

IIROC NOTICE

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Fully-paid Securities Lending

This Notice provides guidance to Dealer Members (**Dealers**) on IIROC's expectations for implementing a fully-paid securities lending program (**FPL program**).

IIROC's Board of Directors has approved the introduction of FPL programs at three Dealers and, subject to certain terms and conditions¹, provided exemptive relief from the following Dealer Member Rules (**DMR**):

- DMR 2200.8(b) - reporting loan accounts separate from trading accounts²

¹ Refer to section 3 *IIROC Requirements*

² Refer to section 3.1.1 *Account set-up*



- DMR 2200.8(e) - recording cash and securities loan transactions of retail clients in a separate account³
- Margin requirements in the Notes and Instructions to Form 1, Part II, Schedule 1 (Lines 4, 8 and 12)⁴.

Dealers must contact IIROC with a change in business model notification before implementing FPL programs at their firms⁵.

1. Overview

1.1. Description

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**) as a means to

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

FPL programs permit Dealers to borrow the fully-paid securities they hold on behalf of their clients and generally operate⁶ as follows:

- a client, retail or institutional, agrees to lend to the Dealer fully-paid securities held in their securities trading account (cash account or margin account).
- the Dealer, as borrower of these securities, provides and segregates collateral for the client.
- the Dealer uses the borrowed securities for their own needs or lends the securities to street borrowers in return for collateral.

In FPL programs, the Dealer borrows from their clients as principal (i.e. 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 anonymous to each other and do not have any legal rights or responsibilities to each other with respect to the loan transaction.

³ Refer to section 3.1.1 *Account set-up*

⁴ Refer to section 3.1.4 *Collateral provided to clients*

⁵ Refer to section 4 *Next steps*

⁶ Refer to section 1.4 *Operation*



1.2 Purpose

Fully-paid securities lending generates income for the client. Street borrowers pay a fee to the lender based on the supply and demand of the securities in the lending market (**borrow fees**). 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.

Dealers will also have greater access to supply to meet their delivery obligations on trades, thereby increasing settlement efficiency.

1.3 Exclusions

For purposes of this Notice, FPL programs do not include arrangements where the Dealer acts as custodian for an institutional⁷ client’s securities, and as lending agent between the institutional client and street borrowers. The street borrower and institutional client are disclosed to each other and are each responsible for the associated counterparty credit risk. The Dealer, as lending agent, acts as administrator for the securities loan transaction and, in most cases, as custodian of the collateral. These arrangements are considered part of traditional securities lending arrangements that fall within the scope of DMR 2200 *Cash and Securities Loan Transactions*.⁸

1.4 Operation

The Dealer holds fully-paid securities in custody for their own clients, clients of other Dealers (Introducing brokers), and/or clients of the Portfolio Managers. If a client wants to be part of the FPL program, they must sign a securities loan agreement with the Dealer and acknowledge that they understand and accept the risks associated with lending out their fully-paid securities.

Once the client is enrolled in the FPL program, the Dealer may borrow securities from the client at any time. When the Dealer borrows fully-paid securities from the client’s securities trading account, they send a confirmation to the client and set collateral aside for them. The client continues to see the lent fully-paid securities in their account but the positions will not be shown as segregated and cannot be used in any hedging strategy.

The term of the loan may be for a specified period of time (fixed term loan), overnight or, most commonly, open-ended, that is, it can be terminated at any time by either the client or the Dealer. Each day that the securities are out on loan, the Dealer marks to market the collateral

⁷ As defined in DMR 1.1 “*Institutional Customer*”

⁸ For such arrangements, the Dealer is required to make clear disclosure in the account statements that lending arrangements, including those involving fully-paid securities, will have no Canadian Investor Protection Fund (CIPF) coverage. For guidance on CIPF disclosure language, refer to section 3.2.4 *Account statements*.



for the client. The collateral is excluded from the calculation of loan value in the client's account.

The Dealer makes the following payments to the client in their securities account:

- the client's portion of the borrow fee (deposited every month)
- manufactured payments⁹ (i.e. in lieu of dividends and distributions) for the fully-paid securities that are out on loan (deposited on normal pay date)

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 securities that are out on loan at 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 contact the Dealer. The Dealer may restrict the client's participation and eligibility in the FPL program if the client frequently terminates fully-paid securities loan transactions.

When a loan is terminated, the Dealer will attempt to recall, borrow or buy-in the securities within stipulated timeframes.

