part of provincial securities legislation, would complement existing federal bankruptcy and insolvency rules governing dealer insolvencies,[152] may enhance the operation of investor protection fund schemes like the Canadian Investor Protection Fund,[153] and may generally enhance the overall safety and efficiency of the Canadian securities clearing and settlement system. International standards suggest that it is important for domestic regulatory and supervisory authorities to enforce effective segregation of customer assets by securities intermediaries.[154]

In addition, like our proposal to oversee the use of DRS systems, it may be appropriate for such rules to provide for some oversight by the CSA of the systems used or operated by dealers and custodians for the clearance and settlement of securities transactions, the maintenance of securities accounts, and the safeguarding of securities.[155]

Question 25: Is it sufficient for the Canadian capital markets to rely solely on existing SRO segregation rules? Or, given the growing reliance on the indirect holding system, should the CSA consider an active role in developing comprehensive rules on segregation of customer assets?

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[152] See Part XII of the *Bankruptcy and Insolvency Act* (Canada).

[153] CIPF covers investors up to a maximum of Cdn$1,000,000 per account for any combination of cash and securities, which appears to compare favourably with the U.S. Securities Investor Protection Corporation (SIPC). We understand that SIPC covers up to U.S.$500,000 in assets, but imposes a limit of up to $100,000 for cash. As a result, it is possible that the risk of holding a credit balance in a securities account maintained with a Canadian dealer is less than that with a U.S. broker-dealer.

[154] See CPSS-IOSCO report, at para. 3.62.

[155] The USA expressly provides for rule-making authority in this area. See proposed s. 11.3(17)(ii) of the consultation draft USA. It should be noted that the systems of CSD/CCP utilities in Canada, such as those of CDS, are already subject to rigorous regulation and oversight.

PART IV: CONCLUSION AND REQUEST FOR COMMENTS

As noted in this Paper, the continued success of Canada's capital markets depends on the ability of our markets to compete on a global scale. In order to compete globally, we must improve the clearing and settlement process in Canada, including improvements to operational systems and processes and reforms to applicable laws and regulation. The implementation of STP will achieve the key objectives of reducing firm and systemic risk as well as improving the operational efficiency of our securities clearing and settlement system.

Implementing STP on an industry-wide basis will require changing business processes, identifying common technology, setting standards, and building interfaces and utilities.

The CSA surveys have raised concerns about the degree of STP preparation and readiness of market participants. Market participants are reluctant to invest in upgrading back-office systems and improving processes without industry co-ordination because it is difficult to justify the investment solely on an individual return-on-investment basis. The decision to invest will make sense if all market participants make a concerted effort to act together. We believe that market participants will be prepared to invest in and implement STP within their firms with the proposals set out in this Paper.

The CSA agree that it is necessary to take regulatory action and, with the Proposed Instrument, propose to require dealers and institutional investors to match institutional trades as soon as practicable after a trade is executed, and in any event no later than the close of business on T. The purpose of the Proposed Instrument is to provide a framework in provincial securities legislation for ensuring more efficient post-trade processing of trades in publicly traded securities.

Achieving industry-wide STP by mid-2005 is a lengthy and complex undertaking that will likely not be achieved unless market participants are already expending time, resources and effort. All market participants and regulators must work together to implement STP in Canada by mid-2005.

You are encouraged to comment on any aspect of the Paper, the Proposed Instrument and Companion Policy. In particular, you are asked to respond or otherwise comment on the specific questions set out in the Paper and reproduced below. Your submissions should be sent in accordance with the instructions set forth in the accompanying notice published by each CSA jurisdiction with the Paper.

Question 1: If the CSA were to implement mandatory STP readiness certificates, what should be the subject matter of such certificates?

Question 2: Is it important to the competitiveness of the Canadian capital markets to reach STP at the same time as the U.S.? Please provide reasons for your answer. Are there any factors or challenges unique to the Canadian capital markets?

Question 3: Should it be one of the CCMA's tasks to identify the critical path to reach specific STP goals? If so, what steps and goals should be included?

Question 4: Should the CSA require market participants to match institutional trades on trade date? Would amending SRO rules to require trade matching on T be more effective than the Proposed Instrument? Is the effective date of July 1, 2005 achievable?

Question 5: Is a close of business definition required? If so, what time should be designated as close of business?

Question 6: Should the Proposed Instrument expressly identify and require matching of each trade data element, or is it sufficient for the Proposed Instrument to impose a general requirement to match on T and rely on industry best practices and standards to address the details?

Question 7: Should the CSA rely on the best practices and standards established by the CCMA ITPWG?

Question 8: The CSA seek comments on the scope of the Proposed Instrument. Have we captured the appropriate transactions and types of securities that should be governed by requirements to effect trade comparison and matching by the end of T and settlement by the end of T+3? Have we appropriately limited the rule to *public* secondary market trades?

Question 9: Is the contractual method the most feasible way to ensure that all or substantially all of the *buy side* of the industry will match their trades by the end of T?

Question 10: Should an exception to the requirement to match a trade on T be allowed when parties are unable to agree to trade details before the end of T and are required, as a result, to correct the trade data elements before matching?

Question 11: Should registrants be required to report all exceptions from matching by the close of business on T? If so, who should receive the report (e.g. recognized clearing agency, SROs, and/or securities regulatory authorities)?

Question 12: Is it necessary to mandate the use of a *matching service utility* in Canada? If so, how would the appropriate centralized trade matching system be identified? Are there institutional investors or investment managers that may not benefit from being forced into an automated centralized trade matching system? Can STP trade matching be achieved without a matching service utility?

Question 13: Should the scope of functions of a matching service utility be broader?

Question 14: Are the filing and reporting requirements set out in the Proposed Instrument for a matching service utility sufficient, or should a matching service utility be required to be recognized as a clearing agency under provincial securities legislation?

Question 15: Can the Canadian capital markets support more than one matching service utility? If so, what should be the inter-operability requirements?

Question 16: Should the CSA mandate a T+3 settlement cycle? Should the CSA mandate a T+1 settlement cycle when the U.S. moves to T+1 and the SEC amends its T+3 Rule?

Question 17: Should the CSA require the reporting of corporate actions into a centralized *hub*? If not, is it more appropriate for exchanges and other marketplaces to impose this requirement through listing or other requirements? Who should pay for the development and maintenance of the central *hub*?

Question 18: Should the CSA wait until a *hub* has been developed by the industry before it imposes any requirements?

Question 19: Should the CSA require issuers and offerors to make their entitlement payments by means of the LVTS?

Question 20: If there is a CSA requirement to make entitlement payments in LVTS funds, should the requirement apply only to payments in excess of a certain minimum value? If so, what should that minimum value be?

Question 21: Should the CSA consider implementing any additional rules to encourage and facilitate the investment funds industry to move towards an STP business model? If so, what issues should be addressed by the CSA?

Question 22: Should the CSA develop rules that require the immobilization and, to the extent permitted by corporate and other law, dematerialization of publicly traded securities in Canada?

Question 23: To the extent DRS systems operate in Canada, should a securities regulatory authority regulate transfer agents that are operating or using such DRS systems?

Question 24: Should there be separate DRS systems and should they be required to be inter-operable?

Question 25: Is it sufficient for the Canadian capital markets to rely solely on existing SRO segregation rules? Or, given the growing reliance on the indirect holding system, should the CSA consider an active role in developing comprehensive rules on segregation of customer assets?