



## NOTICE TO MEMBERS

No. 2005 - 055

June 16, 2005

### **REQUEST FOR COMMENTS**

### **CLEARING OF OVER-THE-COUNTER ENERGY DERIVATIVE CONTRACTS**

### **AMENDMENTS TO CDCC'S RULES**

#### **Summary**

The Canadian Derivatives Clearing Corporation (CDCC) intends to provide central counterparty and clearing services for over-the-counter (OTC) energy derivative transactions occurring on Acceptable Marketplaces. This project necessitates substantial changes to CDCC's Rules and more particularly the introduction of a new Part D – Over-The-Counter Derivative Instruments, as well as numerous amendments to the general Part A. The purpose of this analysis is to provide explanations and justifications to such amendments.

The proposed amendments to CDCC's Rules have the following objectives:

- i) Provide the necessary structure in order for CDCC to offer central counterparty services for participants that transact on Acceptable Marketplaces.
- ii) Adapt existing CDCC Rules in order for them to be applicable to OTC energy derivative transactions. This objective is met by first, generalizing certain provisions that were specific to exchange-traded transactions and second, by creating a new section which addresses specific legal, operational and risk management issues related to OTC energy derivatives clearing.

#### **Process for Changes to the Rules**

CDCC is a recognized self-regulatory organization (SRO) by the Autorité des marchés financiers (the Autorité) and as such, carries on activities as a clearing house and as a SRO in Québec.



The Board of Directors of CDCC has the power to approve the adoption or amendment of Rules of CDCC. The amendments are submitted to the Autorité for approval.

As the proposed amendments to CDCC's Rules are substantial, CDCC has agreed on a voluntary and exceptional basis to submit the amendments to a public consultation process. Therefore, comments on the proposed amendments to CDCC's Rules must be submitted within 60 days following the date of publication of this notice in the bulletin of the Autorité. Please submit your comments to :

*Ms. Joëlle Saint-Arnault*  
*Secretary*  
*Canadian Derivatives Clearing Corporation*  
*Tour de la Bourse*  
*P.O. Box 61, 800 Victoria Square*  
*Montréal, Quebec H4Z 1A9*  
*E-mail : [legal@m-x.ca](mailto:legal@m-x.ca)*

A copy of these comments shall also be forwarded to the Autorité to :

*Ms. Anne-Marie Beaudoin*  
*Director – Secretariat of L'Autorité*  
*Autorité des marchés financiers*  
*800 Victoria Square, 22<sup>nd</sup> Floor*  
*P.O. Box 246, Tour de la Bourse*  
*Montréal, Quebec H4Z 1G3*  
*E-mail : [consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)*

## **Appendices**

For your information, you will find below an analysis document of the proposed rule amendments, the proposed regulatory text as Appendix 1 as well as the risk model document as Appendix 2 (will be available shortly in English on the website). The implementation date of the proposed amendments will be determined following approval by the Autorité des marchés financiers.

# **CLEARING OF OVER-THE-COUNTER ENERGY DERIVATIVE CONTRACTS – PROPOSED CHANGES TO THE RULES OF THE CANADIAN DERIVATIVES CLEARING CORPORATION (CDCC)**

## **A – Proposed Amendments to the Rules**

CDCC intends to provide central counterparty and clearing services for OTC energy derivative transactions occurring on Acceptable Marketplaces. This project necessitates substantial changes to CDCC's Rules and more particularly the introduction of a new Part D – Over-The-Counter Derivative Instruments, as well as numerous amendments to the general Part A and necessary adjustments to Part B (Options) and Part C (Futures). The purpose of this analysis is to provide explanations and justifications to such amendments.

## **B – Rationale**

The rationale for these amendments is to provide central counterparty services to a market that is currently hindered due to a lack of a viable credit solution. A central counterparty platform would promote trading opportunities thereby, fostering more efficiency and price transparency in a market that is of increasing importance.

## **C – Objectives**

The proposed amendments to CDCC's Rules have the following objectives:

- I. Provide the necessary structure in order for CDCC to offer central counterparty services for participants that transact on Acceptable Marketplaces.
- II. Adapt CDCC Rules in order for them to be applicable to OTC and energy derivative transactions. This objective is met by first, generalizing certain provisions that were specific to exchange-traded transactions and second, by creating a new section which addresses specific legal, operational and risk management issues related to OTC energy derivatives clearing.

