

Appendix F – Revised guidance (Clean copy)

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Guidance on fully paid securities lending

Executive Summary

The Canadian Investment Regulatory Organization (**CIRO**) is publishing guidance regarding Dealer Members' practice of borrowing fully paid and excess margin securities¹ from their retail clients and compliance with Part B.2. of Rule 4600 of the Investment Dealer and Partially Consolidated (**IDPC**) Rules.

Part B.2. of Rule 4600 does not apply to institutional client securities lending, including institutional client fully paid lending, which is governed under the traditional lending requirements of Rule 4600.² Should the institutional client choose to be treated as a retail client for the purpose of their fully paid lending arrangement with the Dealer Member (**Dealer**), such arrangement is subject to the application of Part B.2. of Rule 4600 and the expectations of this guidance.³

In this guidance, all rule references are to the IDPC Rules unless otherwise specified.

¹ Across this guidance we refer to this practice as simply 'fully paid lending'.

² Part A and Part B.1. of Rule 4600.

³ Section 4620.

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1. Fully paid securities lending overview

1.1 Fully paid lending

Fully paid securities lending refers to the Dealer Member (**Dealer**) practice of borrowing client's fully paid or excess margin securities.

1.2 Benefits of fully paid lending

Securities lending is a common market practice in Canada. Dealers with self-clearing operations generally have securities lending desks that, among other things, earn revenue by lending securities (that they own and/or hold for clients on margin) to institutions such as hedge funds, financial institutions and other broker-dealers (**street borrowers**).

In addition, Dealers borrow their client's fully paid securities or excess margin securities, to meet their in-house demand or the street borrower's demand. The clients earn passive income on the loaned assets as a result.

Securities lending is beneficial to the market because it unlocks securities for which there is demand, for instance to:

- facilitate trading strategies like short selling,
- meet collateral requirements, and
- fulfill settlement obligations, thereby increasing settlement efficiency.

1.3 Key characteristics of fully paid lending

Dealers hold fully paid and excess margin securities in custody for their own clients, clients of other Dealers (introducing brokers), or clients of portfolio managers. In practice, Dealers generally borrow these securities as part of fully paid lending programs (**FPL programs**), which operate as follows:

- eligible retail clients agree to lend to the Dealer fully paid or excess margin securities⁴ held in their securities trading account (cash account or margin account);
- the Dealer, as borrower of these securities, provides collateral to the lending clients; such collateral is held by the Dealer in trust for such clients in a separate account (cash collateral) or at a collateral agent (e.g. securities collateral);
- the Dealer uses the borrowed securities for their own needs or lends the securities to street borrowers in return for collateral.

In fully paid lending, such as for instance FPL programs, the Dealer borrows from their clients as principal, meaning that the Dealer transacts directly with their client as borrower, and then with the street borrower as lender, in two separate transactions. The client and street borrower are unknown to each other and do not have any legal rights or responsibilities to each other with respect to the loan transaction. Street borrowers pay a fee to the lender based on the supply and demand of the securities in the lending

⁴ From this point on in guidance, we simply use 'securities' to refer to 'fully paid and excess margin securities', unless otherwise specified.

market. In particular, securities that have limited supply, but substantial demand are considered “hard to borrow” and command higher borrow fees. The Dealer shares the borrow fee with the client, which is deposited in the client’s securities account every month.

While the title and ownership of the loaned securities transfers to the borrower, the lending client remains the beneficial owner of these securities. As a result, the Dealer generates manufactured payments (i.e. in lieu of dividends and distributions) for the securities that are out on loan, which are deposited in the client’s securities account on a normal pay date.

1.4 Risks associated with securities lending

Fully paid lending does not come without risks, especially for the retail client who may not have the same level of sophistication, trading knowledge or tools as institutional lenders. Some of these risks are discussed below.

1.4.1. Market risks

Loaned securities are often in demand by street borrowers to support short sales. Short selling could potentially put downward pressure on the long-term value of the client’s long security position. The likelihood of downward market impact increases for securities that are not widely held nor actively traded.

