



## **Securities Lending White Paper**

**January 31, 2003**

## EXECUTIVE SUMMARY

### 1. Purpose

**This white paper:**

- **analyses current practices and standards** in the securities lending market in Canada and identifies related inefficiencies and risks
- **sets out views on what must change to allow the straight-through processing (STP) of securities lending transactions** – the processing of securities lent through the processing chain without manual intervention – and
- **seeks comments from all stakeholders in Canadian securities markets** on the perceived benefits and challenges of, and proposed solutions for, more efficient processing of securities lending/borrowing transactions in Canada.

### 2. Context

As securities transaction volumes and volatility have generally increased over the past decade, pressure in capital markets globally has grown to improve systems, processes and risk management mechanisms to cope with these changes. This instigated the U.S. capital markets to set a target date to reduce the settlement cycle to one day after trade date (T+1) rather than the current three days (T+3) by implementing STP. Canadian institutional and retail market stakeholders, through the Canadian Capital Markets Association<sup>1</sup> (CCMA), reviewed this development and confirmed the need to move to T+1 and adopt STP improvements concurrently with the U.S. because of the benefits implicit in doing so and the economic costs associated with not changing as set out in the table below<sup>2</sup>:

<b>Benefits of Moving to STP/T+1 with U.S.</b>	<b>Costs in Not Moving with the U.S.</b>
<ul style="list-style-type: none"><li>• By improving processing and settlement efficiency, we can expect to see:<ul style="list-style-type: none"><li>• Fewer errors</li><li>• Lower operating costs</li><li>• Reduced operational, market, settlement and systemic risks</li><li>• Greater competitiveness of Canadian capital markets</li></ul></li></ul>	<ul style="list-style-type: none"><li>• If Canada were to remain at T+3 when the U.S. moves to T+1 or substantively greater levels of STP, Canada would almost certainly see higher settlement costs and higher risk than in the U.S.</li><li>• With North-American securities markets so highly integrated, different settlement periods and STP levels between the two countries could result</li></ul>

<sup>1</sup> The CCMA was formed in 2000 to promote securities industry initiatives such as STP and T+1. The CCMA has a wide range of industry members, including representatives of broker/dealers, custodians, transfer and paying agents, credit unions, banks, investment managers, clearing houses, insurance companies and their associations, with federal and provincial regulators as observers. Background on the CCMA, its objectives, the benefits and challenges of STP/T+1 and CCMA committee white papers can be found on the CCMA Web site at [www.ccma-acmc.ca](http://www.ccma-acmc.ca).

<sup>2</sup> The consequences of *not* moving to T+1 with the U.S. was assessed in a November 2000 economic analysis commissioned by the CCMA and published by Charles River Associates (CRA); this paper can be found on the CCMA Web site on the Media/Publications page.

Benefits of Moving to STP/T+1 with U.S.	Costs in Not Moving with the U.S
<ul style="list-style-type: none"> <li>In North America's competitive securities industry, these benefits should translate into improved prices for trades for the final investor</li> </ul>	<p>in some trading activity (including the related jobs and other economic benefits) moving south, given the natural flow of transactions to the U.S., the marketplace with the narrower bid-ask spreads and greater liquidity</p>

The intention to promote greater straight-through processing and move institutional and retail capital markets to T+1 prompted Canadian securities market stakeholders, including regulators, to consider all aspects of the securities processing cycle that could be an impediment to STP and T+1. To this end, the CCMA Board of Directors formed a number of committees, including the **Securities Lending Working Group (SLWG)**, which is composed of a cross-section of industry representatives with extensive experience in all aspects of securities lending.

In May 2002, the U.S. Securities Industry Association (SIA) announced that it would re-examine its June 2005 implementation target date for shortening the securities settlement cycle to T+1 from T+3. In July 2002, the SIA concluded that the industry would focus on STP in 2003 and 2004, rather than on moving to T+1 in 2005, and said that shortening the settlement period would be evaluated again in 2004.

Given the conclusions in the November 2000 Charles River Associates economic analysis that there was no benefit for Canada to move equities settlement to T+1 ahead of the U.S., and consistent with the CCMA's stated strategy of maintaining the same equities settlement cycle as the U.S., the CCMA advised on July 19, 2002 that it would defer its announcement of a possible change in the settlement period until 2004 and focus on achieving STP in Canada. Significantly improving the straight-through processing of securities lending has been identified as a priority area. While the analysis and recommendations here are relevant in the T+3 environment, it is particularly important to make progress in this area so that, in the event that the T+1 settlement date in the U.S. is re-instated in or shortly after 2004, Canadian industry participants are prepared to move quickly.