## **D – Impact of the Proposed Rules**

Membership requirements have not been expanded but the requirements for clearing members to remain conforming have been adjusted to ensure that clearing members remain in good standing with those entities involved in the delivery process.

The current margin fund methodology was expanded to include OTC derivative (OTC DI) transactions on energy. CDCC members wishing to clear energy contracts will be required to supply specific base deposits related to OTC transactions.

CDCC has taken the opportunity to improve the clearing fund requirement calculation. The current method is a volume-based approach which penalizes clearing members who transact a large number of contracts. The proposed method which is a risk-based approach will subject member portfolios to stress scenarios thus focusing the majority of the clearing fund requirement on those members which introduce the highest levels of residual risk to the clearinghouse.

## **E – Detailed justification of amendments to the Rules of CDCC**

### **Notes to reader:**

1. Various definitions were included throughout the Rules as a means of capturing all elements of OTC DI transactions. These newly created definitions will be described in the sections of this document where they first appear.

### **Part A**

#### **Overview:**

- Section A outlines the Rules that are applicable to all transactions deemed acceptable by the corporation for clearing. Section A can be viewed as generic to all transactions. The changes made to this section involved certain clarifications or updates as well as the creation of new terms meant to capture exchange-traded and over-the-counter derivative instruments.

### **Rule A-1: Definitions**

See Note to reader 1.

### **Rule A-1A: Membership in the Corporation**

#### **Section A-1A01: Eligibility for Membership**

- Includes membership criteria for those Clearing Members that choose to clear physically settled OTC DI transactions.
- This amendment is similar to the current requirement of Clearing Members to remain in good standing with the Canadian Depository for Securities (CDS).
- In the case of OTC DI transactions which are physically settled with the delivery of electric power, the CDCC requires that the Clearing Member (and any clients for which clearing is performed) who intends to clear these physically settled transactions remain in good standing with the Alberta Electric System Operator (Market Centre). This membership requirement is necessary so as to ensure that Clearing Members (and/or clients) transacting in the forward market for electric power, are capable of either receiving or delivering electric power at specific locations such as power plants or manufacturing locations.
- The same reasoning holds true for the physical settlement of OTC DI transactions on natural gas. The Clearing Member (and/or clients) are required to be able to deliver/receive natural gas at any hub locations or along the pipeline interconnections which the CDCC considers an Acceptable Marketplace.
- Requirements for continued good standing with any and all Delivery Agents are required as a means of signalling potential Non-Conformity as described in Rule D.

Definitions used in this section:

- “OTC DI” or “Over-The-Counter Derivative Instrument” has been defined in Section A-1 and refers to transactions concluded on an Acceptable Marketplace.
- “Acceptable Marketplace” has been defined in Section A-1 to identify the market(s), other than the Exchange, identified as appropriate by the Corporation for the clearing and settlement of OTC DI transactions.
- “Market Centre” the local facility where the exchange of the Underlying Interest occurs, such as, The Alberta Power Pool or the AECO-C & NIT natural gas hub.
- “Delivery Agent” definition added in A-1 to introduce the concept of an agent who assumes the responsibility of delivery and title transfer for any physically settled OTC DI transactions. Examples of Delivery Agents include The Alberta Electric System Operator or TransCanada Pipelines.

Section A-1A02: Standards of Membership

- In order for an applicant to be considered for membership, such applicant must have or propose to have a business interest in the clearing and settlement of OTC DI transactions.

Definitions used in this section:

- “OTC DI”

Section A-1A04

- Includes the reference to membership standing and contractual obligations with any Market Centres and/or Delivery Agents that may lead the Corporation to declare a Clearing Member as Non-Conforming within the context of the Rules.
- This requirement is necessary to provide the CDCC with the ability to declare a Clearing Member as Non-Conforming if such Clearing Member (or clients) no longer has the capacity to perform on the physical delivery obligations required under the terms of an OTC DI transaction.
- Includes an article which stipulates that the CDCC reserves the right to consider a Clearing Member as Non-Conforming if such Clearing Member does not settle with the CDCC by the appropriate Settlement Time.

Definitions used in this section:

- “OTC DI”
- “Acceptable Marketplace”
- “Market Centre”
- “Delivery Agent”

## **Rule A-2: Miscellaneous Requirements**

### Section A-201: Designation of Clearing Offices

- This section was removed given the advent of electronic trading and pledging of collateral.