1.4.2 Loss of voting rights

When the title and ownership of the loaned securities transfers to the borrowing Dealer, client’s voting rights on loaned securities also pass to such Dealer and, if loaned on to street borrowers, pass on to the ultimate borrower. If the client wishes to vote on the securities, they need to request a recall of the securities (i.e. terminate the loan). There is a risk that:

- the Dealer may not get the securities back to the client in time to vote;
- fully paid lending, such as FPL programs, may exacerbate “empty voting”. Empty voting refers to a practice where securities are borrowed in large numbers to effect a vote on a significant transaction or contested proxy battles, which may not be aligned with how the client, who is the beneficial owner, would have voted.

1.4.3 Tax implications

The client may have tax implications associated with:

- the manufactured payments, and
- exercising their right to the collateral.

Since the client remains the beneficial owner of the securities that are out on loan, in order to reflect the client’s entitlement to the economic benefit of their loaned securities, the Dealer makes a “manufactured payment” to the client that mirrors all dividends and distributions on the securities. The client may experience unintended and undesired tax consequences because the manufactured payment may not have the same tax treatment as the dividends and distributions normally received from the issuer of the security.

The client may exercise their right to the collateral under certain circumstances such as, in the event of insolvency of the Dealer or when the Dealer is unable to recall loaned securities within stipulated timeframes. If the client exercises this right, they may have a deemed disposition of the loaned security which could result in tax implications.

1.4.4 Delay in recalling securities

The client may not get their securities back from the Dealer on termination of the securities loan transaction if there is limited availability for the Dealer to recall, borrow or buy-in the securities. The client will be impacted in the following circumstances:

- if the client wants to vote on the securities,
- if the client wants to transfer the securities out, or
- if there is a trading halt on the loaned securities. In such cases, the client's recourse is reflected in the value of the collateral until the halt is lifted or removed on the loaned securities.

This risk does not impact the client if they sell the securities on loan.

1.4.5 Recourse in the event of a Dealer insolvency

In fully paid lending, the credit risk to the client arises from a Dealer insolvency. If the borrowing Dealer were to go insolvent, the client may not receive their loaned securities back and may have limited recourse to the collateral because:

- The Investor Protection Fund (IPF) does not cover the client's securities that are on loan. If there is a shortfall in the assets available in the customer pool, the client may not receive back the securities on loan. However, client securities subject to a securities loan arrangement, such as a FPL program, but that are not on loan, remain eligible for IPF coverage.
- 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.

1.4.6 Conflicts of interest

Fully paid lending has the potential to raise compensation-related conflicts of interest. Some examples are discussed below.

- In a managed account, the portfolio manager is authorized to conduct discretionary trading on behalf of a client and has a fiduciary duty to act in the best interest of the client in exercising that authority. A conflict of interest may arise as the portfolio manager may be influenced by the potential revenue generated through the client's participation in fully paid lending.
- Where the Dealer has a proprietary/firm trading desk, they may generate profits by borrowing client's securities to cover short selling in their own proprietary trading accounts. In the long-term, short selling could potentially drive down the value of the client's securities.

- The likelihood of short selling impacting the value of securities is higher for securities that are not widely held or have smaller market capitalizations. If these securities have an attractive borrow fee, a conflict of interest for the Dealer may arise when borrowing and lending out these securities. Ultimately it is the client that bears the risk of loss in value of their securities which may be over and above the borrow fee they are earning.
- When there is both internal Dealer demand and street borrower demand for securities held by the client, the Dealer may favour their own demand at the expense of the client. An inappropriate conflict of interest may arise if the compensation the client receives from the Dealer, as ultimate borrower, is less than the borrow fee the client would have received if the securities were loaned to street borrowers.

1.4.7 Market integrity

The potential for market manipulation may increase if the types of securities being lent are not actively traded or not widely held. Such securities may be more vulnerable to practices like “short and distort”⁵ schemes and short squeezes⁶. Similarly, increased short selling in these securities may make them hard-to-borrow. This would result in delays in obtaining securities if a loan is terminated, and increased issues with settlements.

Dealers are expected to mitigate such risks through efficient risk management measures and compliance with our rules and standards.