### 3. Deliverables and Scope of This White Paper

The **SLWG's mandate** is to identify, analyze and bring forward to the industry, for discussion and resolution, all cross-industry processing issues and challenges related to securities lending to ensure a smooth transition to STP for the Canadian market. SLWG deliverables include:

- Review of processes, policies, regulations, systems and affected participants for STP impact
- Development of approaches/solutions for identified impacts
- Identification of standards, business best practices, benchmarks and progress paths, legal and regulatory requirements, testing and infrastructure readiness

- Identification of approaches/solutions for implementation issues
- Provision of ongoing feedback and support to other related and implementation working groups
- Development of performance-tracking requirements
- Creation of a white paper for industry review and discussion.

Following the change in target from T+1 to STP, SLWG agreed to still include the preparation for T+1 as part of its mandate to ensure that the lending community in Canada is prepared for a new T+1 implementation date as this could be announced as early as June 2004. The Working Group strongly recommends that all securities market participants include T+1 assessments as part of their firm's analysis and plans to bypass steps that may be "throwaways" if T+1 is re-introduced and to obtain STP efficiencies.

Following the CCMA's announcement to refocus its efforts on STP, the SLWG further clarified its scope to be:

"The electronic processing of a securities loan among all parties involved in the process, on a system-to-system basis, complying with industry rules/regulations and standards."

Within this scope, SLWG determined that its work should include identifying cross-industry process and other improvements associated with securities lending in the following areas:

- Recall management (e.g., recall notification, acknowledgement, resubmission, return, acceptance and termination processes, corporate actions handling when securities are out on loan, etc.)
- Standards and best practices, including timelines, documentation and legal agreements, proxy voting and other corporate actions, etc.
- Legislative/regulatory/rules changes that may be advisable
- Communications to interested parties to obtain input and, later, to promote change for greater efficiency.

The SLWG white paper complements the work of, and is supplemented by input from, the CCMA's other committees. These include the Institutional and Retail Trade Processing Working Groups, Dematerialization Working Group, Corporate Actions Working Group, Legal/Regulatory Working Group and Communications and Education Working Group (refer [www.ccma-acmc.ca](http://www.ccma-acmc.ca) for information on the work of these committees).

The white paper includes the following sections:

1. Introduction
2. Background

3. Challenges/Problems with Current Systems/Procedures for Securities Lending
4. Analysis/Options/Proposed Solutions to Reach STP for Securities Lending
5. Going Forward (proposed implementation schedule, request for comments, expected next steps).

**Appendix A** summarizes the white paper recommendations. Other appendices to the white paper list SLWG members, set out a diagram of the current securities lending process in Canada, summarize equivalent U.S. recommendations and provide a detailed project plan for SLWG activities.

#### 4. Background

Securities lending involves the temporary loan<sup>3</sup> of securities for cash or other securities of an equivalent or greater value (collateral) with a contractual obligation to re-deliver a like quantity of the same securities at a future date.

Securities lending transactions benefit financial market participants, from large firms down to investors, by enhancing the profitability and flexibility of their securities portfolios, facilitating the execution of a broad range of financial transactions and enhancing the liquidity of financial markets by facilitating arbitrage and hedging strategies and the short-selling of securities.

Typical borrowers of securities include investment dealers, banks, insurance companies, hedge funds and individuals. Typical securities lenders include custodians lending securities on behalf of their clients, third-party lenders, pension funds, investment funds, mutual funds and investment dealers. In Canada there are estimated to be as many as 100 borrowers (mainly non-Canadian) and 400 beneficial owners of securities, over 75 per cent of which are Canadian,<sup>(1)</sup> who participate in securities lending programs with approximately 10 lending agents.