Definitions used in this section:

- None

### Section A-202: Offices

- Uses the “Clearing Member” definition to avoid referring to both Ordinary and Associate clearing member classifications.
- Reference to former A-201 was removed as A-201 no longer exists.

Definitions used in this section:

- None

### Section A-206: Records

- Inserted (f) in sub-section 1) to ensure record-keeping on the part of Clearing Members for all Over-The-Counter Derivative Instruments that are submitted for clearing.

Definitions used in this section:

- “OTC DI” or “Over-The-Counter Derivative Instrument” has been defined in Section A-1 as a means of referring to transactions concluded on an Acceptable Marketplace.
- “Trade Confirmation” is defined as the official documentation issued by the CDCC for the acceptance of an OTC DI transaction and which contains all of the relevant transaction details.

### Section A-216: Liability

- In article (1), the term “unless otherwise specified” was included because the CDCC will be providing delivery information on the part of both Clearing Members and their respective clients.
- Sub-section 2) introduces the notion of risk limits on OTC DI clearing activity to limit concentration risk from either Clearing Members or their respective clients.
- Sub-section 3) the term “Exchange Transactions” was replaced by “Transactions”.

Definitions used in this section:

- “Transactions”

### **Rule A-3: Capital Requirements**

Section A-308: Restrictions on Certain Transactions and Positions

- In sub-section 1) a), the concept of Over-The-Counter Derivative Instruments (OTC DI) was included.
- In the event that the Board of Directors of CDCC determines that the financial and/or operational condition of a Clearing Member is not sound, it becomes necessary for the CDCC to have the right to no longer accept any newly concluded OTC DI from such Clearing Member.

Definitions used in this section:

- “OTC DI”

### **Rule A-4: Enforcement**

Section A-401: Action against a Non-Conforming Member

- In sub-section 1) a) and b), the reference to opening purchase and opening writing transactions was removed to expand the rule so as to not exclude the OTC DI, for which opening and closing transaction types do not exist.

Definitions used in this section:

- “Transactions”

Section A-402: Creation of a Liquidating Settlement Account

- The notion of any priority in the liquidation of deposited collateral further to a Member having been considered Non-Conforming was removed.

Definitions used in this section:

- None

Section A-403: Pending Transactions

- As OTC DI transactions will never be registered without novation (and hence acceptance) occurring, these transactions can never be considered pending therefore this sub-section does not apply to the OTC DI class of transactions.

- Sub-section 3) was removed because all Options are included in the new definition of Transactions.

Definitions used in this section:

- “Transactions”

Section A-404: Open Positions

- In sub-section 1) the reference to Futures was replaced by the reference to Transactions.
- The notion of Mark-To-Market Valuation was introduced in this section and is used as the OTC DI equivalent to the concept of “Settlement of Gains and Losses” in futures transactions.
- The term “Options Purchased” was replaced by “Hedging Transactions” to capture all costs incurred in the hedging of all transactions which the CDCC chooses to maintain rather than closeout immediately.

Definitions used in this section:

- “Transactions”
- “Mark-To-Market Valuation”

### **Rule A-6: Clearing Fund Deposits**

Section A-601 Clearing Fund Maintenance and Purpose

- Sub-section 2), includes a Clearing Fund Base Deposit for OTC DI in the amount of \$100,000. This amount is a fixed amount and is necessary to ensure that all Clearing Members have a margin requirement within the Clearing Fund for the safety of the clearing system. As the OTC DI transactions are substantially larger in scope than Options and Futures, the initial base deposit was chosen to be larger than the individual deposits for both Options and Futures.

Section A-602 & A-603:

- Reflects the change in methodology from a volume-based approach to a risk-based approach, using stress testing to calculate the average Uncovered Residual Risk and to attribute it to members accordingly. The goal of this approach is to more accurately reflect the risk profile of the transaction held within clearing member accounts.
- Applies to all products cleared by CDCC; i.e. Futures, Options, OTC DI.

Definitions used:

- “Uncovered Residual Risk” to introduce the risk-based, stress-test approach to calculating a clearing member’s contribution to the Clearing Fund.



