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CIRO Bulletin

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Rules Bulletin > Request for Comments

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Rule Connection: IDPC Rules
Division: Investment Dealer

Proposed rule amendments - Fully paid securities lending and financing arrangements

Executive Summary

Comments Due By: April 15, 2024

The Canadian Investment Regulatory Organization (**CIRO**) is publishing for comment proposed amendments to the Investment Dealer and Partially Consolidated (**IDPC**) Rules and IDPC Form 1 (**Form 1**) relating to fully paid securities lending and financing arrangements (**Proposed Amendments**).

The Proposed Amendments:

- enhance the rule framework regarding retail fully paid securities lending,
- carry out CIRO's commitment to update our rules to address lessons learned from Dealer Members offering fully paid lending programs, and
- address a few inconsistencies in the existing financing arrangements rules.

We anticipate the amendments to have a positive impact on investors, institutional and retail, and Dealer Members because they:

- codify and clarify measures that are intended to protect retail investors,
- enhance procedural efficiency, including by removing the need for board exemptions,
- enable flexibility with regard to different lending models and client types,
- add clarity and consistency.

We are also publishing for comments the revised Guidance on Fully Paid Securities Lending (**Draft FPL Guidance**), which will replace the existing guidance GN-4600-22-001.

The Proposed Amendments initiative runs parallel to the Rule Consolidation Project.[1] As discussed later in this Bulletin, at this stage we do not anticipate substantive cross dependencies between the two. There is a possibility that the Proposed Amendments are implemented first and then adopted into the Dealer Consolidated Rules.

How to Submit Comments

Comments on the Proposed Amendments and Draft FPL Guidance should be in writing and delivered by **April 15, 2024** (60 days from the publication date of this Bulletin) to:

Member Regulation Policy
Canadian Investment Regulatory Organization
Suite 2600
40 Temperance Street
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Copies should also be delivered to the Canadian Securities Administrators (**CSA**):

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

and

Capital Markets Regulation
B.C. Securities Commission
P.O. Box 10142, Pacific Centre
701 West Georgia Street, Vancouver, British Columbia, V7Y 1L2
e-mail: CMRdistributionofSROdocuments@bcsc.bc.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the CIRO website at www.ciro.ca

[1] The Rule Consolidation Project seeks to consolidate the rules applicable to investment dealers (IDPC Rules) and rules applicable to mutual fund dealers (MFD Rules) into one set of consolidated rules applicable to both dealer categories (**DC Rules**). Please consult CIRO's website for further information and updates on this project.

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1. Background

Fully paid securities lending[2] refers to the Dealer Member (**Dealer**) practice of borrowing client's fully paid or excess margin securities.

This practice is not new in Canada and forms part of securities lending in general. Over the years, Dealers, especially those who custody client securities (either directly or on behalf of introducing brokers and portfolio managers), have been offering fully paid lending programs (**FPL program**) to their clients. Under these programs, the Dealer borrows client securities as a principal and in turn uses such securities to meet their in-house demand or lends them out to third parties. To secure the loan, the Dealer provides collateral to the client either directly or via a collateral agent.

Fully paid lending offers tangible benefits of unlocking assets for which there is market demand while generating additional income for the lending clients and their Dealers. At the same time, fully paid lending doesn't come without risks, and it is therefore important that a client fully understand these risks before consenting to the dealer using their securities within their operations or lending them to others.[3]

IDPC Rule 4600 historically[4] regulated traditional securities lending, which is mainly geared towards institutional lending, as well as the more isolated retail lending situations.[5] In 2019, in view of the characteristics and risks of the FPL programs and their mass retail client target, CIRO (IIROC at that time) set out a more rigorous framework of conditions and restrictions for fully paid lending programs (**FPL T&Cs**). This was done in consultation with the Canadian Securities Administrators (**CSA**), the Canadian Investor Protection Fund (**CIPF**) and outside legal counsel. Pursuant to this framework, approved Dealer FPL programs were subjected to:

- a modified client protection regime which necessitated exemptions from IDPC Rule clause 4603(3)(ii) and the capital requirements in the Notes and Instructions to Schedule 1 of Form 1, and
- several terms and conditions that were designed to:
    - 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.

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[2] We use 'fully paid securities lending' and 'fully paid lending' interchangeably throughout this Bulletin.

[3] Refer to section 1.4 of the revised draft fully paid lending guidance included within Appendix E for a discussion of the risks associated with securities lending.

[4] Before December 2021, securities lending was regulated under Dealer Member Rule 2200 *Cash and Securities Loan Transactions*, latter replaced with IDPC Rule 4600.

[5] In particular, IDPC Rule section 4607 deals with collateral arrangements that are common in retail securities lending arrangements. This in combination with the more generic IDPC Rules and the Form 1 requirements applicable to the Dealer – retail clients relationship laid out the retail lending and customer protection regime.

This framework was outlined in GN-4600-22-001, *Guidance on Fully-Paid Securities Lending Programs* (**FPL Guidance**).[6] In this guidance, CIRO committed to gather information on the operation and evolution of the approved FPL programs for the purposes of developing rules tailored around such programs. The objective was to codify measures that have proven effective, preserve investor protection and remove the need for Board exemptions.

The Proposed Amendments around fully paid lending which we are publishing for comment in this bulletin seek to achieve such objective. They are the result of our review of the existing framework and consultations with our advisory committees and individual Dealers who currently operate or seek to operate these programs.

In addition, during the review we identified a few areas in the IDPC Rules and Form 1 that needed revisions for further clarity and consistency. Although these areas of the rules are not specific to fully paid lending, they deal with the related area of Dealer financing arrangements. For this reason, we recommend revisions as part of the same rule proposal.

1.1. Current Dealer fully paid lending activity

At present there are eight Dealers approved to offer FPL programs. More Dealers have expressed interest in these programs.

