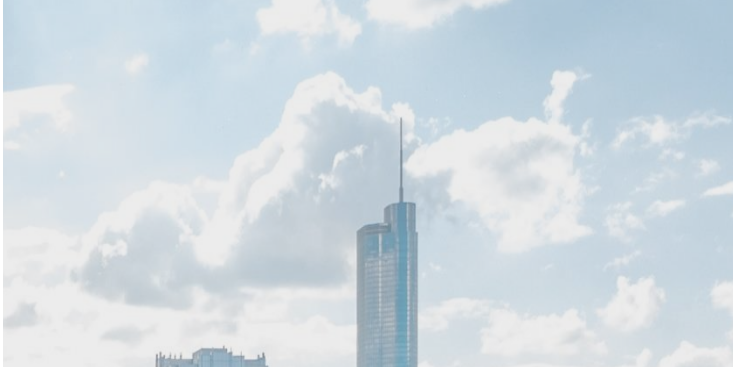
IIAC
The Investment Industry Association of Canada
ACCVM
Association canadienne du commerce des valeurs mobilières



April 15, 2024

Re: Proposed Amendments to The Investment Dealer and Partially Consolidated (IDPC) Rules and IDPC Form 1 Relating to Fully Paid Lending (FPL) and Financing Arrangements (The Proposed Amendments) and Relating to The Revised Guidance on Fully Paid Lending (Draft FPL Guidance)

April 15, 2024

Submitted via Email

Attention:

Member Regulation Policy
Canadian Investment Regulatory Organization
Suite 2600
40 Temperance Street
Toronto, Ontario M5H 0B4
Email: memberpolicymailbox@ciro.ca

Dear CIRO,

The Investment Industry Association of Canada (**IIAC**) is the national association representing investment firms that provide products and services to retail and institutional investors in Canada.

The IIAC has considered the benefits and opportunities that should be available to retail investors, the desire to create a more level playing field with traditional lending arrangements and the costs of the proposed amendments.

We provide the enclosed recommendations and analysis for your consideration.

Our responses to CIRO's questions are attached at Schedule "A".

Respectfully submitted,

Investment Industry Association of Canada

Laura Paglia

Per: Laura Paglia**,** President & CEO

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A. EXECUTIVE SUMMARY

1. **Public Consultation Is Key:** The proposed Rules grant CIRO discretion to make material changes to Dealer Member's FPL programs which should be subject to public comment.

2. **Risk Disclosures Should be Helpful and Meaningful to Investors:** To be helpful and meaningful to investors, risk disclosures should be balanced, accurate and reflect the materiality and remoteness of the risk.

3. **Investor Opportunities and Benefits should be Expanded :** The securities eligible to be lent should be expanded to include all securities that meet the definition of a qualified security pursuant to the *Income Tax Act (RS. C,1 (5th Supp).*

4. **Collateral that Meets Investor Protection Concerns is Maintained:** The full market value (100%) of the securities borrowed has provided sufficient protection of investor assets. Rule 4624(3), and corresponding guidance, should continue to require 100% of the market value of the securities borrowed as collateral.

5. **Investors Serviced by a Portfolio Manager Should Be Provided with the Full Benefit of that Expertise**: Retail investors serviced by a portfolio manager, licensed through CIRO or directly by a member of the Canadian Securities Administrators, should fully benefit from the discretionary services they provide.

6. **Investors Serviced by an Introducing Broker or Portfolio Manager Subject to Dealer Member Service Agreements Should have Ease of Access to Fully Paid Securities Paid Lending Opportunities:** A new and expedited process is needed, whereby registrants with leveraged accounts and not subject to any early warning, are able to proceed to offer FPL, in accordance with rules and without notification requirements.

7. **Retail Investor Risk Tolerances Should be Addressed in accordance with suitability obligations:** Participation in fully paid securities lending is more properly considered in an overall risk assessment of an investor's accounts and risk tolerance in accordance with suitability obligations. Suitability requirements at Rule 3402(1)(ii) and 3402(3) require that the action put the retail client's interest first, which were not in effect at the onset of the securities paid lending program.

8. **Recording Keeping and Client Communications Should Reflect Investor and Dealer Needs:** These include amendments for marked-to-market cash value and inter-listed securities.

9. **Reasonable Transition Periods are Needed**

B. DETAILED RECCOMENDATIONS

1. Public Consultation Is Key

The proposed Rules grant CIRO discretion to:

- Prescribe how segregated securities are held and how the amount/value of securities must be calculated (Rule 4312(3)),
- Further restrict the securities that a Dealer Member can borrow, by publishing on the Corporation's website (Rule 4628 (2)(3), and
- Prescribe additional requirements or restrictions on the Dealer Member activity (Rule 4630 (1)).

