By email

February 26, 2024

Keith Evans
Executive Director
kevans@ccma-acmc.ca
416-365-8594

Pat Dunwoody
Executive Director
patdunwoody@cefta.ca
647-256-6637

Attention: Staff of the Investment Funds & Structured Products Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario M5H 3S8

E-mail: rchan@osc.gov.on.ca; dmckall@osc.gov.on.ca; mtang@osc.gov.on.ca

Dear OSC Staff:

Re: Request for Regulatory Guidance – Acceptable Use of Cash Collateral for Delayed Basket Securities in ETF Subscriptions

On behalf of the members of the Canadian Capital Markets Association ("CCMA") and the members of the Canadian ETF Association ("CETFA"), we are requesting guidance from OSC Staff regarding the permissibility under National Instrument 81-102 *Investment Funds* ("NI 81-102") of the acceptance of cash collateral for "Delayed Basket Securities" in the exchange traded funds ("ETF") unit subscription process.[1] Delayed Basket Securities are late-delivered Basket Securities that were agreed (at the time of subscription) to be delivered by an authorized participant ("AP") to an ETF by the settlement date for an in-kind subscription for ETF units.[2]

As there is no formal process or centralized collateral facility in Canada (such as in other jurisdictions), there is a lack of clarity amongst some industry participants as the permissibility of this practice, notwithstanding the mitigation of failed trades caused by the Delayed Basket Securities. Regulatory guidance would eliminate this lack of clarity and provide certainty to the industry. Furthermore, the industry has agreed there should be established standards for the practice. Regulatory guidance would assist in setting and communicating the expectations for these industry standards.

[1] While various forms of collateral have been discussed, the industry has coalesced around the use of cash collateral only (for Delayed Basket Securities) at this time.

[2] An AP may subscribe for ETF units by delivering to the ETF manager as consideration for the purchase a group of securities approved by the manager of the ETF ("Basket Securities").

CCMA'S EXCHANGE TRADED FUNDS TASK FORCE and CETFA's WORKING GROUP

In the spring of 2023, the CCMA's Operations Working Group struck the ETF Task Force ("ETFTF") to explore matters of concern with respect to ETF's transitioning to T+1. The ETFTF is comprised of subject matter experts in the ETF space and includes representation from banks, non-bank owned investment dealers, custodians, and CETFA. Various issues were raised, ranging in length of time to address. The principal short-term matter that arose at the beginning of the ETFTF's discussions was the acceptability of collateral in the subscription/redemption processes for ETF units. This matter was narrowed to focus on cash collateral in the subscription process for Delayed Basket Securities.

CETFA also formed a working group to consider the collateral process from the perspective of its investment fund managers and bring their views to the ETFTF. A significant number of CETFA investment fund managers have also been directly involved in ETFTF discussions.

IMPACTS OF DELAYED BASKET SECURITIES

ETFs do not issue ETF units until payment is received in accordance with the requirements of Section 9.4 of NI 81-102. In the case of Delayed Basket Securities, typical practice is to adopt a conservative interpretation approach - ETF units are not delivered to the AP until all Basket Securities, including all Delayed Basket Securities, are delivered to the ETF. Thus Delayed Basket Securities result in "Delayed ETF Units" (ETF units that have not been delivered to an AP, pending settlement of Delayed Basket Securities). Such Delayed ETF Units in turn cause a delay in the onward delivery of such ETF units to market participants who have purchased them in the secondary market.

T+1 and Mitigation of Fail Risk

With the approaching T+1 transition date of May 27, 2024, there is concern that the shortened settlement cycle will increase the incidence of Delayed Basket Securities, resulting in Delayed ETF Units occurring more frequently and increasing the rate of downstream settlement failures.[3] The shortened settlement timeline will make it more challenging to obtain, on a timely basis, all Basket Securities required for an in-kind ETF subscription. APs are dependent on other market actors providing timely delivery of securities. The T+1 settlement cycle will make it more difficult to obtain the full basket of securities for in-kind subscriptions within the one day post-trade settlement cycle, simply because there is reduced time to resolve routine issues, such as delayed return of securities on loan, or corporate actions that cause delay in movement. As most ETF units purchased by an AP through subscription orders are ultimately sold in the secondary market, delays in the primary market will adversely impact the secondary market such as increasing failed trades.