As of June 2023, the overall number of clients enrolled in approved FPL programs amounted to 165,000 clients. The majority of these clients are retail clients[7]. As of June 2023, the dollar amount of fully paid securities on loan under the FPL programs was around half a billion CAD. These programs generated total revenue of around 18.8 million CAD in the 12-months preceding June 2023 which was shared between Dealers and clients. Borrowed securities are generally being used to lend to the street, or cover Dealer internal demand, for short selling, collateral requirements, or settlement purposes.

Dealers expect their FPL programs to continue to grow as clients become more familiar with these programs. They also provided feedback with regards to the need for flexibility in a few areas, such as borrowing from institutional clients, the securities eligible for lending and collateral type.

2. Proposed Amendments

The Proposed Amendments can be categorised into:

- amendments specific to retail fully paid lending,
- amendments with impact on financing arrangements, and
- amendments of consequential nature.

Below we discuss such amendments and their impact. The text of the Proposed Amendments to the IDPC Rules and Form 1 is set out in **Appendix A** and **Appendix B**; a blackline of the amendments is set out in **Appendix C** and **Appendix D**.

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[6] The guidance was initially issued on June 17, 2019, through the issuance of IIROC Rules Notice 19-0109 and subsequently replaced by GN-4600-22-001 with substantially the same guidance that was updated to reflect changes in rule numbering resulting from the implementation of IIROC's plain language rules.

[7] A small percentage of institutional clients are enrolled in the programs run at two Dealers.

2.1 Proposed Amendments on fully paid lending

We are proposing to:

- Introduce a new Part B.2. in Rule 4600 entitled *Borrowing retail client fully paid and excess margin securities*, and
- make corresponding amendments to the Notes and Instructions of impacted Statements and Schedules in Form 1.

These amendments largely codify into our rules those FPL T&Cs that we deem efficient and preserve investor protections. In doing so, we keep the same policy approach with regards to fully paid lending in most areas with a few exceptions. We discuss these exceptions together with the codified requirements in the following sections.

2.1.1 The overall scope of new proposed Part B.2. of Rule 4600

The proposed Part B.2. of Rule 4600 sets out specific requirements for Dealers when borrowing fully paid or excess margin securities from retail clients. In a departure from the current FPL T&Cs, the requirements set out in Part B.2 of Rule 4600:

- are mandatory where the borrowing activity involves retail clients, and
- would only apply to borrowing activity involving institutional clients where the client opts to be treated as a retail client for lending purposes.[8]

Dealer FPL activity versus Dealer FPL programs

The requirements of part B.2. of Rule 4600 are intended to apply to all Dealer fully paid lending arrangements with the retail client regardless of whether this is done via a Dealer structured program (e.g., FPL program) or not. The proposed approach adds clarity, ensures a consistent customer protection regime across the retail client base, and mitigates regulatory arbitrage from arbitrary interpretations of what constitutes a program.

Retail FPL versus Institutional FPL

The FPL T&Cs although tailored around FPL programs, which tend to attract retail clients, do not distinguish between institutional and retail clients. Instead, the Proposed Amendments seek to differentiate between the two client categories, in line with the existing client differentiation approach of Rule 4600. Following internal and industry consultations, we agree that more flexibility is warranted with regards to the institutional client in consideration of traditional lending market practices and the level of institutional client sophistication and risk mitigation tools at their disposal.

As such, Part B.2. in essence brings into the rules the more onerous FPL T&Cs and their client protection regime with applicability on the retail client fully paid lending. Institutional client lending on the other hand would continue to be subject to the traditional lending requirements of Rule 4600, unless the institutional client opts to be treated as a retail client. In other words, when lending fully paid or excess margin securities, the institutional client has the flexibility of structuring their loan arrangement

[8] Proposed IDPC Rule, section 4620.

pursuant to the more generic requirements of Rule 4600 on financing arrangements or subject the arrangement to the more onerous requirements of the proposed Part B.2. of Rule 4600.

2.1.2 Proposed section 4621 *Consent and Suitability*

This section specifies the requirements that a Dealer can only borrow client securities upon the client's prior consent and the determination, where applicable, that the fully paid lending services are suitable for the client.[9] These requirements are aligned with our overall requirements around client consent[10] and suitability determination,[11] as well as the FPL T&Cs and we do not anticipate any net new impact as a result of their implementation.

2.1.3 Proposed section 4622 *Securities Loan Agreement*

This section specifies the requirement for a written securities loan agreement between the borrowing Dealer, lending client and any third party to the loan arrangement (e.g., introducing broker, portfolio manager, collateral agent) and prescribes the minimum mandatory provisions in that agreement.[12] These requirements are aligned with current rule requirements, FPL T&Cs[13] and market practices, which is why we do not anticipate any net new impact as a result.

2.1.4 Proposed section 4623 *Disclosures*

This section sets out the specific requirements that the borrowing Dealer provide the client with adequate disclosures regarding the loan arrangement, including its structure, benefits, risks and the Investor Protection Fund (**IPF**) coverage limitations, and obtain client's acknowledgment to have understood such disclosures. These requirements are aligned with our more generic requirements around client disclosures, as well as the FPL T&Cs,[14] and we do not anticipate any net new impact as a result of their implementation.

2.1.5 Proposed section 4624 *Collateral*

This section sets out the requirement that the borrowing Dealer must provide, and maintain for the duration of the loan, adequate collateral to fully secure the loan. In addition, the section prescribes the minimum criteria for the collateral to be deemed adequate, such as the collateral must be:

- cash, or when so permitted by CIRO, debt securities with a margin rate of 5% or less,
- at a minimum 102% of the market value of the borrowed securities for the cash collateral, and 105% for the securities collateral,
- held in a form acceptable to CIRO, such as the forms prescribed in the proposed subsection 4624(5).

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[9] There is no obligation to assess the suitability of a fully paid lending program service offered through an order execution only account (pursuant to IDPC Rule subsection 3404(1)).

[10] IDPC Rule section 4312.

[11] IDPC Rule 3400.