The above may result in material changes to a Dealer Member's FPL program and should be subject to public comment in accordance with Joint Rule Review Protocol set out in the Memorandum of Understanding Regarding the Oversight of CIRO among the Canadian Securities Administrators.[1]

2. Risk Disclosures Should be Helpful and Meaningful to Investors

Risk disclosures to investors should be meaningful and helpful. To achieve this, risk disclosures must be accurate and reflect the materiality and remoteness of the risk. Rather than the speculative and hypothetical, a consideration of the chances of a risk materializing should better inform the risks that should be disclosed and the contents of the disclosure.

i) Section 1.4.4: Delays in recalling securities.

Balanced alternative wording is needed.

Disclosure should explain that:

- Investors may sell, exclude securities, or leave an FPL program at any time.
- The ability to sell their securities or get their securities returned on termination of the securities loan transaction, is subject to market risks, which include liquidity. For

[1] Pursuant to s. 2(c) of the Joint Rule Review Protocol, a public comment rule change is any rule change that is not a housekeeping rule change. Pursuant to s. 2(b) of the Joint Rule Review Protocol, a housekeeping rule change has no material impact on investors, issuers, registrants, CIRO, CIPF or the Canadian capital markets generally and that:

(i) makes necessary changes of an editorial nature (such as correcting a textual mistake or inaccurate cross-reference, correcting a translation, making a formatting change, or standardization of terminology),
(ii) changes the routine internal processes, practices, or administration of CIRO,
(iii) is necessary to conform to applicable securities legislation, statutory or legal requirements, accounting, or auditing standards, or to other CIRO Rules or by-laws (including those that the RRs have approved or non-objected to, but which CIRO has not yet made effective), or
(iv) establishes or changes a due, fee or other charge imposed by CIRO under a Rule that the RRs have previously approved or non-objected to.

example, short sales may be subject to a security that has been designated as a 'pre-borrow' security by a Market Regulator. [2]

ii) Section 1.4.5: Recourse in the event of dealer insolvency.

The following paragraph should be more accurately worded:

At this time, the treatment of client collateral in the event of Dealer insolvency under the *Bankruptcy and Insolvency Act* (**BIA**) remains untested in court. As such there is no absolute legal certainty regarding those instances the court will determine that the client collateral is allocated to the "customer pool fund," the "general fund," or otherwise subject to other priority treatments.

Suggested alternative language is as follows:

The treatment of client collateral in the event of Dealer insolvency under the *Bankruptcy and Insolvency Act* (BIA) is subject to the terms of the BIA and any related case law.

iii) 1.4.7: Market Integrity.

This section should be deleted. These risks are not unique to FPL. They may exist, for example, with margin lending where securities that are not fully paid for may be loaned with less or no restriction.

iv) 2.4 Disclosure and Client's Acknowledgement

Balanced, educational wording regarding both the benefits and risks of loaned securities being used to facilitate short selling is warranted. [3] We note that FINRA Rule 4330 (e, Customer Protection – Permissible Use of Customer's Securities simply states at (b) (B) (f): Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities:

f. that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales

The revised risk disclosure language should also stipulate that the purpose of FPL is market liquidity and efficiency through improved price discovery and facilitated hedging activities.

3. Investor Opportunities and Benefits should Be Expanded.

Please see Schedule A, Question 2.

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[2] Section 1. 1 of Universal Market Integrity Rules defines "Pre-Borrow Security" to mean a security that has been designated by a Market Regulator to be a security in respect of which an order, that on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order.

[3] There are several sources in support. Examples include: https://www.paslaonline.com/downloads/esgresources/RMA-addressing-misconceptions-in-securities-lending-final-202204.pdf.; Canadian Securities Lending Market Ecology (bankofcanada.ca)

4. Collateral That Meets Investor Protection Concerns is Maintained

We ask that Rule 4624(2) and s. 2.5 of FPL Guidance be amended to exclude the need for exemptive relief and include non-cash collateral. This accords with Guideline B-4 *Securities Lending* issued by the Office of the Superintendent of Financial Institutions Canada and eliminates the administrative burden of seeking exemptive relief.

Pursuant to s. 3.1.4 of the current Guidance on Fully Paid Securities Lending Programs, the total amount of cash collateral to be set aside and calculated daily is the sum of:

i) 100% of the market value of the fully paid securities borrowed by the Dealer and adjusted daily for any mark-to-market deficiency (i.e. if the value of the fully paid securities increases relative to the cash collateral), and
ii) 100% of the overcollateralization collected from street borrowers for the fully paid securities loaned by the Dealer.

The above has proven to have provided sufficient protection for investor assets and therefore need not be changed. We therefore request the following amendments:

Rule 4624(3) be amended to require the collateral value to be a minimal equal 100% of the market value of the securities borrowed for cash collateral.