#### Section A-607: Withdrawals

- The amendment was introduced in order to clarify the conditions under which a clearing member may withdraw any surplus from its clearing fund contributions.

#### Section A-608: Form of Deposits

- The amendment reflects the proposal to accept longer-term and more varied collateral and to provide the Corporation with discretion to determine the appropriate haircuts on collateral for which there is no actively traded market. This amendment is introduced due to the request from market participants and does not expose the CDCC to any residual risks.

#### Section A-609: Application of Clearing Fund

- Sub-section (1), point a) was changed to reflect the notion of Transactions.
- Sub-section (1), point d) was modified to include unsettled portions of any OTC DI.
- Sub-section (1), point e) was modified to reflect the notion of Transactions.
- Sub-section (2), a portion was removed to eliminate redundancy as it is already included in the last paragraph of sub-section (1).

#### Definitions used:

- “Transactions”
- “OTC DI”

### **Rule A-7: Margin Requirements**

#### Section A-701: Margin Maintenance and Purpose

- In sub-section 1), the definitions of “Long Position” and “Short Position” were expanded to include the buying or selling of OTC DI.
- Sub-section 2f), includes the notion of using Clearing Member Margin deposits for any hedging needs that become required in the event that a Clearing Member is deemed to be Non-Conforming.

#### Definitions used:

- “Long Position”
- “Short Position”
- “Transaction”
- “OTC DI”

#### Section A-706: Margin Calculations

- OTC DI transactions cannot be margined using the existing SPAN and/or TIMS margining systems used by the CDCC at present. As a means of clarifying this point, it was necessary to explicitly state that a separate margining algorithm employing industry standard methodologies will be used.
- Furthermore, the nature of some of these markets requires the margining model to be adjusted in order to ensure adequate risk coverage for the CDCC.
  - Realized settlement amounts are not settled on a daily basis and as such will be margined at their full value until final settlement is done.
  - Changes in position value due to the Mark-To-Market process will also be margined at full value as there is no daily settlement of gains and losses (as is the case for futures).
- The liquidating value is added to the margin amount to account for worst-case losses over the holding period. This is similar to the model implemented within TIMS and SPAN, but since many OTC DI transactions cover multiple periods of time, a multivariate normal distribution for worst case losses is employed.

Definitions used:

- “Settlement Amount”

#### **Rule A-8: Daily Settlement**

#### Section A-801: Daily Settlement Summary

- Point d) was included to capture the Settlement Amounts stemming from OTC DI transactions within the daily cash settlement with Clearing Members. These settlement amounts may include:
  - The settlement amount for any physical deliveries;
  - The settlement amount arising from intermittent cash flows payable under the terms of a financially settled OTC DI.

Definitions used:

- “Settlement Amount”

#### Section A-802: Daily Settlement

- In sub-section 1), the notion of Transaction replaced the terms Option or Future.

Definitions used:

- “Transaction”

#### Section A-803: Application of Settlement Credit

- The OTC DI Margin Requirement Report was included in this section to ensure that the Corporation has access to any settlement credit payable to a Clearing Member as a means of satisfying any margin requirement.

#### Definitions used:

- OTC DI Margin Requirement Report

#### **Rule A-9: Adjustments in Contract Terms**

- Throughout Rule A-9, the term Derivative Instrument was replaced by the term Transactions in the event that any OTC DI written on an Underlying Interest is an equity which needs to be adjusted due to any corporate action.

#### **Part B**

#### **Rule B-1: Clearing of Exchange Transactions in Options**

#### Section B-104: Novation

- This section forms the legal basis whereby the obligations under a transaction are transferred to CDCC.
- Furthermore, this section specifies that the legal obligation of CDCC is towards its clearing members only and excludes clients of the clearing members.

#### Sub-sections B-1008 b), B-1208 c) and B1511 b):

- Were deleted since payment of the net settlement amount is already provided for in Section A-801 and A-802. Maintaining net payment provisions for each type of product weakens the netting provisions of the Rules. Therefore, there should be only one net settlement amount provision and every specific product netting provision should be removed so as to avoid contradiction.

#### **Part C**

#### **Rule C-1: Clearing of Exchange Transactions Respecting Futures**

#### Section C-104: Novation

- This section forms the legal basis whereby the obligations under a transaction are transferred to CDCC.
- Furthermore, this section specifies that the legal obligation of CDCC is towards its clearing members only and excludes clients of the clearing members.