[3] There are discussions in various jurisdictions concerning increasing fail rates and potential solutions such as "T-0 creates" for ETFs. https://www.etfstream.com/articles/investors-paying-the-price-for-t-1-creation-inefficiencies.

A standardized cash collateral process would help to mitigate such delays in the settlement of ETF units and the associated risks, by enabling delivery of ETF units to APs on the original settlement date, and timely onward delivery to other participants and provide consistency for the industry. Such a process would permit an ETF to accept cash delivered by the AP as collateral against Delayed Basket Securities, and deliver the corresponding ETF units to the AP. This increases efficiency in the capital markets and reduce settlement fail risk (both for primary and secondary markets), while also protecting the ETF and investors.

It is noted that it has been reported that globally there will be an increased use of cash collateral and/or cash-in-lieu[4] in the ETF primary market due to the timing changes associated with T+1.[5]

Investment Dealer Capital

Situations where an AP is awaiting delivery of Delayed ETF Units also have the potential to negatively impact the capital charges to which investment dealers are subject. APs will often deliver Basket Securities throughout the day as they become available, and cannot perfectly forecast situations where delivery to the ETF of a given security will be delayed. For example, if an investment dealer delivers $9.9 million of Basket Securities on a subscription for $10 million of ETF units, without the use of collateral for the $100,000 of Delayed Basket Securities, the ETF units cannot be delivered to the AP. The investment dealer's balance sheet is negatively impacted (its assets drop by $9.9 million). This can result in capital charges that ultimately are passed on to the investor.

Settlement Efficiency

Where APs do not have the ability to provide cash as collateral for Delayed Basket Securities, they typically will wait until they have possession of all of the Basket Securities before delivering the securities as payment for the ETF units. Otherwise, if the APs delivered a partial basket of securities, and the remaining component of the basket was not received in time by the AP and could not be delivered to the ETF, there would be Delayed ETF Units.

Where the APs can use cash collateral, they will be able to deliver the securities of the basket as they become available, rather than all at once in bulk at the payment deadline with the knowledge that they will receive the ETF units whether all of the Basket Securities are delivered or part of the Basket Securities plus cash collateral are delivered. Operationally, this is a more efficient process.

---

[4] Cash-in-lieu refers to the permanent replacement of Delayed Basket Securities with cash (the Delayed Basket Securities will not be provided by the AP).

[5] https://www.bbh.com/us/en/insights/investor-services-insights/how-t1-impacts-the-global-etf-ecosystem.html. See also, https://www.investmentexecutive.com/newspaper_/news-newspaper/whats-on-the-regulatory-horizon-for-etfs/.

COLLATERAL IN VARIOUS JURISDICTIONS

U.S.

In the U.S., the practice of collateral provision for Delayed Basket Securities is publicized, accepted, and well established.[6] As reported to the ETFTF, market participants using the collateral mechanism in the U.S. find that this stabilizes transaction processing and improves the "smoothness" of the market.

Primary market settlement in the US for ETFs is conducted either through continuous net settlement ("CNS") at the National Securities Clearing Corporation ("NSCC"),[7] or for non-CNS eligible securities, settled on a bilateral basis (manually through The Depository Trust Company).

The bilateral collateral arrangements are governed by agreements between the parties. AP Agreements address two different cash mechanisms to address Delayed Basket Securities, cash-in-lieu or collateral[8]. Under the cash-in-lieu process, the ETF manager will acquire the Delayed Basket Securities rather than the AP providing such securities at a later date and receiving back the deposited cash. Under the collateral mechanism, cash is temporarily provided by the AP. Upon delivery of the Delayed Securities to the ETF manager, the cash is returned to the AP. The collateral is delivered in accordance with "Cash Collateral Settlement Procedures".[9]

From a legal and regulatory perspective, the U.S. *Investment Company Act of 1940* ("40 Act") is silent on collateral use for Delayed Basket Securities – it neither explicitly prohibits nor explicitly permits such collateral use. It is understood that the collateral practice developed early in the offering of ETFs in the U.S. ETF managers described the practice in exemption applications they filed with the United States Securities and Exchange Commission ("SEC") for relief to enable them to issue ETFs. A description of the practice is contained in various filings to the SEC, such as noted in footnote 23 of In the Matter of iShares Trust, BlackRock Fund Advisors, iShares, Inc., BlackRock Fund Advisors, and SEI Investments Distribution Co., dated November 12, 2010:

> "To the extent contemplated by an AP Agreement, Creation Units will be issued to such Authorized Participant notwithstanding the fact that the corresponding Fund Deposits have not been received in part or in whole, in reliance on the undertaking of the Authorized Participant to deliver the missing Deposit Securities as soon as possible, which undertaking shall be secured by such Authorized Participant's delivery and maintenance of collateral consisting of cash in the form of U.S. dollars in immediately available funds (marked-to-

---

[6] APs that create and redeem ETFs that hold foreign underlying securities are also generally required to post collateral. https://www.ici.org/doc-server/pdf%3Appr_15_aps_etfs.pdf.

[7] Note that NSCC is targeting May 28, 2024 to launch its T0 Create/Redeem cycle with submission of a Cash Collateral Amount (buffer) and an end of day Collateral Cash Adjustment (true-up) https://dtcclearning.com/products-and-services/equities-clearing/etf-processing/etf-release.html. NSCC rules are approved by the Securities and Exchange Commission.

[8] E.g., https://www.sec.gov/Archives/edgar/data/1479026/000119312515282875/d837615dex99h2.htm.

[9] These are maintained by the transfer agent for the ETF manager and are available to the AP upon request.

> market daily) of 105% or more of the value of the missing Deposit Securities. The AP Agreement will permit the Fund to buy the missing Deposit Securities at any time and will subject the Authorized Participant to liability for any shortfall between the cost to the Fund of acquiring such Deposit Securities and the value of the collateral."[10]

Similar language may be found in other ETF documentation.[11]

Europe

The Central Bank of Ireland issued a report on ETFs in 2017 that included reference to collateral for Delayed Basket Securities.[12] ETFs that are under the Undertaking for Collective Investment in Transferable Securities contain the flexibility in their prospectuses for collateral for Delayed Basket Securities. At the time of the report it was noted that European ETFs typically function on a cash (delivery versus payment) basis compared to the predominant in-kind (free of payment) basis for creations in the U.S. and as such, the collateral mechanism for Delayed Basket Securities is not typically used in Europe.

While Europe is still on a T+2 settlement cycle, European Fund and Asset Management Association's reply to the European Securities and Markets Authority's call for evidence on shortening the settlement cycle highlights the benefits of funds moving to T+1.[13] It would be expected that issues such as Delayed Basket Securities would arise when Europe moves to T+1, possibly increasing the use of collateral as a mitigation against increased failed transactions.

Canada

In Canada, there is no centralized collateral facility for ETFs and until such a facility is operational, collateral use would be left to bilateral arrangements governed by contract between the parties (akin to the non-CNS eligible securities process in the U.S.). Similar to the U.S.'s 40 Act, NI 81-102 is silent in regards to the use of collateral for Delayed Basket Securities.

The lack of a mature collateral process in Canada (i.e. no centralized facility) and the silent nature of NI 81-102 regarding collateral for Delayed Basket Securities has led to some uncertainty in the industry as to the permissibility of cash collateral use and the adoption of a conservative stance in the absence of a "bright-line" rule. While a parallel may be drawn between the silent nature of both the 40 Act and NI 81-102 regarding the permissibility of collateral for Delayed Basket Securities, there is more specificity around payments and unwinding of purchase orders in NI 81-102.

---

[10] https://www.sec.gov/Archives/edgar/data/1006249/000119312510258899/d40appa.htm#tx118362_22.

[11] See "Procedures for Creation Unit Purchases" at p. 30 of Statement of Additional Information dated December 30, 2023: https://institutional.fidelity.com/app/proxy/content?literatureURL=/B-CT12-PTB.PDF.

[12] https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-6/discussion-paper-6---exchange-traded-funds.pdf.

[13] https://www.efama.org/sites/default/files/files/EFAMA%20reply%20to%20ESMA%20CfE%20on%20shortening%20of%20the%20settlement%20cycle.pdf.