2. Risks and concerns

2.1 Risks associated with securities lending

Securities lending is an area that is currently dominated by institutions. The FPL program will extend securities lending to retail investors who typically do not have the same level of sophistication, trading knowledge or tools as institutional lenders. There are certain risks associated with being a securities lender that the average retail client may not fully understand. Some of these risks are discussed below.

2.1.1 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.

⁹ Refer to section 2.1.3 *Tax implications of manufactured payments*



2.1.2 Loss of voting rights

In securities loan transactions, the lender remains the beneficial owner but the title and ownership of the securities transfers to the borrower. Voting rights on the client's fully-paid securities that are out on loan pass to the Dealer and, if lent 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 vote¹⁰.
- the FPL program 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.

2.1.3 Tax implications of manufactured payments

Since the client remains the beneficial owner of the fully-paid securities that are out on loan, in order to reflect the client's entitlement to the economic benefit of their lent 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.

2.1.4 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 fully-paid securities on loan.

¹⁰ Refer to section 2.1.4 *Delay in recalling securities*



2.2 Recourse in the event of a Dealer insolvency

In securities loan transactions, the borrower provides collateral to the lender equivalent to the market value of the securities that have been borrowed. The lender generally collects an overcollateralization amount to protect themselves from the credit risks associated with default by the borrower.

Dealers with large-scale FPL programs may have increased leverage risk from reinvesting or re-hypothecating the additional liquidity.

In FPL programs, the credit risk to the client arises from a Dealer insolvency. If a Dealer were to go insolvent, the client may not receive their lent securities back and may have limited recourse to the collateral because:

- The *Bankruptcy and Insolvency Act (BIA)* allocates the collateral as follows¹¹:
 - Securities collateral provided to the client goes to the “general fund”.
 - Cash collateral provided to the client goes to the “customer pool fund”.
- CIPF does not cover the client’s fully-paid securities that are on loan under the FPL program. There is a risk that, in the event of a Dealer insolvency, if there is a shortfall in the assets available in the customer pool, the client may not receive back the securities on loan. All fully-paid securities of clients in the FPL program that are not on loan, however, remain eligible for CIPF coverage.

2.3 Conflicts of interest

The FPL program 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 the FPL program.
- Where the Dealer has a proprietary/firm trading desk, they may generate profits by borrowing client’s fully-paid securities to cover short selling in their own proprietary

¹¹ Dealer insolvencies are addressed under Part XII of the BIA. Refer to Section 261 for definitions of “general fund” and “customer pool fund”, and Section 262 for rules on how the assets in each fund are allocated.



trading accounts. In the long-term, short-selling could potentially drive down the value of the client's securities¹².

- 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 since it is the client that bears the ultimate 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 fully-paid 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 lent to street borrowers.

2.4 Market integrity

The potential for market manipulation may increase if the types of securities being introduced into the FPL program are not actively traded or not widely held. Such securities may be more vulnerable to practices like “short and distort”¹³ schemes and short squeezes¹⁴. Similarly, increased short-selling in these securities may make them hard-to-borrow and therefore, result in delays in obtaining securities if a loan is terminated, and increased issues with settlements.

3. IIROC requirements

IIROC has established terms and conditions to address the above investor protection and market integrity concerns which would effectively:

- give more control and information to clients related to the risks of fully-paid lending,
- increase the likelihood of the client's recourse to collateral in the event of a Dealer insolvency, and
- limit fully-paid securities lending to liquid securities with reduced volatility.

3.1 Program restrictions

¹² Refer to section 2.1.1 *Market risks*

¹³ 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.

¹⁴ 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”.



3.1.1 Account set-up

The Dealer must record the client's fully-paid securities lending transactions and the cash collateral in the same account as, or a sub-account(s) of, the securities trading account (**FPL combined account**)¹⁵.

3.1.2 Securities eligible for the FPL program

The Dealer must ensure that the FPL program is restricted to equity securities that are

- listed on an Exchange¹⁶, and
- held by clients in their non-registered accounts only¹⁷.

The Dealer must also ensure that for equity securities listed on an exchange in Canada, the FPL program includes only those securities that meet at least one of the following criteria¹⁸:

- 6-month average volume weighted average price (VWAP) \geq \$2.00, or
- 6 month average daily trading volume \geq 100,000 shares, or
- 6-month average free float market capitalization \geq \$200 million.

The Dealer is required to maintain a list of securities eligible under the FPL program based on the above criteria. They must review their FPL program transactions against this criteria at least monthly and terminate loans that don't meet the criteria as soon as possible.