#### Section C-109: Amounts Owed in Futures Accounts

- This section was deleted since payment of the net settlement amount is already provided for in Section A-801 and A-802. Maintaining net payment provisions for each type of product weakens the netting provisions of the Rules. Therefore, there should be only one net settlement amount provision and every specific product netting provision should be removed so as to avoid contradiction.

### **Part D**

#### Overview:

- The purpose of this newly created Part D of CDCC's rules is to enumerate the processes and controls that will become binding for Clearing Members who wish to participate in the clearing and settlement of Over-The-Counter Derivative Instruments.
- The structure of Part D was partially inspired by Part C – Futures, as the product description of many of these Over-The-Counter Derivative Instruments is closely aligned with the current exchange-traded futures.

#### **Rule D-1: Clearing of Over-The-Counter Derivative Instruments (“OTC DI”)**

#### Section D-101: Responsibility of Members for OTC DI

- The purpose of this section is to place the responsibility of clearing OTC DI on the Clearing Member, whether it be transactions executed by a client or by the Clearing Member itself.
- Another point to note is that the CDCC requires a copy of any and all clearing agreements signed between a Clearing Member and its Client, thus ensuring that CDCC is aware of the identity of the client behind the transaction.

#### Section D-102: Maintenance of Accounts

- Clearing Members who choose to clear OTC DI through the Corporation must maintain separate client and firm accounts.

#### Section D-103: Agreement Regarding Accounts

- All Clearing Members are required to maintain both client and firm accounts if they intend to clear OTC DI.
- In both accounts, CDCC has a security interest on positions, posted collateral and other funds held in those accounts.
- CDCC must obtain a security interest in order to secure its right over the positions, collateral and other funds residing within such account.

#### Section D-104: Acceptance Criteria of OTC DI transactions

- This section is necessary as a means of outlining the criteria to be used in the acceptance of OTC DI. Contrary to the case of exchange-traded products which originate from a regulated market where both products and participants are regulated, OTC DI and its participants are not regulated by exchanges. Therefore, the Corporation will impose certain restrictions on OTC DI transactions as a means of managing its risks.
- These criteria may be classified in one of two ways:
  - Transactions: the Corporation reserves the right to refuse the clearing of certain product types and/or Underlying Interests as a means of managing the risk of illiquidity within Clearing Members' accounts.
  - Clearing Member: the Corporation reserves the right to refuse the clearing of acceptable transaction types in order to avoid any over-concentration of risks within any firm and/or client account.
- These criteria shall be made available through the issuance of a periodic notice and will be disseminated to Clearing Members and the public through the existing processes used by the CDCC for this purpose.

#### Definitions used:

- “Acceptance Criteria” as defined in Section A-1 is the set of all parameters used by the CDCC as a gauge for either accepting or rejecting a transaction.
- “Acceptable Underlying Interests” as defined in Section A-1 is an Underlying Interest which has been deemed acceptable by the CDCC and which forms part of an OTC DI transaction brought to CDCC for clearing.
- “Acceptable Instrument Types” as defined in Section A-1 is an Instrument Type deemed acceptable by the CDCC for clearing.
- “Acceptable Marketplace”.

#### Section D-105: Novation

- This section forms the legal basis whereby the obligations under a transaction are transferred to CDCC.
- Furthermore, this section specifies that the legal obligation of CDCC is towards its Clearing Members only and excludes clients of the Clearing Members.

#### Section D-106: Obligations of the Corporation

- This section was created to specify exactly at what moment novation occurs and the obligations of CDCC for the notification to its Clearing Members that it has interposed itself between the original transacting parties.
- In addition, CDCC will inform Clearing Members of any transactions not accepted for clearing by the Corporation and the reasons for its decision by the end of the day.

- The key point of this section is to place the responsibility on CDCC for defining exactly when novation does or does not occur once an OTC DI transaction is presented for clearing.

Definitions used:

- “Trade Confirmation”
- “Acceptance Criteria”

Section D-107: Limitation of Liability

- This section is needed:
  - To outline that CDCC’s sole responsibility is towards its Clearing Members and does not involve any relationship with a client, broker or other person. This is a result of the novation concept, which entails the replacement of the original trade by two separate trades involving the CDCC and the transacting parties.
  - To outline that CDCC is not responsible for certain obligations specified in OTC DI where there exists a “Guaranteeing Delivery Agent” to which these obligations are transferred.