[12] In the Draft FPL Guidance, we clarify that while there can be separate agreements when multiple parties are involved, for the purposes of our rules they will be deemed part of a master securities loan agreement.

[13] FPL T&C outlined in section 3.2.1 of the FPL Guidance.

[14] FPL T&C outlined in section 3.2.2 of the FPL Guidance.

The collateral requirements proposed here differ from the current requirements of Rule 4600, and specifically section 4607, due to the changes introduced by the FPL T&Cs for fully paid lending collateral arrangements.[15] The proposed section 4624 largely codifies the collateral FPL T&Cs, in that collateral is restricted to cash unless CIRO permits the use of securities as collateral, and collateral is held in acceptable forms.

In a departure from the collateral value requirements of Rule 4600 and collateral FPL T&C, we are standardizing the collateralization rate to 102% for cash collateral and 105% for securities collateral. This is intended to eliminate the confusion and practical inconsistencies flagged by consulted Dealers with the current FPL T&Cs approach. The current FPL T&Cs require the Dealer to pass to the client any overcollateralization received from the street borrower, which may result in inconsistent collateralization between one loan and/or client to another. The proposed collateralization rates are consistent with industry lending practices. We expect that the consistency introduced with this provision will have a positive impact on Dealers.

2.1.6 Proposed section 4625 *Asset reuse prohibition*

This section specifies restrictions on the reuse of the securities loaned as well as the assets that are provided as collateral. The scope of this section is to mitigate risks that result from asset reuse, which can span from Dealer default risk to more systemic contagion risks.

This requirement is aligned with the FPL T&Cs[16] and we do not anticipate any net new impact as a result.

2.1.7 Proposed section 4626 *Recordkeeping*

This section sets out the requirement that retail fully paid lending transactions are recorded in the securities trading account of the lending retail client, and such records must clearly distinguish the loaned securities and collateral provided.

Currently IDPC Rule clause 4603(3)(ii) requires that the client's financing accounts are kept separate from the client securities trading account. In comparison, the FPL framework[17] requires Dealers to record the client fully paid lending transactions (retail and institutional) into the client's securities trading accounts and apply for Board exemption from clause 4603(3)(ii).[18]

The proposed section 4626 codifies the recordkeeping approach of the FPL T&Cs with regards to retail fully paid lending.[19] In comparison, in line with client differentiation approach of the Proposed Amendments and Rule 4600, institutional fully paid lending will be governed by the existing recordkeeping requirement of IDPC Rule clause 4603(3)(ii) which applies to traditional lending.

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[15] FPL T&Cs as outlined in section 3.1.4 of the FPL Guidance. While the guidance deals with the situations when cash is the only collateral type allowed under the FPL programs, CIRO has permitted the granting of securities as collateral in exceptional circumstances where the proposed collateral holding model (i.e., via a collateral agent for the client) increases the likelihood of the client's recourse to collateral in the event of the borrowing Dealer insolvency.

[16] Outlined in sections 1.4 and 3.1.4 of the FPL Guidance.

[17] See FPL Guidance for an outline of such framework and the basis for it.

[18] Outlined in Section 3.1.1 and 3.2.4 of the FPL Guidance.

[19] In comparison, institutional fully paid lending will continue to be governed by IDPC Rule clause 4603(3)(ii).

This rule change adds clarity with regards to recordkeeping requirements and eliminates the present need for a Board exemption from clause 4603(3)(ii). As a result, we anticipate the impact to be that of reduced burden for the affected stakeholders.

2.1.8 Proposed section 4627 *Client communications*

This section specifies the requirements that communications to the lending clients around the loan arrangement adequately disclose the securities on loan, the collateral provided, the revenue earned, and commissions or fees paid directly or indirectly by the client. These requirements are aligned with our overall requirements around client communications and the FPL T&CS,[20] and we do not anticipate any net new impact as a result of their implementation.

2.1.9 Proposed section 4628 *Securities eligible for borrowing*

The existing IDPC Rules do not restrict the fully paid securities that a Dealer can borrow from their clients. In comparison the FPL T&Cs restrict the securities that the Dealer can borrow to equity securities that are listed on an exchange and held by clients in non-registered accounts.[21] Additional restrictive criteria seek to ensure that the borrowed Canadian listed equity securities meet certain low volatility thresholds.[22]

Under section 4628 we propose a more flexible approach given that market conditions may necessitate us to restrict or expand such criteria in an efficient manner. We codify in subsection 4628(1) the condition that Dealers can only borrow securities held by clients in their non-registered accounts. Pursuant to the proposed subsection 4628(2), CIRO will have the authority to prescribe from time-to-time restrictions on the securities that a Dealer can borrow from the client when it deems to be in the interest of the clients and the public. The restriction criteria will be published on CIRO's website.

For the time being we intend to bring forward the existing FPL T&Cs restrictions as CIRO prescribed restrictions subject to the following:

- as part of this publication, we ask the question whether the existing restriction that only equity securities that are listed on the exchange can be borrowed by the Dealer should be expanded to include other securities; and
- regarding the existing Canadian listed equity securities, we plan to make a calculation modification. Once the Proposed Amendments become effective, Dealers must use the '6-month average volume weighted average closing price $\geq$ $2.00' instead of the '6-month average volume weighted average price $\geq$ $2.00' as one of the securities eligibility criteria for their FPL activity. We believe that the policy scope of this restriction, i.e., preservation of market integrity, will still be met with this simpler and less burdensome calculation methodology.

The securities eligibility criteria, to be published by CIRO once the Proposed Amendments enter in effect, is attached as **Appendix F**.

[20] Outlined in Sections 3.2.3 to 3.2.5 of the FPL Guidance.
[21] FPL T&Cs outlined in Section 3.1.2 of the FPL Guidance.
[22] FPL T&Cs outlined in Section 3.1.2 of the FPL Guidance.