The provisions of Part 9 of NI 81-102 prescribe how primary market purchases of securities of mutual funds, including ETFs, are completed. Section 9.4(2) of NI 81-102 provides that payment of the issue price of such securities must be made on or before the second business day after the pricing date for the securities by cash, making good delivery of the securities that comply with the requirements of that section, or a combination of these methods.[14] An ETF cannot release units into the CDS account of a purchasing dealer until full consideration has been delivered to the custodian on behalf of the ETF in accordance with the terms of NI 81-102.

In the case of Delayed Basket Securities, if a cash-in-lieu payment arrangement is not acceptable to the parties, without an alternative payment, Section 9.4(4) of NI 81-102 provides that the ETF manager must redeem the ETF units and the purchase cannot be completed because sufficient consideration for the ETF units has not been delivered. There is not uniform agreement amongst all of the industry participants whether cash delivered to the ETF and held as collateral against future delivery of Delayed Basket Securities clearly satisfies the requirements of NI 81-102.

Notwithstanding competing views of permissibility based on the current drafting of NI 81-102, from a policy perspective, the acceptance of cash collateral for Delayed Basket Securities is in the interest of the markets, their participants and investors. A collateral process allows subscriptions to settle on a timely basis and reduces failed trades. The acceptance of cash collateral for Delayed Basket Securities as payment for ETF units does not import additional risk to ETFs or the markets and should be permitted. The collateral process should be standardized, with agreed upon governance and procedures such as recommended in this letter. Under such a collateral process:

(a) the ETF receives cash in an amount that exceeds the value of the Delayed Basket Securities;
(b) cash is delivered to the ETF, held by the ETF's custodian in an account in the ETF's name;
(c) the cash amount is adjusted mark-to-market on the Delayed Basket Securities value (with the ETF receiving additional cash or the AP receiving cash back based on the mark-to-market calculation); and
(d) the ETF manager has a contractual right, upon delivery of appropriate notice to the AP, to use the cash to purchase the Delayed Basket Securities if the ETF manager in good faith believes it is in the best interest of the ETF.

There would be no reason or need to unwind the purchase order – the ETF is whole, without loss. Further details of the proposed process parameters are outlined in Appendix 1.

EXAMPLE OF CASH COLLATERAL USE

An example may help outline the desired clarity for cash collateral permissibility. Assume an ETF is comprised of 5 underlying Basket Securities (A, B, C, D, and E). The AP places an order for 1,000 units of the ETF. At the time of order on the pricing date, the AP anticipates having all of the Basket Securities available for delivery on the settlement date. The AP and the ETF manager agree that payment will be 1,000 shares of A, B, C, D, and E. However, on settlement date, the AP is

[14] Pending amendments to NI 81-102 would change the payment deadline to a reference settlement date, The reference settlement date for ETFs is expected to be T+1 on May 27, 2024.

waiting for receipt of 1,000 shares of security E from another counterparty. Assume that on the pricing date (the date of the purchase order) that 1,000 shares of security E has a market value of $1 million. Being unable to remit payment as agreed to as per the purchase order/trade ticket, and the AP and ETF manager having previously agreed to a cash collateral mechanism for Delayed Basket Securities, the AP delivers securities A, B, C, D and the cash collateral for 1,000 shares of security E to the ETF manager and the ETF units are delivered to the AP. Assuming a haircut of 2% for this example, and assuming there was no market price change in security E between the pricing date and the settlement date, the cash collateral provided on settlement date is $1,020,000. There is no re-ticketing of the purchase order.

Assume that the market value of security E changes so 1,000 shares is now worth $1,010,000. The AP tops up the cash collateral with an additional mark-to-market amount of $10,000. The ETF manager now has $1,030,000 of cash for the pending 1,000 shares of security E. If it is determined that the 1,000 share of security E will not be delivered, the ETF manager can use the cash collateral and purchase the 1,000 shares of security E for $1,010,000). The ETF manager would return the excess cash collateral it possesses (i.e. $20,000 less expenses associated with purchasing the 1,000 shares) to the AP.

Alternatively, if the AP is able to deliver the 1,000 shares to the ETF manager prior to the ETF manager deciding to acquire the 1,000 with the cash collateral itself, the AP makes such delivery and the ETF manager returns the cash collateral it was holding to the AP (in this case, $1,030,000).[15]

The APs payment is made with a combination of cash (on a temporary basis) and securities; once the Delayed Basket Securities are available and delivered, the cash collateral is returned. Whether the ETF manager receives the 1,000 shares of security E or uses the cash collateral to acquire the shares, the ETF is never in a loss position.