Definitions used:

- “Guaranteeing Delivery Agent” as defined in Rule A-1 designates a specific form of Delivery Agent which will be employed by the CDCC to transfer ownership of an Underlying Interest between the two parties involved in an OTC DI transaction. This Guaranteeing Delivery Agent guarantees the acquisition and the delivery of the physical Underlying Interest in the event of a delivery failure, thus limiting CDCC’s liability in the context of a failed delivery.

### **Rule D-2: Marking-To-Market**

Section D-201: Reference Prices and Forward Curves

- The purpose of this section is to provide guidance on how the Mark-To-Market element of the margin will be computed for OTC DI transactions accepted for clearing. In the absence of a centralized marketplace, the determination of the value of any OTC DI requires more sophisticated analytical approaches to be applied.
- Reference Prices will be obtained from a variety of data sources which the Corporation deems reliable and will be combined to produce a Forward Curve for any individual commodity. Forward Curves are representations of the value of a specific commodity at some later date. An analogy may be made with the current exchange-traded products:
  - A strip of CGB contract prices provides the market’s expectations of the value of on-the-run Canadian Government Bonds at specific points in time in the future. As of the writing of this document, the June 2005, September 2005, December 2005 and March 2006 CGB prices are observable.

- Unlike the exchange-traded equivalent, the Forward Curve construction process is necessary as a means of valuing any position that does not fall into any fixed maturity bucket. In these cases, interpolation will be used to obtain an estimate of position value for a particular commodity.
- Forward Prices will be extracted (possibly interpolated) from the applicable Forward Curve to be used in the determination of the Mark-To-Market valuation of any position.

Definitions used:

- “Reference Price”
- “Commodity”
- “Forward Curve”
- “Forward Price”

Section D-202: Mark-To-Market Valuation

- Whether the position is of the forward or of the swap type, the Mark-To-Market value will be determined by computing the net present value of all future cash flows.

**Rule D-3: Physical Delivery of Underlying Interest on Over-The-Counter Derivative Instruments**

Section D-301: Definitions

- Certain OTC DI transactions deemed acceptable by the Corporation will entail physical delivery of the Underlying Interest.

Definitions used:

- “Security Funds” – the concept of Security Funds is introduced to ensure that the Corporation is compensated for a delivery failure of the Underlying Interest.
- “Time of Delivery” – is defined in order for the Corporation to be able to recognize the moment at which a Clearing Member is considered to have failed to deliver.

Section D-302: Delivery Through The Corporation

- This section specifies that any physical deliveries required under the terms of an OTC DI will be fulfilled through the Corporation.

Section D-303: Delivery Process

- This section outlines the delivery process and the resulting Net Delivery Requirement.
- Due to the nature of the electricity market in Alberta, the distinction between a Guaranteeing Delivery Agent (i.e. AESO) and a Delivery Agent needs to be made:

- Where a Guaranteeing Delivery Agent exists, it is made clear that the Corporation shall not bear the responsibility of acquiring the physical commodity in the event of a failure to deliver on the part of the seller. The Corporation's sole responsibility shall be to ensure that Settlement Amounts are effected between buyer and seller.
- In those cases where a Guaranteeing Delivery Agent does not exist, the Corporation shall bear the responsibility of acquiring the physical commodity and providing it to the buyer under the terms of the OTC DI transaction.

Definitions used:

- “Net Delivery Requirements” – are defined to be the instructions issued by the Corporation, to a Guaranteeing Delivery Agent or to a Delivery Agent, which summarize the net deliverable quantities of the Underlying Interest to be exchanged by the transacting parties.
- “Delivery Agent”
- “Underlying Interest”
- “Guaranteeing Delivery Agent”
- “Security Funds”

Section D-304: Failure to Deliver or to Accept Delivery

- This section outlines the impacts of a failure to deliver or to accept delivery and demonstrates that this is dependent on the commodity and the Market Centre which is applicable.
  - Where a Guaranteeing Delivery Agent exists, a delivery failure does not constitute a default event and as such, the Clearing Member who is responsible for effecting the deliveries is not considered Non-Conforming. A failure to settle with the Guaranteeing Delivery Agent, may cause the Clearing Member or his Client to no longer be in good standing with the Market Centre services by the Guaranteeing Delivery Agent and at that point the Clearing Member becomes Non-Conforming.
  - Conversely, in the absence of a Guaranteeing Delivery Agent, a Clearing Member who fails to deliver is considered to be Non-Conforming by the Corporation and as such is subject to the usual procedures relating to Non-Conformity. This article grants the Corporation the rights on the positions and collateral to satisfy the obligations under the terms of the OTC DI.