2.1.10 Proposed section 4629 *Special audit report*

Under this section we propose to codify the condition in the FPL T&Cs that the borrowing Dealer produce a special purpose independent audit report regarding the Dealer's fully paid lending activity.[23] The intent of this requirement is to ensure that adequate check and balances are in place at the borrowing Dealer.

In a departure from the FPL T&Cs, which stipulate that the borrowing Dealer must produce the special audit report on an annual basis, we are proposing that such report be produced upon CIRO's request. This is in alignment with our conduct and prudential risk-based approach now that Dealers have been running well-established FPL programs for several years.

We anticipate the impact of this provision to be between neutral to reduced burden for Dealers.

2.1.11 Proposed section 4630 *Additional requirements and restrictions*

This section sets out CIRO's authority to prescribe additional requirements or restrictions when deemed in the clients' and public interest. It further prescribes the contours of how CIRO can exercise such authority, such as when it seeks to further:

- increase the transparency of the fully paid lending activity,
- increase the likelihood of the lending client's recourse to collateral in the event of a Dealer insolvency, and
- preserve market integrity.

Certain Dealer programs may have unique features that require CIRO staff to impose additional requirements with the client interest in mind, such as with regards to collateral holding model under the program or the information that must be disclosed to the client.

Having such authority enables CIRO to respond efficiently and swiftly to the needs of the investors and industry while taking into consideration different Dealer business models, market conditions and risks as well as the evolution of jurisprudence (e.g. on the matter of Dealer bankruptcy and the client's recourse rights). CIRO will continue to exercise such authority in a transparent manner, and we expect the impact to be positive.

2.1.12 Proposed amendments to Form 1

In parallel to the above rule proposal (new Part B.2 of Rule 4600), we are proposing necessary corresponding amendments to Form 1 specific for fully paid lending transactions. The current Form 1 requires margin of either loan value deficiency or market value deficiency for financing transactions with 'other counterparties' depending on whether the Dealer has segregated the collateral or not. The Proposed Amendments exclude fully paid lending transactions from these margin requirements but introduce a new margin requirement that applies if the Dealer does not put aside adequate collateral for the fully paid lending client. The Proposed Amendments related to Form 1 specific to fully paid lending transactions include:

[23] FPL T&Cs outlined in section 3.3.3 of the FPL Guidance

- introducing a margin requirement that applies if the Dealer does not put aside adequate collateral in compliance with the provisions of the proposed Part B.2. of Rule 4600 [Schedule 1, *Notes and Instructions* (7)(iv)(c)],
- allowing a one-day grace period for the Dealer to top-up collateral before a capital charge is triggered, which is consistent with operational practices and other financing arrangements [Schedule 1, *Notes and Instructions* (14)],
- adding requirements around collateral reporting and restrictions, such as to exclude collateral when determining free credits, client margin, and net equity [Statement D *Notes and Instructions* (2), Schedule 4 *Notes and Instructions* (2), (5)(v), (8)(1)(d), and Schedule 10 *Notes and Instructions* (4)].

These amendments add clarity and certainty with regards to the applicable margin and collateral reporting requirements in Form 1. Also, they eliminate the need for Dealers to request Board exemptions from the current margin requirements when carrying fully paid lending.[24]

2.2 Proposed amendments on financing arrangements

The amendments proposed under this section seek to address existing overlaps and inconsistencies in the rule provisions that deal with financing arrangements. We intend the impact of these amendments to be that of enhanced rule clarity and consistency without any added burden on stakeholders.

2.2.1 Amendments to definitions in sections 1201 and 4602

We propose to amend section 1201, by replacing the current term *written cash and securities loan agreement* with the terms *cash loan* and *securities loan*. We do not think it necessary to define what a written agreement is as the rules already set out the provisions to be included in a written agreement. In comparison, the new terms align with the terminology used in IDPC Form 1 which puts the emphasis on the transaction and the differences between a cash loan and securities loan.

We propose to introduce in section 4602 the term *financing arrangements*, which captures a *cash loan*, a *securities loan*, a *repurchase agreement*, or a *reverse repurchase agreement*. The intention is to make the rules that reference these transactions, indiscriminately, easier to read. We also propose a minor amendment to the current term *overnight cash loan agreement* for added clarity.

2.2.2 Amendments to sections dealing with *financing arrangement*[25] agreements

We propose to bring into section 4604 the agreement requirements for financing arrangements currently spread out between Rule 4600, and Rule 5800. In doing so we add clarity and consistency to our requirements and address any unnecessary overlaps or duplications which exist between these provisions at present. More specifically:

- we combine the requirements of section 4604, 5810, 5840 and 5850 into section 4604 while removing inconsistencies and adding clarity, such as:

[24] Currently Dealers with FPL programs rely on Board exemptions from the margin requirements in the Notes and Instructions to Form 1, Part II, Schedule 1 (Lines 4, 8 and 12), given the lack of margin and collateral rules specific to these programs. Section 3 and 4 of FPL Guidance.

[25] As discussed above, this new term is intended to capture a *cash loan*, a *securities loan*, a *repurchase agreement*, or a *reverse repurchase agreement*.

- replace ‘securities’ with ‘asset’, to capture the application of the requirements for securities as well as cash;[26]
- remove entirely subsection 5840(1), because it implies that the requirements of section 5840 (to be brought into section 4604) are limited only to loan transactions involving cash;
- the requirements in section 5840 (as proposed to be merged into section 4604) are intended to also apply to securities loan transactions that do not involve cash;
- polish the drafting in the rest of the subsections;

- add in section 4604 (under clause (2)(iv)) the requirement that the written agreement set out the parties' rights to call on demand any collateral deficiency. Currently this requirement is limited to borrow/lend agreements with registered entities and repo/reverse repo agreements.[27] We believe this is true for all financing arrangements in general and regardless of the counterparty.

2.2.3 Amendments to sections 4605 and 4606

We propose to combine section 4605 and clause 4606(1)(ii) into the renumbered section 4610 under the new title *Collateral other than cash and securities*. This change adds clarity to the scope of these provisions and addresses any unnecessary repetitions.