2. CIRO’s requirements on fully paid lending

2.1 Overview of regulatory framework

Dealers who carry out fully paid lending with their retail clients, including retail clients of an introducing broker or portfolio manager whose accounts the Dealer carries, must comply with the:

- IDPC Rules requirements of general application,⁷
- IDPC Rules requirements specific to financing arrangements (Rule 4600), and in particular Part B.2 of Rule 4600, and
- Form 1 requirements.

Dealers must contact CIRO with a change in business model notification before engaging in fully paid lending activity. CIRO can prescribe additional requirements and restrictions on such activity in compliance with section 4630.

⁵ Investors who commit “short and distort” fraud generate false adverse information about issuers whose securities they sold short in order to drive down the price of the securities.

⁶ If the client holds a material position in a security which is out on loan and the client suddenly terminates the loan, this may artificially push the price of the security upwards due to short sellers trying to release positions quickly to deliver on the recall, thereby effecting a “short squeeze”.

⁷ Subject to the Dealer business model, these include standards of conduct and requirements around know-your-customer, know your product, product due diligence, suitability determination, conflicts of interest management, customer asset protection, supervision and risk management, to name a few.

2.2 Pre-conditions for borrowing client securities

A Dealer can borrow the client's securities only upon the lending client's prior consent as part of a written securities loan agreement.⁸

In addition, the Dealer can only borrow securities from their clients upon the determination that the borrowing arrangement is suitable to the lending client, such determination carried out in compliance with Rule 3400.⁹ The suitability determination exemptions of section 3404 do apply to fully paid lending. For instance, when the Dealer is borrowing from the clients' accounts it carries, the Dealer may rely on the suitability determination of the client's introducing broker or the portfolio manager.¹⁰ Also, Dealers who borrow from their clients' order execution only accounts are exempt from the suitability determination requirements.¹¹

2.3 Securities loan agreement

For the Dealer to borrow their clients' securities, the Dealer must enter into a written securities loan agreement with the lending client, containing at the very minimum the terms prescribed in section 4622.

In practice, it is not uncommon for there to be third parties involved in the securities loan arrangement, such as an introducing broker, a portfolio manager or a collateral agent. These entities can be a party to the same loan agreement between the borrowing Dealer and the lending clients or a series of agreements which nevertheless are treated as part of the same securities loan agreement for the purposes of our rules. The agreement, or agreements, must clearly identify the roles, rights and responsibilities of the client as the lender, the Dealer as the borrower and those of the third party in the loan arrangement. For instance, when the Dealer borrows from the clients' accounts it carries on behalf of an introducing broker or portfolio manager, the securities loan agreement(s) must clearly identify:

- the client as the lender;
- the Dealer, in its capacity as carrying broker (for the introducing broker) or custodian (for the portfolio manager), and as the borrower.
- the introducing broker or portfolio manager and their responsibility for client eligibility, appropriateness and suitability.

The client or the Dealer can terminate a loan at any time. The client may want to terminate a loan for a variety of reasons including:

- selling the securities,
- exercising their voting rights, or
- transferring the securities out of the account.

The client can sell their loaned securities any time and follow normal-course processes at the Dealer to place their sell order. If the client wants to terminate the loan for any other reason, they must notify the

⁸ Clause 4621(1)(i).

⁹ Clause 4621(1)(ii).

¹⁰ Subsection 3404(2).

¹¹ Subsection 3404(1).

Dealer in advance. The Dealer may restrict the client's participation and eligibility in fully paid lending, such as in a FPL program, if the client frequently terminates the securities loan transactions. When a loan is terminated, the Dealer will attempt to recall, borrow or buy-in the securities.

The client has the right to impose restrictions on the Dealer borrowing in the client's accounts such as:

- securities that they would like to exclude from lending, and
- the total dollar value of securities they are willing to lend. The Dealer is expected to review their fully paid lending transactions against this criterion daily and terminate loans that exceed the client's imposed limit as soon as possible.