Section D-307: Deposit of Security Funds

- Describes the mechanism under which the Corporation will obtain compensation for non-delivery of the Underlying Interest in a similar fashion as in C-509 which applies to exchange-traded futures.



#### Section D-308: Other Powers of the Corporation

- One of the clearinghouse's main roles is the assurance of market integrity. The Rules are meant to ensure that the Corporation will be able to satisfy this role in the event of a default as well as during any subsequent economic uncertainty. The purpose of this article is to grant the Corporation any additional powers to ensure that it has the rights to continue fulfilling its role under any unforeseen circumstances.

#### Section D-310: Force Majeure

- A provision was required to specify the rights of the Corporation in the event of Force Majeure that would make delivery of the Underlying Interests impossible.

### **Rule D-4: Physically Settled Over-The-Counter Derivative Instruments**

#### Section D-401: Definitions

- This section includes the required definitions for OTC DI transactions that are acceptable for clearing and are physically settled.

#### Section D-402: Over-The-Counter Derivative Instruments (OTC DI) Acceptable for Clearing with the Corporation

- This section specifies that the Corporation will publish, from time to time, the list of parameters that comprise the acceptance criteria for physically settled OTC DI transactions.

#### Section D-403: Final Settlement Through the Corporation

- This section provides for the calculation methodology to be used by the Corporation in determining the Settlement Amounts to be exchanged under the terms of the OTC DI transactions.
- It should be noted that this section is separated between physically settled Commodity/Security OTC DI transactions, in anticipation of expanding the Corporation's clearing activities.

#### Definitions used:

- "Notional Quantity" is defined to represent the size of the transaction upon which settlement calculations will be performed.
- "Profile" is defined to be the type of commodity deliverable under the terms of the transaction. In the case of electricity, it represents the number of hours per day whereas for natural gas it represents either firm or interruptible delivery commitment.

#### Section D-404: Unavailability or Inaccuracy of Reference Index Price

- Due to the potential for unreliable pricing in OTC DI marketplaces, the Corporation reserves certain rights with regards to specifying the Reference Prices used in the settlements process. They include:
  - Suspension of payment of settlement amounts until such time as the Corporation determines that an appropriate Reference Price has been obtained.
  - Determine, on its own, the appropriate Reference Prices to be used in the settlements process using the best available market information.

#### Section D-405: Payment and Receipt of Settlement Amount

- This section outlines when payment of settlement amounts will be effected.
- It should be noted that due to the conventions of the energy market, energy specific OTC DI transactions include a time delay of at most 55 days between the time of delivery and final settlement with the Corporation.

#### Section D-406: Instrument Specifications

- This section includes the instrument specifications for physically deliverable OTC DI.
- All elements in this section detail the necessary characteristics to determine the obligations of the contracting parties under each type of transaction.

#### **Rule D-5: Financially Settled Over-The-Counter Derivative Instruments**

- The analysis provided for Rule D-4 applies *mutatis mutandis* to Rule D-5.

#### **F – Public Interest**

This initiative is in the public interest as it introduces new risks as well as new opportunities into the financial market system. The risks associated with energy derivative transactions as well as the opportunities in efficiency gains from multilateral clearing need to be disclosed and understood.

#### **G – Process**

CDCC underwent a consultation process with its Risk Management and Advisory Committee which is composed of clearing members as well as independent representatives. The purpose of the consultation process was to obtain counsel on market and risk related issues as well as their advice on associated rule changes. As an outgrowth of this consultation process was feedback on the proposed initiative from those committee members who represented their clearing firms. Thereafter, the proposed amendments were submitted to CDCC's Board of Directors for approval. Once approval was obtained on May 30, 2005, the proposed amendments are exceptionally published by CDCC for a 60 day comment period and submitted for approval to the

Autorité des marchés financiers in Québec and for information to the Alberta Securities Commission and Ontario Securities Commission.