2.2.4 Amendments to Form 1 regarding *financing arrangement* agreements

In parallel to the proposed IDPC Rules amendments regarding *financing arrangement* agreements, discussed under this section 2.2, we are proposing corresponding amendments to Form 1 which are necessary to ensure alignment between these two instruments with regards to these agreements, such as:

- Amendments to Schedule 1, *Notes and Instructions* (8)(i)
- Amendments to Schedule 1, *Notes and Instructions* (11)
- Amendments to Schedule 7, *Notes and Instructions* (7)(v)(iii), (8)(i)
- Amendments to Schedule 1 and 7, *Notes and Instructions* (13)

2.3 Proposed consequential amendments

These are amendments to other provisions in the IDPC Rules and Form 1 that are indirectly impacted by the Proposed Amendments discussed above and are necessary to ensure alignment with such amendments. These consequential amendments consist of:

- amending section 4318 to clarify that Dealers maintain the fully paid and excess margin securities in segregation until the date the securities are borrowed or loaned;
- amending section 4429 to clarify that only fully paid securities, with the exception of new issues and securities borrowed by the Dealer under Part B.2. of Rule 4600, may be transferred into a name other than the Dealer's name;

[26] See proposed revisions in clause 4604(2)(i) and (iii), which correspond to current clauses 5840(3)(i) and (iii), and 5850(2)(i) and (iii).
[27] Current subsection 4604(2) and clause 4606(1)(i).

- deleting from Rule 4600 section 4607, which relates to current financing activity with "other counterparties", to prevent confusion and overlap with the newly introduced Part B.2. of Rule 4600. The margin implications from credit risk exposure when dealing with 'other counterparty' are already addressed in Schedule 1 and 7 of Form 1. The relevant portions of the existing 4607 provision are included in Schedule 1 and 7 to clarify the collateral requirements that allow the market value deficiency margin to be applied to other counterparties;

- making non-material amendments to a few provisions in the IDPC Rules and Form 1 to ensure structural consistency as well as alignment of language and cross-references, namely:
    - alignment language and cross-references in section 4312 and section 4424,
    - structural changes in section 4429,
    - structural changes in Rule 4600,
    - alignment of cross-references in section 5130,
    - structural changes or alignment of language in Rule 5800 and Rule 5900,
    - structural changes (e.g. sections numbering) in Form 1.

We anticipate the impact of these financing arrangement amendments to be that of rule alignment and to reflect current practices without any negative impact or added burden on stakeholders.

3. Draft FPL Guidance

We are proposing revisions to the existing FPL Guidance, as a result of the Proposed Amendments. The revised guidance clarifies our expectations regarding Dealer compliance with our rules when offering fully paid lending to retail clients pursuant to the proposed Part B.2. of Rule 4600. We encourage stakeholders to read the Proposed Amendments on fully paid lending together with the revised guidance.

The Draft FPL Guidance is attached under **Appendix E**. The Draft FPL Guidance will enter into effect same time with the Proposed Amendments and replace current FPL Guidance.

4. Impact of the Proposed Amendments

4.1. Stakeholder impact

For the most part the Proposed Amendments:

- codify into our rules aspects of the current regulatory framework around fully paid lending that we deem efficient and preserve investor protection and market stability;
- add clarity and consistency to the existing rules around financing arrangements, without changing their substance.

Therefore, in these areas we anticipate that the impact of the Proposed Amendments will be that of added transparency and efficiency, without additional burden on affected stakeholders.

With regards to those areas where we have materially revisited our approach, we anticipate the impact to be positive and outweigh resulting costs, if any. More specifically:

- The proposed client differentiation approach adopts a stricter investor protection regime with regards to retail fully paid lending while enabling more flexibility with regards to institutional fully paid lending. We believe this approach strikes the right balance between investor protection and rulemaking proportionality and aligns with the overall client and business model differentiation approach of the IDPC Rules.
- The proposed standardization of the collateralization requirements [proposed subsection 4624(3)] will likely result in some Dealers with active FPL programs having to add additional collateral to meet this requirement. We believe such costs are outweighed by the benefits of the added investor protection and consistency across the industry that this new requirement brings.
- The proposed CIRO authority to impose additional requirements and restrictions on the Dealer fully paid lending activity (proposed section 4630), enables CIRO to respond efficiently and swiftly to the needs of each FPL program, within the prescribed contours of its authority.
- The elimination of the need for Board exemptions with regards to loan recordkeeping and margin requirements will result in burden reduction for affected Dealers and CIRO.

The Proposed Amendments do not impact Mutual Fund Dealers, because at present they are not permitted to engage in fully paid lending. We intend to assess the future applicability of the Proposed Amendments on these dealers later on as part of the Rule Consolidation Project.

An assessment of the impact of the Proposed Amendments is included as **Appendix G**.

4.2. Regional impact

No regional-specific effects as a result of the Proposed Amendments have been identified as they impact indiscriminately all industry stakeholders across Canada.

4.3. Impact of other policy projects

There are no substantive cross dependencies between the Proposed Amendments and the parallel Rule Consolidation Project at this stage, mainly due to the lack of comparable provisions in the Mutual Fund Dealer Rules. We expect the impact of having to reflect the Proposed Amendments, once approved, into the new consolidated rules to be minimal.

We do however anticipate an indirect impact as a result of the Proposed Derivatives Rule Modernisation amendments,[28] once they enter into effect. Under these amendments the definition of 'institutional client' has been expanded to include individuals who meet the definition's thresholds and request to be treated as institutional investors. The new definition does not influence our determination to differentiate between the institutional and retail clients for the purposes of the Proposed Amendments. However, the affected stakeholders should give due consideration to this upcoming change.