2.4 Disclosure and client's acknowledgment

At the time of entering into the securities loan agreement, the borrowing Dealer must provide the lending client with adequate written disclosures regarding the loan arrangement and obtain the lending client's written acknowledgment to have read and understood the disclosures provided.¹²

The securities loan disclosure should include a clear description of:

- the loan structure, such as for instance the FPL program, the type of accounts or sub-accounts to be opened and the purpose of borrowing the client securities,
- the benefits of the arrangement for the clients,
- relevant risks specific to the client, such as:
 - market risks that could result from the loaned securities being used to facilitate short selling which could put downward pressure on the price of the loaned securities,
 - restrictions on access to loaned securities on demand if the Dealer is unable to recall the securities within the timeframes stipulated by the Dealer,
 - potential tax implications from the client receiving manufactured payments from the Dealer (in lieu of dividends and distributions directly from the issuer) or exercising their rights to the collateral,
 - potential tax implications arising from ambiguities in the application of tax laws related to fully paid lending from registered or non registered accounts, as applicable,
 - loss of voting rights on securities that are out on loan, including that the Dealer may not be able to recall the loaned securities in time to vote (i.e. before the record date) and that the loaned securities could be voted on contrary to how the client might have wanted to vote,
 - lending out securities may trigger insider or early warning reporting requirements under applicable securities laws,
 - restrictions on access to collateral, and

¹² Section 4623.

- o in the event of insolvency of the Dealer, limitations on recourse to collateral,
- and
- the limitations on the IPF coverage, including the following statement or a statement that is substantially similar:

Fully paid securities lent under [Dealer Members's] fully paid lending activity are not eligible for the Investor Protection Fund (IPF) coverage. Fully paid securities not lent under [Dealer Members's] fully paid lending activity and held at [Dealer Member], as at the date of insolvency of [Dealer Member], are eligible for the IPF coverage.

2.5 Collateral

Once the Dealer and the client enter into a securities loan agreement, which in practice can mean the client is enrolled in the Dealer's FPL program, the Dealer may borrow securities from the client at any time. At the time of borrowing the client securities, the Dealer must provide to the client, and maintain for the duration of the loan, adequate collateral to fully secure the loan.

For the collateral to be deemed adequate it must, at a minimum, satisfy the requirements of section 4624. These requirements seek to protect the client's claim on the collateral, given that this is the only recourse they may have in the event of Dealer's default or insolvency.

At this time, CIRO has restricted the collateral to cash collateral in consideration of investor protection concerns. In exceptional circumstances, CIRO may permit the use of qualified securities as collateral¹³ and only when it is satisfied that the clients' interests are not compromised.

On a daily basis, the Dealer must mark to market the borrowed securities and collateral, on a loan-by-loan basis,¹⁴ and adjust for any collateral deficiency (e.g. if the value of the fully paid securities increases relative to the required collateral).

2.6 Asset reuse prohibition

Section 4625 sets out asset reuse restrictions in order to minimize the risks associated with such practices. As such, neither the Dealer nor the client can reuse for any other purposes the assets provided as collateral under section 4624. This means that the collateral cannot be withdrawn by the client or used to settle the purchase of securities in the account. Similarly, the Dealer cannot reuse or rehypothecate the assets while they are set aside as collateral. For further clarity, the collateral is excluded from the calculation of the loan value in the client's account or from free credits available for use by the Dealer.

For clarity, similar to the collateral, fully paid securities that have been loaned by the client to the Dealer cannot be reused by the Dealer or the client. Since securities loaned under Part B.2. of Rule 4600 are fully paid for by the client, the Corporation requirements related to fully paid securities would prohibit the Dealer or client from using the fully paid securities for purposes other than the lending transaction. For example, if the fully paid securities were needed to cover a margin requirement in the client account, the securities would no longer be considered fully paid and would no longer qualify for a fully paid lending arrangement. Our rules however do not prohibit the lending client from engaging in hedging strategies

¹³ Subsection 4624(2).

¹⁴ Clause 4603(1)(i).

where the hedged securities are not reused but instead simply providing an economic hedge in the hedging strategy.

2.7 Recordkeeping

The Dealer must record the client's securities loan transactions in the same account as, or a sub-account(s) of, the client's securities trading account (**FPL combined account**).¹⁵ Such records must clearly distinguish the loaned securities and collateral provided.

