CCMA ACMC Canadian Capital Markets Association
Association canadienne des marchés des capitaux

Operations Working Group
Exchange-traded Funds Task Force
Report - July 13, 2023

Overview

The Exchange-traded Funds Task Force ("ETFTF") was established by the Operations Working Group ("OWG") of the CCMA to:

(1) identify and document concerns for exchange-traded funds ("ETF") arising from the transition to a T+1 settlement cycle, and

(2) investigate potential solutions for these concerns.

The ETFTF is to report on its initial findings to the OWG, with the OWG to make a determination as to next steps.

The ETFTF is represented by firms involved in the ETF settlement process (custodians, ETF providers, and authorized participants [such as broker-dealers]), with attending individuals having ETF settlement knowledge.

ETF Settlement Process

Primary Market

The creation of ETF units is achieved through the delivery of an underlying basket of securities in exchange for ETF units (the redemption process is the reverse – ETF units are exchanged for the underlying basket). The creation and redemption process is performed in the primary market, off-exchange. In Canada, the creation/redemption trades settle trade-for-trade (in the U.S., there is an opportunity to settle these trades by CNS at NSCC). The basket securities trade in accordance with market convention for such securities (which for Canada and the U.S., most securities are transitioning to T+1). Refer to Appendix 1 of this report for a high-level visual of the process.

Secondary market

The ETF units are traded on marketplaces on a secondary market basis. In Canada, ETF units are listed on recognized exchanges and trade in accordance with the rules of the exchanges (which will require T+1 settlement).

Discussion of the Concerns

The ETFTF raised and discussed various concerns for ETFs and the transition to T+1:

1. Lack of standardization of ETF basket confirmation files
2. Lack of a centralized clearing agency process for primary market ETF transactions
3. Lack of collateralization in the primary market
4. Impact of pricing files on striking an ETF's net asset value
5. Primary and secondary markets on different settlement cycles

1. **Lack of standardization of ETF basket confirmation files** Unlike the U.S. market, ETF basket confirmation files are not standardized in Canada.

Creation or redemption orders for ETF units are typically placed as trades on the create/redeem order date by the authorized participant. The ETF provider (or its custodian) sends a confirmation to the authorized participant in the evening of T. The confirmation's details need to be entered into the authorized participant's system in order for the authorized participant's back office (and its back office service provider) to process the trades for settlement.

The later in the day that the ETF provider/custodian sends the confirmation to the authorized participant, the more difficult it is to attain processing deadlines that are in the morning, especially without standardization of the files. Temporary CUSIPs assigned on the confirmations cause mismatches - manual entry of the confirmation data is challenging on a short timeline.

Some firms have constructed workarounds for the non-standard files.

<u>Initial Conclusion</u>: Further investigation is warranted to obtain further details on the Canadian and U.S. approaches. Standardization would facilitate increased automation, posing fewer barriers to timely settlement. However, this concern is less critical than the lack of collateralization.

2. **Lack of a centralized clearing agency process for primary market ETF transactions**

In the U.S., there is an established clearing agency process for ETFs – trades are automatically set-up in the depository for settlement. That does not currently exist in Canada.

This can cause issues in various ways. For example, in Canada, files have to be created for upload into third party vendors for the clearing agency, back office service providers, and order management systems. As basket securities are delivered on a free of payment basis to the custodian, if the wrong securities are delivered, it can take a significant period of time to resolve. Currently, there is no simple process that matches the securities sent by the authorized participant to the custodian to the ETF units that the custodian has to deliver back to the dealer. In a T+2 environment, there is time to review bookings to determine if there is an out-of-balance so the problem can be rectified; under T+1, there would be little or no time to resolve.

<u>Initial Conclusion</u>: The process runs smoothly in the U.S. and there would be an appetite for a similar approach in Canada. It is likely a medium to longer term initiative and would involve discussions with the clearing agency.

3. **Lack of collateralization in the primary market**

Under National Instrument 81-102 *Investment Funds*, collateralization of basket securities is not permissible. If an individual security is not delivered to the custodian, the ETF units cannot be created – the whole basket fails.

In a T+2 environment, if an authorized participants does not have sufficient inventory of securities for the basket on T, there is still an opportunity to obtain the basket securities up to the processing deadline for T+2 settlement (such as by way of a securities loan or settling a basket security on a T+1 basis). In a T+1 environment, this will not be possible – there would not be sufficient time to deliver the basket securities. The primary market ETF unit creation would fail causing the secondary market trade to likewise fail.

Initial Conclusion: The shortened settlement cycle will introduce systemic issues due to a lack of collateralization. This is not an issue in the U.S. and a similar approach should be explored for Canada.

4. Impact of Pricing Files on striking an ETF's net asset value

Concern was raised with respect to establishing the net asset value for ETFs and a desire to obtain NAVs earlier.

Based on current processes, custodians/administrators will not be able to strike NAVs any faster unless pricing files are received earlier.

Initial Conclusion: As pricing is set after market close and pricing files are typically scrubbed by pricing vendors and custodians, delivery of earlier NAVs will be difficult. It does not specifically impact settlement.

5. Primary and secondary markets on different settlement cycles

A mismatch between the settlement cycles for the primary and secondary ETF markets adds complexity to the create/redeem process. There can also be foreign exchange hedging discrepancies.

Initial Conclusion: The potential for settlement mismatches exists currently. The impact of T+1 requires further investigation.