The Canadian securities lending market is growing, consistent with such markets in major global financial centres. The expansion in securities lending and related activities around the world reflects the increasing integration of the world's financial markets. To get a sense of the current and potential market size in Canada, there are an estimated \$519 billion in debt and equity securities available for lending, of which \$56 billion<sup>4</sup> or 11 per cent was on loan during a recent survey period – securities on loan refers explicitly to collateralized loans and excludes repurchase agreements. There are an estimated 4,200 re-allocations per month, of which 224

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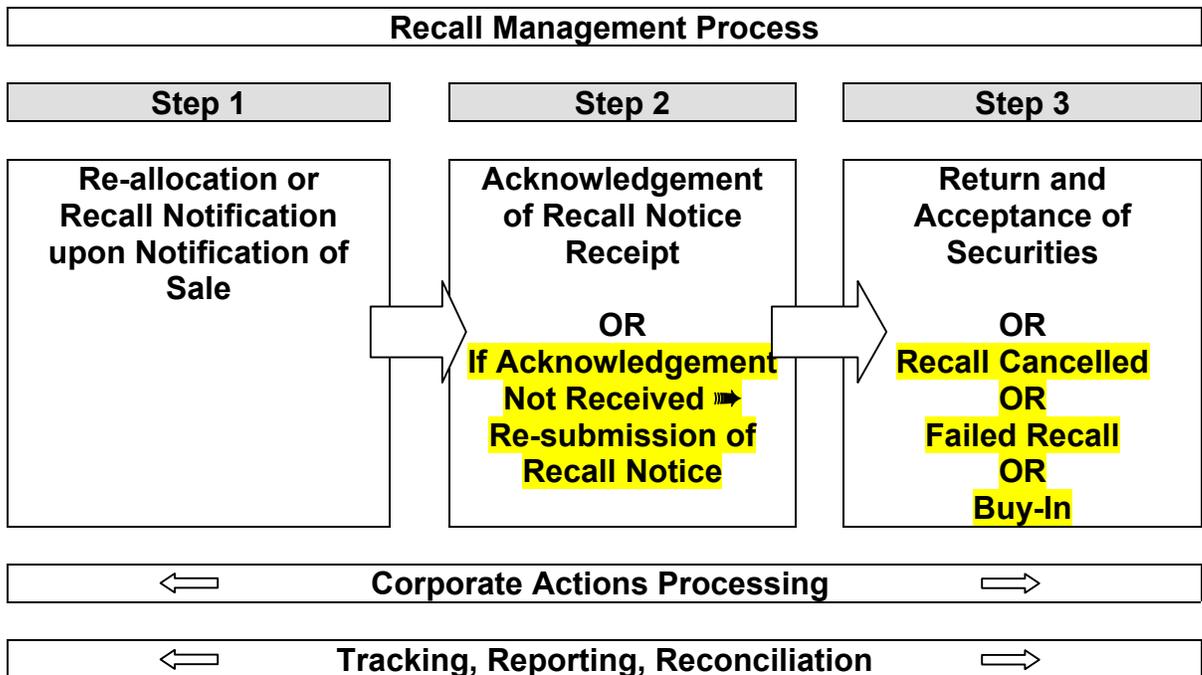
<sup>3</sup> Language referring to “loans” and “collateral” is used throughout this paper, in accordance with industry practice, because this language best describes the practical arrangements involved. However, from a legal point of view, it is recognized that a number of contracts in use by the industry provide for exchanges of securities for cash, or other securities or property, on a basis which is not a “loan” and does not involve “collateral.” It is important that these structures be respected by courts, and the language used in this White Paper should not be construed as contradicting the relevant contractual provisions.

<sup>4</sup> Except where otherwise noted, data in this paper were obtained by eClientscope from a survey of SLWG members in 2002 and may not reflect lending activity at other times of the year; see Section 2.d of the white paper for further details.

result in recalls, or an estimated five per cent of sales notifications result in a recall – of the 224 recalls, 10 or less than five per cent were cancelled. There are 20-30 missed recalls a month – about 10 per cent – that do not settle on time.

As research for the white paper, SLWG also investigated best practices in the U.S. and other countries.

The process of recalling securities on loan is the most complex operational aspect of securities lending. The diagram below summarizes the process at a high level. The text in shading highlights additional steps that may have to be taken due to errors or problems often caused by the manual nature of the securities lending process.