With respect to Rule 4625(2), the restriction should apply only to prohibit the reuse of the same collateral for another transaction. In addition, it should state that cash collateral can be invested in overnight investments.

With respect to Form 1, Part II – Schedule 1 Notes and Instructions, (7) Securities Borrow arrangements (iv) Margin Requirements: for securities borrow arrangements:

…

Insert (c) Where the Dealer Member borrows fully paid or excess margin securities from a client pursuant to Part B.2 of 4600, the margin required is equal to ~~the excess of the collateral required under subsection 4624(3) over~~ 100% of the market value of the actual collateral segregated for the client in compliance with subsection 4624(5). Insert end

(14) Insert Line 8 - In the case of securities borrowing arrangements for client fully paid and excess margin securities pursuant to Part B.2 of 4600, where a collateral deficiency exists as calculated under ~~Note 7(iv)(c)~~ subsection 4624(3), action must be taken to correct the deficiency. If no action is taken, the amount of the collateral deficiency must be immediately provided out of the Dealer Member's capital. In any case, where the deficiency exists for more than one business day, it must be provided out of the Dealer Member's capital. Insert end

5. Investors Serviced by a Portfolio Manager Should be Provided with the Full Benefit of that Expertise.

Please see Schedule A**,** Question 1.

6. Investors Serviced by An Introducing Broker or Portfolio Manager Subject to Dealer Member Service Agreements Should Have Ease of Access to FPL Opportunities

The expectation that the dealer obtains confirmation of a non-objection letter from CIRO or a notification from the Canadian Securities Administrators before an introducing broker or portfolio manager's clients may benefit from fully paid lending has proven cumbersome. A new and expedited process is needed, whereby registrants with leveraged accounts and not subject to any early warning, are able to proceed to offer FPL, in accordance with Rules and without notification requirements.

7. Retail Investor Risk Tolerance Should be Addressed in Accordance with Best Interest Obligations Where Suitability Obligations Apply

Participation in securities paid lending is more appropriately considered in the overall risk assessment of an investor's accounts and risk tolerances in accordance with current best interest or fiduciary obligations, where suitability obligations apply. These obligations were not in effect at the onset of the securities paid lending program. Risk tolerance considerations do not apply to Order Execution Only accounts. Rule 4622(d) and the corresponding provisions of section 2.3 of FPL Guidance should be deleted.

8. Recording Keeping and Client Communications Should Reflect Investor and Dealer Needs

a) We recommend that Rule 4626 be amended to include the following:

- The respective marked-to-market cash value may be reported where the collateral is provided in the form of permitted debt securities.

- For inter-listed securities:

i) The collateral may be maintained in one currency and reported to clients in another currency. For example, cash collateral held in trust in US dollars and reported to client in CAD dollars, with FX rate used.

ii) The Dealer may determine market value, based on either market. Companion Policy 81-102CP, subsection 3.7(8) states, in part, that "… the Instrument requires the daily marking to market of the securities involved in a securities lending, repurchase or reverse repurchase transaction. The valuation principles used in this marking to market may be those generally used by the agent acting for the investment fund, even if those principles deviate from the principles that are used by the investment fund in valuing its portfolio assets for the purposes of calculating net asset value."

b) In addition, the streamlining of client notifications within monthly statements is more in keeping with investor preferences and needs. The client communication requirements in Rule 4627 as explained in section 2.8 of FPL guidance should be adjusted to monthly to avoid daily, confirmation or notices that have proven unhelpful. In addition, FPL Guidance section 2.8 references trade confirmations as part of client reporting. The word 'trade' is not applicable and may be deleted.

9. Reasonable Transition Periods are Needed

The effective date of any changes to FPL programs should allow existing FPL programs a minimum two-year transition period.

C. SCHEDULE "A"

Responses to Questions from CIRO Request for Comment

We provide the following responses to questions raised by CIRO in its request for comment:

Question 1: Do you have any concerns with the proposed client differentiation approach whereby the retail client fully paid lending is subject to the more rigorous requirements of Part B.2. of Rule 4600, as opposed to the institutional client who can lend securities in accordance with traditional lending requirements.

Yes. Retail investors serviced by a portfolio manager, licensed through CIRO or directly by a member of the Canadian Securities Administrators, should fully benefit from the discretionary services they provide.

The consent and suitability requirements in Rule 4621 should be addressed by the Portfolio Manager.

For example, the Portfolio Manager may include the FPL agreement, including risk disclosures, as an addendum to the investment portfolio statement or equivalent master document provided to the investor and seek the investor's consent to participate in securities paid lending and execute the documentation on the investor's behalf. An opt out provision. may be included.

Apart from the above, the FPL agreement which should remain between lender and borrower.

Question 2: Should we allow the Dealer to borrow securities from their retail client other than equity securities that are listed on an exchange? Why yes or why not? If yes, also indicate the type/quality of the securities that should be allowed and the underlying reason.