2.8 Client communications

Dealer's activity with clients, including fully paid lending, triggers several client communications under the IDPC Rules such as, trade confirmations or notices, periodic statements and reports.¹⁶ These communications must adequately disclose the securities on loan, the collateral provided, the revenue earned, and commissions or fees paid directly or indirectly by the client.¹⁷

Depending on the Dealer business and fully paid lending model, the obligation to deliver the client communication under our rules may be with the borrowing Dealer, the introducing broker, the portfolio manager or the collateral agent. The responsibility for such obligation must be clearly disclosed to the client in the securities loan agreement.

For the purposes of complying with section 4627, we consider the following client communications regarding the loan activity in the client's account to be adequate:

- prompt trade confirmation or notices with all required details related to the securities loan transaction are sent to the lending client once the following has occurred:
 - securities have been loaned,
 - the loan is terminated, or
 - there is a change in fees and/or rates.
- the monthly statements¹⁸ sent to the lending client on the FPL combined account:
 - distinguish client securities that are on loan and collateral received in return from securities that are segregated,
 - include the market value of security positions on loan in the total market value of the security positions in the FPL combined account,
 - exclude cash collateral from the total cash balance in the FPL combined account, and
 - provide the following specific disclosure on IPF coverage:

¹⁵ Subsection 4626(1). This is distinct from the general rule requirement, under clause 4603(3)(ii), whereby financing accounts must be kept separate from the client's securities trading accounts.

¹⁶ Sections 3808 to 3811, section 3816 and subsection 4603(4).

¹⁷ Section 4627.

¹⁸ Subsection 4603(4).

Fully paid securities lent under [Dealer Members's] fully paid lending activity are not eligible for the Investor Protection Fund (IPF) coverage. Fully paid securities not lent under [Dealer Members's] fully paid lending activity and held at [Dealer Member], as at the date of insolvency of [Dealer Member], are eligible for the IPF coverage.

- the annual performance report and fee/charge report for the FPL combined account incorporate the lending activity in the client account in the following manner:
 - where the Dealer pays the client a spread or split of the total borrow fee received from street borrowers:
 - the annual performance report includes that portion of the securities lending revenue earned by the client, and
 - the annual fee/charge report includes, at a minimum, text disclosure describing all compensation earned by the Dealer, and the introducing broker or portfolio manager as applicable, from lending the client securities.
 - where the Dealer pays the client a fixed or gross borrow fee and/or deducts an amount for fees and charges:
 - the annual performance report includes the gross fee amount received by the client before any deductions, and
 - the annual fee/charge report includes:
 - the dollar amount of all fees and charges paid by the client to the Dealer, and to the introducing broker or portfolio manager as applicable, and
 - text disclosure that describes all compensation earned by the Dealer, and the introducing broker or portfolio manager as applicable, from lending the client securities.

2.9 Restrictions on securities eligible for borrowing

Pursuant to section 4628, CISO may impose restrictions on the securities eligible for borrowing when it deems to be in the interest of the clients and the public. These restrictions are published on CISO's website.

To ensure compliance with the securities eligibility restrictions, Dealers are expected to maintain a list of securities eligible under their fully paid lending activity based on the restrictions criteria. They are also expected to review their fully paid lending transactions against these criteria at least monthly and terminate loans that don't meet the criteria as soon as possible.

2.10 Conflicts of interest

Fully paid lending raises material conflicts of interest concerns, as discussed earlier. This is especially the case when the Dealer borrows securities from their clients to settle or cover their own inventory trading strategies.

Dealers are reminded of their obligation to identify and address material conflicts of interest in the best interest of their client.¹⁹ This includes avoiding engaging in the activity that gives rise to the conflict of interest with the client until such time the Dealer can demonstrate that it can manage such conflict in the client's best interest, in compliance with our conflicts of interest requirements.

2.11 Borrowing from clients of introducing brokers and portfolio managers

Dealers, as gatekeepers of the capital markets integrity, have a responsibility of detecting and refraining from engaging in activity that is in contravention of CISO rules and securities laws. As such, when borrowing from clients of introducing brokers and portfolio managers, whose accounts the Dealer carries, the Dealer is expected to obtain a confirmation that:

- each introducing broker has received a non-objection letter from CISO before fully paid securities of clients of introducing brokers are borrowed by the Dealer;
- each portfolio manager has notified the applicable Canadian Securities Administrators regulator before fully paid securities of clients of portfolio managers are borrowed by the Dealer.