## 5. Challenges/Problems with Current Systems/Procedures

There are a number of challenges in the current securities lending marketplace in Canada. Similar to those in other parts of Canada's capital markets, they include:

- Manual processes/reliance on paper: **Currently, an estimated 99 per cent of the notices of recalls sent to securities borrowers are provided by way of fax or phone, sometimes with a follow-up phone call, often on T+1. This is in stark contrast to the 99 per cent of trade/sales notifications that are done electronically on a system-to-system basis,** although this does not give an idea as to how many are error-free and do not require data enrichment, meaning this does not identify what percentage of notifications are truly STP. The phone-fax-phone process is subject to errors in transcription or misunderstanding, is potentially time-consuming and is certainly inefficient. The recall also may result in a timing mismatch where a sale takes place on trade date (T) and recall notification on T+1. In this situation, the borrower is only required to return the lent securities on T+4, although in practice, returns are usually made on T+3 or

earlier. There also is no formal acknowledgement process, leading to missed recalls, resubmission of recall notices, cancellations and amendments.

- Incomplete standards/best market practices and incentives/compliance mechanisms: While standards and market practices (e.g., timelines, message content, etc.) are set out to varying degrees in lending agreements, and are in general based on models known to industry practitioners (e.g., under the auspices of the Financial Services Authority (FSA) – visit [www.fsa.gov.uk](http://www.fsa.gov.uk), Risk Management Association (RMA) – visit [www.rmahq.org](http://www.rmahq.org) and Federal Financial Institutions Examination Councils (FFIEC) – visit [www.ffiec.gov](http://www.ffiec.gov)), there is inconsistency across the marketplace and no single standard for default liability and notification. As well, no standard/best practice fully captures the timing of recalls and importance of moving towards 100-per-cent electronic system-to-system communication. Fifty-two per cent of sale notifications are received on T, 38 per cent on T+1 and 10 per cent on or after T+2 and there is an average of just under two days between recall notification and delivery. While manageable bilaterally in the current environment, as volumes increase, this may become more challenging.
- Rules and regulations: Rules and regulations may vary by jurisdiction, for example, regarding the percentage of collateral required to be taken against a loan.
- Communications challenges: There is no single body bringing together both borrowers and lenders to discuss improvements in the securities lending area in Canada.

## 6. Analysis/Options/Proposed Solutions to Reach STP

In view of the challenges and problems in current securities lending operations, proposed solutions focus on:

- Removing manual and paper-based steps, for example, possibly by leveraging the functionality within the systems of the Canadian Depository for Securities Limited
- Identifying and agreeing on desirable standards and market practices
- Ensuring an effective legal/regulatory framework
- Promoting communications to and among securities lending industry stakeholders
- Working to harmonize where possible with the U.S.

Specific recommendations are included in **Appendix A**.

## 7. Going Forward

Addressing these problems will involve a combination of systems development and operational process improvements. **The industry's ability to make these improvements in a timely fashion will depend on co-operation among all the**

**stakeholders in the end-to-end securities lending chain from lender through to borrower.**

To move ahead, the SLWG and CCMA need feedback from you and other stakeholders within the securities industry that are impacted by the current securities lending process. We:

- Seek comments on the perceived benefits and challenges of, and proposed solutions for, a move to STP from the perspective of securities lending in Canada, within the context of a North-American market
- Solicit feedback to support the development of industry standards and best practices, an effective regulation/rules framework and communications options that will allow for a smooth transition from the current, mainly manual, environment to STP
- Request input on the proposed work schedule – at a high level, this is:
  - **March 15, 2003:** Receive feedback on the white paper
  - **May 31, 2003:** Publicize any amendments to white paper recommendations
  - **June 15, 2003:** Formulate detailed standards and best practices recommendations on who should do what by when in terms of data quality, message protocols and timing and identify any rule changes required to pass to the Standards and Best Practices Working Group and Legal/Regulatory Working Group
  - **December 31, 2003:** Work with self-regulatory organizations (SROs), associations, etc. to achieve industry-wide agreement on standards and best practices
  - **June 2004:** Make 80 per cent of recalls and acknowledgements electronically
  - **December 2004:** Make 100 per cent of recalls and acknowledgements electronically
  - **June 2005:** Meet 100 per cent of securities industry institutional trade processing standards (e.g., trades matched on T to facilitate initiation of a recall on T).

**Please send your written comments on the above via e-mail, fax or mail by March 15, 2003, to:**

Ms. Savie Fiorini  
Chair, Securities Lending Working Group  
c/o: Ms. Rosa Sosin  
Canadian Capital Markets Association  
10<sup>th</sup> Floor, 85 Richmond Street West  
Toronto, Ontario, Canada M5H 2C9  
E-mail: [info@ccma-acmc.ca](mailto:info@ccma-acmc.ca)  
Fax: 1 416 365-8700  
Tel: 1 416 815-2046.