Yes. All securities that meet the *Income Tax Act (RSC, 1985, c. 1(5th Supp.)* definition of a qualified security should be eligible for FPL: *Q*ualified security means;

- **(a)** a share of a class of the capital stock of a corporation that is listed on a stock exchange or of a class of the capital stock of a corporation that is a public corporation by reason of the designation of the class by the corporation in an election made under subparagraph (b)(i) of the definition ***public corporation*** in subsection 89(1) or by the Minister in a notice to the corporation under subparagraph (b)(ii) of that definition,
- **(b)** a bond, debenture, note or similar obligation of a corporation described in paragraph (a) or of a corporation that is controlled by such a corporation,
- **(c)** a bond, debenture, note or similar obligation of or guaranteed by the government of any country, province, state, municipality or other political subdivision, or a corporation, commission, agency, or association controlled by any such person,
- **(d)** a warrant, right, option or similar instrument with respect to a share described in paragraph (a), or
- **(e)** a qualified trust unit; (*titre admissible*)

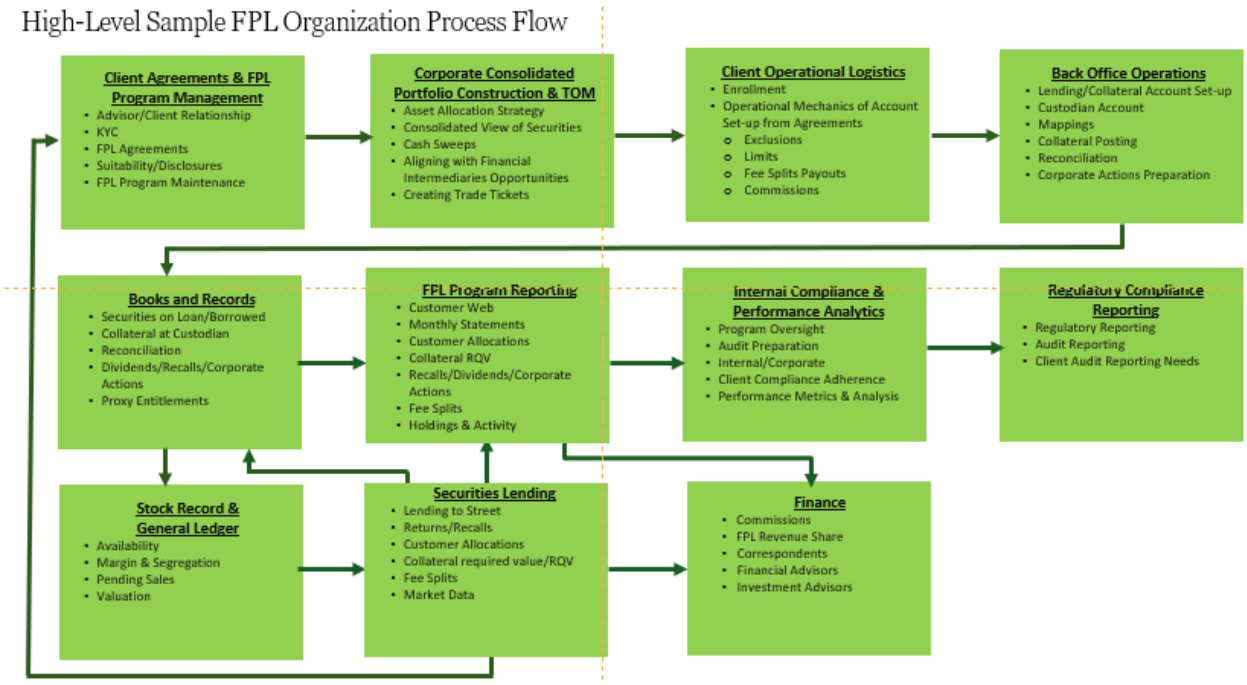
Question 3: Have we identified all the proposed provisions that will materially impact clients, Dealer Members, or CIRO? If not, please list any other proposed provisions that you believe will materially impact one or more parties and why.

Please see enclosed correspondence, which identify the provisions that will impact Dealers and clients.

In addition, considering CIRO's regular audit functions and dealer internal audit resources, the Corporation's requests for a Special Audit report in Rule 4629 and FPL Guidance 2.14 should be limited to instances of dealer insolvency and the language amended accordingly.

Question 4: Overall, do you agree with CIRO's qualitative assessment that the benefits of the Proposed Amendments are proportionate to their costs? Please provide reasons for your stance.

The operations of an FPL program have enterprise-wide impacts as illustrated below:



Any changes give rise to 'domino considerations 'and costs across an enterprise. For the reasons set out in this correspondence, the benefits of the proposed changes that are opposed are unclear and would not outweigh the costs.