If however the AP was not able to use cash collateral, the purchase transaction would fail, and would continue to fail until 1,000 shares of security E were delivered or the purchase order cancelled. If 1,000 shares of securities A, B, C, D had been delivered in anticipation of settlement, they would need to be returned to the AP on purchase order cancellation. This adds operational burden to the process.

COLLATERAL GOVERNANCE

The ETFTF and the CETFA working group agree that there should be industry consensus as to the parameters governing cash collateral for Delayed Basket Securities. The recommended framework parameters are set out in Appendix 1 to this letter. The industry proposes to follow these framework parameters, incorporated into agreements between the parties.

---

[15] Note that if it was agreed that a cash-in-lieu payment would instead be made for the delayed security E, the purchase order would need to be re-ticketed and the ETF manager would use the cash payment to purchase security E itself.

The industry has also agreed that the Delayed Basket Securities cash collateral mechanism should be optional. Parties should not be required to agree to cash collateral use; however, they may do so at their discretion by entering into agreements meeting the framework parameters and in accordance with regulatory guidance. Generally, the mechanism is to be an exception-based solution.

REQUEST FOR GUIDANCE AND PUBLICATION

The industry submits it is important to obtain clarity regarding cash collateral for Delayed Basket Securities since the ability to make use of the mechanism requires consensus between three parties in each instance – the ETF manager, the Authorized Dealer and the custodian. Without direction as to a common view that should be adopted by the industry as to the compliance of this solution with NI 81-102, this mechanism may be available only to certain industry participants depending on the parties to any subscription of Units and the legal advice they receive. Many industry participants wish to utilize this mechanism, but of course only to the extent it complies with NI 81-102. It may be difficult to arrive at consensus amongst the required parties depending on the level and nuance of legal analysis each such party has undertaken to consider this issue.

Additionally, the uncertainty that persists also gives rise to uncertainty around how to properly comply with the requirements of section 12.1 of NI 81-102 and how managers meet their obligations to properly complete compliance reports. Receiving guidance from the regulatory authorities would help alleviate the uncertainty related to this obligation as well.

Thus the question to OSC staff: "*Can an ETF accept the delivery of cash, to be held by the fund as collateral until Delayed Basket Securities are delivered by an AP, to satisfy the requirements of section 9.4 of NI 81-102?*" We submit this as an issue of regulatory interpretation that needs to be resolved for the comfort of the industry broadly. Accordingly, we are requesting regulatory guidance in a written form that can be relied on by the industry at large.[16]

We would be pleased to answer any questions or elaborate on industry views at your convenience.

Yours sincerely,

"Keith Evans"

Executive Director
Canadian Capital Markets Association

"Pat Dunwoody"

Executive Director
Canadian ETF Association

[16] This could be a standalone guidance notice (such as CSA Staff Notice 81-335 *Investment Fund Settlement Cycles*) or another medium that the securities regulatory authorities see fit.

APPENDIX 1

(a) The collateral:

- has a market value equal to at least 102 percent of the market value of Delayed Basket Securities,[17]
- transaction is made under a written agreement that implements these Appendix 1 requirements,[18]
- transferred by the purchaser is immediately available for good delivery under applicable legislation,[19]
- is received by the ETF either before or at the same time as it delivers the ETF units,[20]
- is marked to market on each business day, and the amount of collateral in the possession of the ETF is adjusted on each business day to ensure that the market value of collateral maintained by the ETF in connection with the transaction is at least 102 percent of the market value of the Delayed Basket Securities,[21] and
- is held by the custodian an account in the name of the ETF.

(b) The ETF is entitled to realize on the collateral in good faith at any time.[22]

[17] Modelled on s. 2.13(1)5.(b) of NI 81-102.
[18] Modelled on s. 2.13(1)2. of NI 81-102.
[19] Modelled on s. 2.13(1)4. of NI 81-102.
[20] Modelled on s. 2.13(1)5.(a) of NI 81-102.
[21] Modelled on s. 2.13(1)6. of NI 81-102.
[22] This is similar to provisions in U.S. Authorized Participant Agreements. It also includes the concepts in s. 2.13(1)13.