5. Alternatives Considered

We have considered both alternatives of:

- keeping the current regulatory framework in place, which relies on Board exemptions, or

[28] For information on the status of this initiative, refer to the Proposed Derivatives Rule Modernization, Stage 1, publications on CIRO's website.

- publishing the Proposed Amendments under the umbrella of the Rule Consolidation Project.

These alternatives pose challenges in terms of substance and timelines. In comparison to the current framework, the Proposed Amendments enhance the efficiency and transparency of the regulatory framework around fully paid lending while reducing procedural burden for the stakeholders involved. At the same time, we decided to publish the Proposed Amendments now so that we can move forward with the consultation and implementation of these amendments independent of the complexities and probably longer timelines of the Rule Consolidation Project.

6. Questions

While comment is requested on all aspects of the Proposed Amendments, comment is also specifically requested on the following questions:

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

7. Policy Development Process

7.1 Regulatory Purpose

The Proposed Amendments seek to enhance the rule framework regarding retail fully paid lending and address overlaps and inconsistencies in the existing financing arrangements rules.

The Proposed Amendments have been determined to be in the public interest because they would:

- foster fair and efficient capital markets and promote market integrity,
- facilitate access to advice and products for investors of different demographics,
- promote the protection of investors,
- accommodate innovation and ensuring flexibility and responsiveness to the future needs of the evolving capital markets, without compromising investor protection.

7.2 Regulatory Process

The Board of Directors of CIRO (**Board**) has determined the Proposed Amendments to be in the public interest and on January 24, 2024, approved them for public comment.

We consulted with the following CIRO advisory committees on this matter:

- Financial and Operations Advisory Section - Operations and Capital Formula Sub-Committees
- Conduct, Compliance and Legal Advisory Section - Order Execution Only Sub-Committee

We also consulted with several individual Dealers who currently operate or seek to operate these programs.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the CSA, CIRO staff may recommend revisions to the

Proposed Amendments. If the revisions and comments received are not material in nature, the Board has authorized the President to approve the revisions on CIRO's behalf and the revised Proposed Amendments will be subject to approval by the CSA. If the revisions or comments are material, CIRO staff will submit the Proposed Amendments, including any revisions, to the Board for approval for republication or implementation, as applicable.

8. Appendices

Appendix A - Proposed Amendments to IDPC Rules (clean)

Appendix B - Proposed Amendments to Form 1 (clean)

Appendix C - Proposed Amendments to IDPC Rules (blackline)

Appendix D - Proposed Amendments to Form 1 (blackline)

Appendix E – Revised draft *Guidance on fully paid securities lending*

Appendix F – Fully paid lending – *Securities eligibility criteria*

Appendix G - Impact Assessment

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Rules Bulletin > Guidance Note

Contact:

Member Regulation Policy

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Distribute internally to:

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Rule Connection: IDPC Rules

Division: Investment Dealer

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 securities[1] 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.

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[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.

Table of Contents

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 securities[4] 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 market. In particular, securities that have limited supply, but substantial demand are

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

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 squeezes[6]. 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 retails 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.

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]

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[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.

[8] Clause 4621(1)(i).

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 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:

[9] Clause 4621(1)(ii).
[10] Subsection 3404(2).
[11] Subsection 3404(1).

- securities that they would like to exclude from lending, and
- their maximum risk tolerance limit on 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 risk tolerance 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 client with adequate written disclosures regarding the loan arrangement and obtain the client's written acknowledgment to have read and understood the disclosures provided.[12]

The securities loan disclosure, must conform to our standards of disclosure[13] and at the minimum contain 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,
- all applicable risks specific to the client, such as for instance:
    - 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 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 collateral,
    - 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
    - in the event of insolvency of the Dealer, limitations on recourse to collateral,

and

[12] Section 4623.

[13] Section 3216. We consider the risk disclosure to conform to our standard of meaningful disclosure when it is such that the client, as a reasonably knowledgeable person, would clearly understand the implications and risks of lending their securities.

- 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 collateral[14] 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,[15] 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.

Securities loaned under Part B.2. of Rule 4600 are removed from segregation while on loan and therefore cannot be used by the lending client in any hedging strategy. For example, the Dealer cannot borrow a security from a client if the security is used to reduce margin as part of a margin offset in the client account.

Also, 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.

[14] Subsection 4624(2).
[15] Clause 4603(1)(i).

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**).[16] 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.[17] 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.[18]

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 statements[19] 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:

        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

[16] 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.
[17] Sections 3808 to 3811, section 3816 and subsection 4603(4).
[18] Section 4627.
[19] Subsection 4603(4).

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 Securities eligibility

Fully paid lending is restricted to securities that are held by clients in their non-registered accounts only.[20] CIRO can prescribe from time-to-time additional restrictions when it deems to be in the interest of the clients and the public.[21] These restrictions are published on CIRO's website.

To ensure compliance with the securities eligibility restrictions, Dealer 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.

[20] Subsection 4628(1). For purposes of the fully paid lending activity, Tax-Free Savings Accounts are not considered registered accounts however, the Dealer must ensure compliance with all applicable tax laws.
[21] Subsection 4628(2).

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.[22] This includes avoiding engaging in the activity that gives rise to the conflicts 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 CIRO 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 CIRO 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 CIRO requirements and applicable laws.[23] 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,[24]
- identification of conflicts of interest with clients,[25]
- 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

[22] Section 3112.
[23] Section 1404.
[24] Section 3211 and Rule 3400.
[25] Rule 3100 – Part B

- how client compensation is calculated and when it is deposited to the client account.

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.[26]
- 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 report[27] 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.[28] 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,

[26] The client net equity reported on Schedule 10 must include the value of the loaned securities.
[27] 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.
[28] Section 4629.

- 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 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:
    - 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
    - free credits available for use by the Dealer that excludes cash collateral provided to clients under fully paid lending,
    - margin and segregation requirements for other client assets which excludes client securities on loan and corresponding collateral received,
    - 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.
    - 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 [xxxx].