Regulatory Discussion

The ETFTF agreed that the main immediate concern was the lack of collateralization. A meeting was arranged with staff of the Investment Funds branch of the Ontario Securities Commission to discuss the five ETFTF concerns, with a focus on the lack of collateralization.

OSC staff were aware of the collateralization concerns, being raised previously by some ETF participants. Potential solutions with varying timelines were discussed. As the T+1 transition is less than one year away, blanket exemptive relief for ETFs from the NI 81-102 collateral restrictions would be the most likely achievable short-term solution. There would need to be details on how much collateral would be permitted, timing/cut-off for delivery, the form/acceptability of collateral, mark-to-market for extended collateral, seizure rights, etc. The preference would be a standard for the industry. OSC staff's views were to avoid prescribing the collateral requirements. If the ETFTF were to propose the blanket exemptive relief, it would expedite the process.

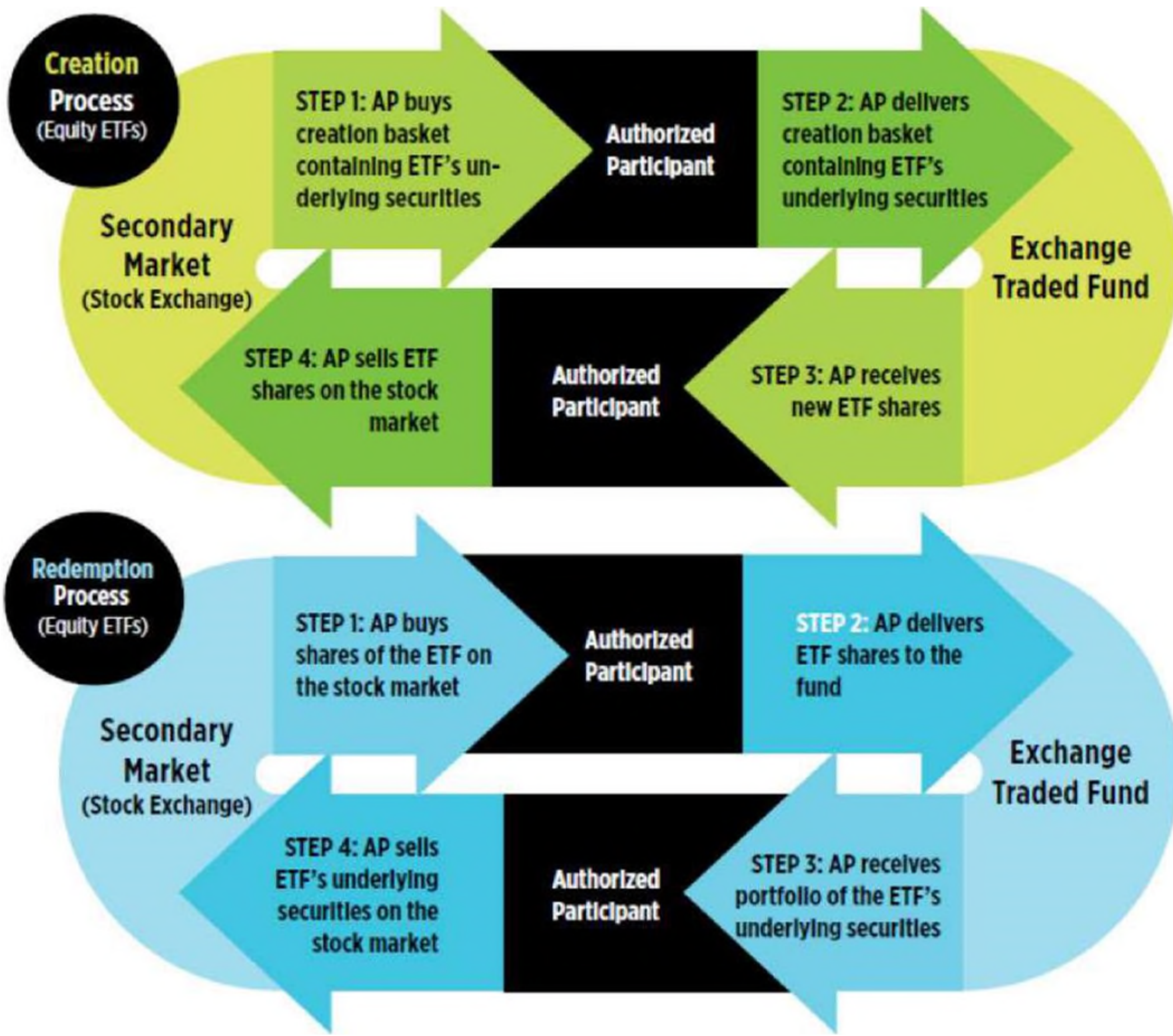
A longer term solution would be codifying the blanket exemptive relief into NI 81-102.

Recommended Action Items

1. Request that the CSA provide blanket exemptive relief from the collateralization prohibitions in NI 81102. In the longer term, seek amendment of NI 81-102.
2. Development of an ETF industry interim collateral process (covering collateral specifics such as acceptable collateral, timing of delivery/return, safekeeping, settlement suspension of short securities, etc.).
3. Continued discussions with CDS to explore a centralized collateral solution.
4. Continued investigation of the other concerns raised as appropriate (lack of file standardization, settlement cycle mismatch, pricing).

Appendix 1

ETF Creation and Redemption Processes[1]



[1] https://www.etf.com/etf-education-center/etf-basics/what-is-the-creationredemption-mechanism.