3.1.3 Restriction on use of fully-paid securities

The Dealer cannot borrow fully-paid securities from their clients under the FPL program to settle or cover their own inventory trading strategies unless the Dealer can demonstrate, to the satisfaction of IIROC, that they can effectively manage the conflicts of interest.

3.1.4 Collateral provided to clients

¹⁵ DMR 2200.8(b) and 2200.8(e) require loan accounts to be set up in a different account and in a different range from the securities trading accounts. IIROC staff supports exemptive relief for Dealers from these Rules.

¹⁶ Defined in UMIR 1.1 as "a person recognized by the applicable securities regulator under securities legislation to carry on business as an exchange".

¹⁷ For purposes of the FPL program, Tax-Free Savings Accounts are not considered registered accounts however, the Dealer must ensure compliance with all applicable tax laws.

¹⁸ IIROC may change the securities eligibility criteria from time to time. Dealers will be notified in writing.



The Dealer must provide cash collateral to the client and keep it in a separate bank account held in trust for clients¹⁹. The collateral cannot be withdrawn by the client or used to settle the purchase of securities in the account. A mark-to-market calculation must be done daily by the Dealer to value the lent securities which may result in changes to the collateral amount.

The Dealer must also provide to clients cash collateral of the same dollar amount as that received from lending the securities to street borrowers, but not less than 100% of the value of the securities.

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 Dealer²⁰.

3.1.5 Client-stipulated restrictions

The Dealer must obtain instructions from the client on:

- securities that they would like to exclude from the fully-paid lending program, and
- their maximum risk tolerance limit on the total dollar value of securities they are willing to lend under the FPL program. The Dealer is required to review FPL program transactions against this criteria daily and terminate loans that exceed the client's risk tolerance limit as soon as possible.

3.1.6 Borrowing from clients of Introducing Brokers and Portfolio Managers

The Dealer must ensure that each Introducing broker has received a non-objection letter from IIROC before fully-paid securities of clients of Introducing brokers are borrowed by the Dealer.

¹⁹ The cash collateral "held in trust" for the client must be in a manner consistent with the definition of trust accounts in the Notes and Instructions to Form 1, Statement D (section D, Line 1).

²⁰ The overcollateralization provided to clients creates a capital charge as required by the Notes and Instructions to Form 1, Part II, Schedule 1 (lines 4, 8 and 12). IIROC staff supports exemptive relief for Dealers from the capital charge requirement because the Dealer will be required to:

- set aside the entire cash collateral amount for the client (and exclude it from free credits available for use by the Dealer),
- hold the cash collateral in a separate bank account in the Dealer's name, and
- restrict the client's access to the collateral.



The Dealer must also ensure that each Portfolio Manager has notified the applicable Canadian Securities Administrators (**CSA**) regulator before fully-paid securities of clients of Portfolio Managers are borrowed by the Dealer.

3.2 Client documentation

3.2.1 Agreements

The Dealer must sign a securities loan agreement directly with the client. Clients of an Introducing Broker or Portfolio Manager must enter into a tri-party securities loan agreement with the Dealer where:

- the client is the lender,
- the Introducing Broker or Portfolio Manager is responsible for client eligibility, appropriateness and suitability, and
- the Dealer, in its capacity as Carrying Broker (for the Introducing Broker) or Custodian (for the Portfolio Manager), is the borrower.

The securities loan agreement must be in a form acceptable to IIROC and must clearly identify the:

- roles and responsibilities of each party,
- events of default,
- rights of the client to the collateral in the event of insolvency of the Dealer and if the Dealer is unable to recall lent securities within stipulated timeframes, and
- the fee schedule and the basis for the fee calculation.

3.2.2 Disclosure to clients

The Dealer must provide a clear description to clients of the FPL program including the type of accounts or sub-accounts to be opened and the purpose of borrowing the fully-paid securities.

The Dealer must also obtain signed risk disclosure acknowledgements from, and provide documentation in plain language²¹ to, the client that explains all applicable risks including:

- market risks that could result from the lent securities being used to facilitate short selling which could put downward pressure on the price of the lent securities,
- restrictions on access to lent securities on demand if the Dealer is unable to recall the securities within the timeframes stipulated by the Dealer,

²¹ The language used must be such that the client, as a reasonably knowledgeable person, would clearly understand the risks of lending their fully-paid securities.