Fully paid securities lending (FPL) – Securities eligibility criteria

Effective [date], a Dealer Member (**Dealer**) can only borrow client fully paid and excess margin securities, pursuant to Part B.2. of IDPC Rule 4600, that meet the following eligibility criteria.

Rule prescribed criteria[1]

The borrowing Dealer must ensure that they only borrow client securities held by clients in their non-registered accounts.

Additional CIRO prescribed criteria[2]

The borrowing *Dealer Member* must only borrow client equity securities listed on an exchange. For Canadian listed equity securities, the Dealer must ensure that they meet at least one of the following criteria:

- 6-month average volume weighted average closing price $\geq$ $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 securities eligibility criteria prescribed by CIRO may change from time to time.

To ensure compliance with the securities eligibility restrictions, Dealers are expected to maintain a list of securities eligible under the fully paid lending activity based on the above 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.[3]

[1] IDPC Rule subsection 4628(1).
[2] IDPC Rule subsection 4628(2).
[3] Guidance on fully paid securities lending GN-[SERIES]-2#-####.

I. Impact Assessment Table

In the impact assessment table below, we list:

- the major policy elements of the Proposed Amendments,
- a description of the intended policy benefits of each element, and
- an assessment of its impact on clients, Dealer Members and CIRO itself.

We discuss the Proposed Amendments and their impact under the following categories:

- Proposed amendments on fully paid lending
- Proposed amendments on financing arrangements
- Proposed consequential amendments

References to the FPL T&Cs are references to the terms and conditions imposed on Dealer fully paid lending programs as outlined in GN-4600-22-001, *Guidance on Fully-Paid Securities Lending Programs.*

The Proposed Amendments do not have an impact on Mutual Fund Dealers, because at present they are not permitted to engage in fully paid lending.

II. Conclusions

We concluded that, if approved, the Proposed Amendments would result in:

- enhanced retail investor protection,
- enhanced procedural efficiency,
- needed flexibility with regards to different lending models and client type,
- added clarity and consistency.

While there could be some cost impacts on Dealers, we believe the benefits of the Proposed Amendments outweigh such costs.

III. Cost Estimate

We do not know the dollar magnitude of the collective impacts of the Proposed Amendments, and we cannot determine it without detailed stakeholder feedback as part of this public consultation.

IV. Questions

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?

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.

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.

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.

Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Investment Dealers	Impact on CIRO
***Proposed Amendments on fully paid lending* (New Part B.2. of Rule 4600)**				
General – Set out enhanced rule framework specific for Dealer fully paid securities lending with retail clients and those institutional clients who choose to be treated as retail clients for the purposes of the fully paid loan arrangement (Part B.2. of Rule 4600).	Enhance our rules around retail client lending by adopting lessons learned over the years from Dealer fully paid lending activity. The Proposed Amendments largely codify FPL T&Cs that we determined to be efficient and preserve investor protection. The Proposed Amendments, in a departure from the FPL T&Cs: • keep with the retail versus institutional client differentiation approach of Rule 4600 and market practices; • apply to retail fully paid lending in general, rather than just programs. In doing so we ensure rule proportionality, enable consistent retail client protection regime and prevent regulatory arbitrage.	*Positive*; enhanced retail client protection, regulatory transparency and proportional regulatory flexibility with regards to institutional clients.	*Positive;* enhanced efficiency as a result of rule clarity and client differentiation approach.	*Positive*; enhanced regulatory efficiency.
Specify the requirement that client securities can be borrowed only upon the client prior consent and suitability determination, (proposed section 4621).	Ensure adequate client awareness, control and protection over their investments. This requirement is aligned with the current rules and FPL T&Cs regarding consent and suitability.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.
Specify the requirement for a written securities loan agreement and the minimum	Ensure that clients receive the protections of a well-structured written loan agreement.	*Neutral to positive*; enhanced rule transparency and clarity	*Neutral to positive*; enhanced rule transparency and	*Neutral to positive*; enhanced rule transparency and clarity

Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Investment Dealers	Impact on CIRO
mandatory provisions, (proposed section 4622).	This requirement is aligned with current rules and FPL T&Cs regarding client agreements.	of client protection measures.	clarity of client protection measures.	of client protection measures.
Specify the client's disclosure and acknowledgement requirements for loan arrangements, (proposed section 4623).	Ensure that clients are provided adequate disclosures specific to the loan arrangement and the Investor Protection Fund (IPF) limitations. It embodies the importance that clients act on the basis of informed decision making. This requirement is aligned with current rules and FPL T&Cs regarding client disclosures and acknowledgment.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.
Set out the minimum requirements regarding collateral adequacy and standardize the minimum collateral value that a Dealer must provide under our rules, (proposed section 4624).	Ensure that Dealers provide and maintain adequate collateral to secure the loan. Collateral is an important risk mitigation tool, especially for the client against the risk of Dealer default or insolvency. This requirement codifies existing market practices and lessons learned from Dealer fully paid lending activity.	*Neutral to positive* enhanced rule transparency, clarity and efficiency of client protection measures.	*Neutral to positive*; enhanced rule transparency, clarity and efficiency of codifying existing collateral market practices and FPL T&Cs. *Positive to negative (added costs)* with regards to the standardization of the collateral value requirement. For some Dealers the impact is that of added operational efficiency. Other Dealers may incur added costs from having to add	*Neutral to positive;* enhanced rule transparency and clarity of collateral arrangements. We expect added efficiency from monitoring standardized collateralization practices.

Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Investment Dealers	Impact on CIRO
			collateral in order to meet the standardized collateralization rates. Ultimately, we believe that the benefits outweigh the costs.	
Specify restrictions regarding the reuse of securities on loan and provided collateral (proposed section 4625)	Mitigate risks that result from asset reuse, which can span from Dealer default risk to more systemic contagion risks. This requirement is aligned with the existing FPL T&Cs.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.
Set out the requirement that loan transactions are recorded in the client's securities trading account, and such records clearly distinguish the loaned securities and collateral provided (*proposed section 4626)*	Codify in the rule the loan recordkeeping requirements set out by the FPL T&C regarding Dealer fully paid lending programs. By doing so we add rule clarity with regards to retail client lending and eliminate the need for Dealers to apply for CIRO Board exemption from clause 4603(3)(ii), each time they seek to carry out fully paid lending activity.	*Neutral to positive*; enhanced rule transparency and clarity of a client protection measure.	*Positive*; reduced burden due to the elimination of the need to seek Board exemption from clause 4603(3)(ii).	*Positive;* enhanced efficiency due to the elimination of the need to issue Board exemption from clause 4603(3)(ii).
Specify the requirement to provide clients with adequate ongoing communications regarding the loan, collateral provided, revenue earned, and commissions or fees, (proposed section 4627)	Ensure that continuous and adequate communications are provided to the client regarding their lending transactions. These requirements are aligned with our overall requirements regarding client communications and FPL T&CS.	*Neutral to positive*; enhanced rule transparency and clarity of a client protection measure.	*Neutral to positive*; enhanced rule transparency and clarity of a client protection measure.	*Neutral to positive*; enhanced rule transparency and clarity of a client protection measure.
Codify the restriction that only client securities in non-registered accounts can be	Preserve client protection and market integrity.	*Neutral to positive*: enhanced rule transparency and clarity	*Neutral to positive*; reduced burden in instances when	*Positive;* enhanced efficiency resulting from CIRO's staff authority to

Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Investment Dealers	Impact on CIRO
borrowed by the Dealer; in parallel set out CIRO's authority to prescribe additional restrictions when in the client and public interest, (proposed section 4628).	In parallel, enhance regulatory efficiency by: • giving CIRO's staff authority to prescribe additional restrictions when in the clients and public interest, such as when market conditions demand prompt regulatory response; and • replacing the 6-month average volume weighted average price (VWAP) with the 6-month average volume weighted average closing price (VWACP).	of a client protection measure.	Dealers adopt the 6-months average VWACP measure when assessing securities eligibility.	respond swiftly to the market conditions.
Set out the requirement that the borrowing Dealer produces a special purpose independent audit report specific for the fully paid lending activity (proposed section 4629).	Ensure that adequate checks and balances are in place at the borrowing Dealer. This section codifies existing FPL T&C with the modification that the report is produced upon CIRO's request, rather than annually. In addition to adding efficiency, this approach aligns with CIRO's conduct and prudential risk-based approach now that Dealers have been running well-established FPL programs for several years.	*Neutral to positive*; enhanced rule transparency and clarity of client protection measure.	*Neutral to positive;* reduced burden as a result of producing the report upon CIRO's request as opposed to annually.	*Positive*; enhanced efficiency due to the conduct and prudential risk-based approach of the audit report requirement.
Set out CIRO's authority to prescribe, in a transparent manner, additional requirements or restrictions when deemed in the clients' and public interest. (proposed section 4630).	Enable CIRO to respond efficiently and swiftly to the needs of the investors and industry while taking into consideration different Dealer business models, market conditions and risks as well as the evolution of jurisprudence (e.g. on the matter of Dealer bankruptcy and the client's recourse rights).	*Neutral*; indirect positive impact as a result of the enhanced procedural efficiency.	*Neutral to positive.* enhanced procedural efficiency.	*Positive*; enhanced procedural efficiency.

Description of proposed amendment	**Related intended benefits**	**Impact on clients**	**Impact on Investment Dealers**	**Impact on CIRO**
Set out in Form 1 requirements specific for retail fully paid lending regarding: • applicable margin for collateral deficiency [*Notes and Instructions (7)(iv)(c)]*, • collateral top up grace period [*Schedule 1, Notes and Instructions (14)*], and • collateral reporting and restrictions [*Statement D Notes and Instructions (2), Schedule 4 Notes and Instructions (2), (5)(v), (8)(1)(d), and Schedule 10 Notes and Instructions (4)]*	Enhance clarity and certainty with regards to the applicable margin and collateral reporting requirements in Form 1. Eliminate the need for Dealers to request Board exemptions from the current margin requirements regarding their FPL programs (i.e. (Notes and Instructions to Form 1, Part II, Schedule 1 (Lines 4, 8 and 12).	*Neutral to positive*; enhanced rule transparency and clarity of client protection measures.	*Neutral to positive*; enhanced clarity and certainty regarding applicable regulatory measures. Reduced burden as a result of eliminating the need for Board exemptions from the margin requirements.	*Neutral to positive*; enhanced regulatory clarity and efficiency.
Proposed amendments on financing arrangements				
Amendments to add clarity, fix overlaps and inconsistencies in the following financing arrangements provisions: Amendments to IDPC Rules: • Section 1201 • Sections 4604 - 4606 • Section 5840 • Section 5850 Amendments to Form 1: • Schedule 1, Notes and Instructions (8)(i) • Schedule 1, Notes and Instructions (11) • Schedule 7, Notes and Instructions (7)(v)(iii), (8)(i) • Schedule 1 and 7, Notes and Instructions (13)	Enhance rule clarity and consistency without any added burden on stakeholders.	*Neutral to positive*; enhanced regulatory clarity and consistency.	*Neutral to positive*; enhanced regulatory clarity and consistency.	*Neutral to positive*; enhanced regulatory clarity and consistency.

Description of proposed amendment	**Related intended benefits**	**Impact on clients**	**Impact on Investment Dealers**	**Impact on CIRO**
Proposed consequential amendments				
Amendments to several provisions in the IDPC Rules and notes to Form 1, which are indirectly impacted by the Proposed Amendments discussed above.	Ensure rules alignment and structural consistency without any negative impact or added burden on stakeholders.	*Neutral to positive;* enhanced rule transparency and consistency.	*Neutral to positive;* enhanced rule transparency and consistency.	*Neutral to positive;* enhanced rule transparency and consistency.