2.12 Policies and procedures

The borrowing Dealer is required to have adequate policies and procedures specific for fully paid lending to ensure compliance with CISO requirements and applicable laws.²⁰ We consider such policies and procedures to be in compliance with our requirements, when they adequately address:

- the minimum eligibility criteria for clients to engage in fully paid lending, such as to participate in a FPL program,
- appropriateness and suitability of the fully paid lending, such as a FPL program, for clients with advisory and managed accounts,²¹
- identification of conflicts of interest with clients,²²
- processes for handling and resolving client questions and requests, and
- operational processes including:
 - how loan transactions are initiated, terminated, and changed and the timeframes for each transaction,
 - how lending opportunities and recall requests are allocated to clients, and
 - how client compensation is calculated and when it is deposited to the client account.

¹⁹ Section 3112.

²⁰ Section 1404.

²¹ Section 3211 and Rule 3400.

²² Rule 3100 – Part B

2.13 Regulatory reporting

The borrowing Dealer needs to ensure accurate reporting of client securities lending balances in the Monthly Financial Report (**MFR**) and Form 1, and calculation of the segregation, concentration and margin requirements as follows:

- The cash collateral provided to clients must be reported on Statement A of the MFR and Form 1 on:
 - Line 6 Loans receivable, securities borrowed and resold
 - Line 53 *Client accounts*
- The collateral (cash or securities) provided to clients must be excluded from client net equity reported on Schedule 10 of Form 1.²³
- The cash collateral must be excluded from free credits reported on Statement D, Line 2 of Form 1.
- The collateral (cash or securities) must be excluded from the calculation of client margin in the FPL combined account.
- The loaned securities must be excluded from the assessment of securities concentration in the MFR and Form 1.
- The loaned securities and the corresponding collateral must be excluded from the determination of segregation requirements in the FPL combined account.
- Margin must be reported on Schedule 1 if the Dealer has not segregated, within one business day, sufficient collateral for the client as required in subsection 4624(3).

2.14 Special audit report

Upon CIRO's request, the borrowing Dealer must produce an independent audit report²⁴ that certifies the adequacy of the policies and procedures, systems and controls concerning the Dealer fully paid lending activity and compliance with the Corporation's requirements.²⁵ We expect this report to demonstrate adequacy, among others, in the following areas:

- the client's securities on loan meet criteria and thresholds set by the client, CIRO and the Dealer,
- the client's securities on loan are separately identified from all other eligible fully paid or excess margin securities that are not being loaned to the Dealer,
- securities loan transactions are separately disclosed in the client's monthly account statement but within the securities trading account, or a sub-account thereof,

²³ The client net equity reported on Schedule 10 must include the value of the loaned securities.

²⁴ CIRO, at its own discretion, may request that the report be produced by an external auditor when there are concerns with the independence of the internal audit.

²⁵ Section 4629.

- the revenue, compensation, fees paid to the client for borrowing their securities are accurately calculated according to the securities loan agreement and confirmation, and
- the Dealer's systems are able to accurately calculate and generate reporting for the following:
 - o client net equity for each client account and in aggregate under the fully paid lending activity
 - i) excluding securities on loan and corresponding collateral
 - ii) including securities on loan and corresponding collateral
 - o free credits available for use by the Dealer that excludes cash collateral provided to clients under fully paid lending,
 - o margin and segregation requirements for other client assets which excludes client securities on loan and corresponding collateral received,
 - o securities record information that separately identifies:
 - i) securities on loan for each client
 - ii) location of all securities on loan
 - iii) securities not on loan for each client and the locations of the securities.
 - o the daily mark-to-market requirements on the collateral to be set aside for the client including:
 - i) accurate pricing of the fully paid securities on loan
 - ii) tracking whether sufficient collateral has been set aside.

3. Applicable Rules

This Guidance relates to the following main rules:

- Part B.2. of IDPC Rule 4600, and
- Notes and instructions to Form 1.

4. Previous Guidance Note(s)

This Guidance replaces Guidance GN-4600-22-001– *Fully-paid Securities Lending*.

5. Related Documents

This Guidance is published under [implementation bulletin under which the Guidance Note is published].