- potential tax implications of receiving manufactured payments from the Dealer (in lieu of dividends and distributions directly from the issuer),
- potential tax implications if the client exercises their rights to the cash collateral,
- loss of voting rights on securities that are out on loan, including that the Dealer may not be able to recall the lent securities in time to vote (i.e. before the record date) and that the lent 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
- in the event of insolvency of the Dealer, limitations on recourse to collateral with increased risk if all of a client's fully-paid securities have been lent to the Dealer, and lack of CIPF coverage for lent securities.

3.2.3 Confirmations

The Dealer must provide a confirmation to the client with all required details related to the securities loan transaction when the following has occurred:

- securities have been lent
- the loan is terminated
- there is a change in fees and/or rates

3.2.4 Account statements

The Dealer must send the client a monthly statement of the FPL combined account which:

- distinguishes client securities that are on loan and cash collateral received under the FPL program from securities that are segregated and fully-paid
- includes the market value of security positions on loan in the total market value of the security positions in the FPL combined account
- excludes cash collateral from the total cash balance in the FPL combined account
- provides the following specific disclosure on CIPF coverage:

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



3.2.5 Performance report and fee/charge report

The Dealer must incorporate fully-paid lending in the performance report and fee/charge report provided to retail clients for the FPL combined 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 must include that portion of fully-paid lending revenue earned by the client.
 - the annual fee/charge report must include, at a minimum, text disclosure describing all compensation earned by the Dealer, and the Introducing Broker or Portfolio Manager as applicable, from lending the fully-paid 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 must include the gross fee amount received by the client before any deductions.
 - the annual fee/charge report must include:
 - i) 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
 - ii) text disclosure that describes all compensation earned by the Dealer, and the Introducing Broker or Portfolio Manager as applicable, from lending the fully-paid securities.

3.3 Regulatory reporting and Books and records

3.3.1 Policies and Procedures

The Dealer is required to have policies and procedures addressing the FPL program to ensure compliance with IIROC requirements and applicable laws including:

- minimum eligibility criteria for clients to participate in the FPL program
- appropriateness and suitability of the FPL program for clients with advisory and managed accounts²²
- identification of conflicts of interest with clients²³
- operational processes including:

²² DMR 1300 *Supervision of Accounts* sets out the Dealer's suitability obligation. The suitability requirement extends to FPL programs; IIROC has issued various guidance notes clarifying the scope.

²³ DMR 42 *Conflicts of Interest* requires Dealers to identify, address, and avoid conflicts that cannot be managed.



- how loan transactions will be initiated, terminated, and changed and the timeframes for each transaction
- how lending opportunities and recall requests will be allocated to clients
- how fees to the client will be calculated and when they will be deposited to the client account
- process for handling and resolving client questions and requests.

3.3.2 Regulatory reporting

The Dealer will need to ensure accurate reporting of fully-paid securities lending balances in the Monthly Financial Report (MFR) and Form 1, and calculation of the segregation, concentration and margin requirements as follows:

- 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*
- Cash collateral provided to clients must be excluded from the following balances reported in the MFR and Form 1:
 - Client net equity reported on Schedule 10 ²⁴
 - Free credits reported on Statement D, Line 2
- The cash collateral must be excluded from the calculation of client margin in the FPL combined account.
- The lent securities must be excluded from the assessment of securities concentration in the MFR and Form 1.
- The lent securities and the corresponding collateral must be excluded from the determination of segregation requirements in the FPL combined account.

3.3.3 Annual audit report

The Dealer must obtain an annual special purpose audit report to certify that the policies and procedures, systems and supervisory controls implemented for the FPL program comply with the following:

- the client's fully-paid securities on loan meet criteria and thresholds set by the client, IIROC and the Dealer

²⁴ The Client net equity reported on Schedule 10 must include the value of the lent securities.



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

4. Next steps

Any Dealer that would like to implement a FPL program must formally notify IIROC of a change in business model and apply to IIROC to facilitate the implementation of a FPL program and for appropriate exemptions from DMR 2200.8(b) and/or DMR 2200.8(e), and the capital



requirements in the Notes and Instructions to Schedule 1 of Form 1. The IIROC Board of Directors will consider the Dealer's proposed FPL program provided that it meets the terms and conditions discussed in section 3.

Over the next couple of years, IIROC will monitor how FPL programs operate and evolve. This will provide valuable information when developing Rules relating to FPL programs. We expect to have IIROC Rules in place for FPL Programs by the end of 2022.

5. Questions

For more information, please contact the Financial and Operations Compliance and/or Business Conduct Compliance relationship manager assigned to your firm.