## 8. Expected Next Steps

Comments received from interested stakeholders will be shared with the SLWG and, if appropriate, other working groups, so that the proposed procedures, standards and best practices, legislative/regulatory/rule changes, communications required and implementation steps can be finalized. An unattributed summary will be publicized via the CCMA Web site so that respondents can be assured that their input has been heard.

The comments will be analyzed and the proposed solutions refined, with any significant points of disagreement to be discussed by the Canadian Capital Markets Association Board of Directors and/or relevant industry association(s).

**A final plan, as well as dissemination and implementation steps, will be publicized in 2003.** In the interim, the CCMA will begin work to address the challenges identified in this paper. Individuals interested in participating in this initiative are invited to contact the CCMA at the co-ordinates above.

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### 4. Analysis/Options/Proposed Solutions to Reach STP/T+1 for Securities Lending

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# 1. INTRODUCTION

As securities transaction volumes and volatility have generally increased over the past decade, pressure in capital markets globally has grown to improve systems, processes and risk management mechanisms to cope with these changes. This moved U.S. capital markets to set a target to reduce the settlement cycle to one day after trade date (T+1) rather than the current three days (T+3) by implementing STP. Canadian institutional and retail securities markets adopted the same target to reduce the time it takes for securities bought and sold to be exchanged for money – the settlement cycle – from three days (T+3) to one day (T+1). It was generally agreed that to achieve T+1 required straight-through processing – the processing of securities lent through the processing chain without manual intervention.

The beneficiaries of a move to STP and T+1 settlement include:

- ***The financial system overall:*** The move to STP/T+1 will strengthen our financial markets by reducing systemic risk and will help keep Canada competitive *vis à vis* the U.S. and globally.
- ***Securities market firms:*** STP/T+1 will necessitate the increased automation of trade processing, which will, in turn, reduce operational risks and costs associated with securities trades, while improving productivity, reducing collateral requirements and improving liquidity.
- ***Investors:*** STP/T+1 and greater automation will reduce transaction risk and improve service for investors. The move to more automated straight-through processing required will support round-the-clock trading now demanded by a growing number of investors.

## a. **Canadian Capital Markets Association and STP/T+1**

The Canadian Capital Markets Association was formed in 2000 to promote securities-industry-wide initiatives such as the move to T+1 and to the straight-through processing environment that this would require. The CCMA is composed of representatives of a wide range of industry members, including broker/dealers, custodians, transfer and paying agents, credit unions, banks, investment managers, clearing houses, insurance companies and their associations, with federal and provincial regulators as observers. Background on the CCMA and its objectives, and on the benefits and challenges of STP and T+1, can be found on the CCMA Web site at [www.ccma-acmc.ca](http://www.ccma-acmc.ca).

## b. **Securities Lending Working Group (SLWG)**

The intention to promote greater straight-through processing and move institutional and retail capital markets to T+1 prompted Canadian

securities market stakeholders, including regulators, to consider all aspects of the securities processing cycle that could be an impediment to STP and T+1. To this end, the CCMA Board of Directors formed a number of committees, including the Securities Lending Working Group (a list of members is provided as **Appendix B**). The work of the SLWG white paper includes input from and supplements the work of other CCMA committees. These include the Institutional Trade Processing Working Group (ITPWG), Retail Trade Processing Working Group (RTPWG), Dematerialization Working Group (DWG), Corporate Actions Working Group (CAWG), Legal/Regulatory Working Group (LRWG) and Communications and Education Working Group (CEWG). For information on the work of these committees, refer to [www.ccma-acmc.ca](http://www.ccma-acmc.ca).

**c. Change from T+1 to STP**

In May 2002, the U.S. Securities Industry Association (SIA) announced that it would re-examine its June 2005 target implementation date for shortening the securities settlement cycle to T+1 from T+3. In July 2002, the SIA concluded that the industry would focus on STP in 2003 and 2004, rather than on moving to T+1 in 2005, and said that shortening the settlement period should be evaluated again in 2004.

Given the conclusions in the November 2000 Charles River Associates economic analysis that there was no benefit for Canada to move equities settlement to T+1 ahead of the U.S., and consistent with the CCMA's stated strategy of maintaining the same equities settlement cycle as the U.S., the CCMA announced on July 19, 2002 that it would defer its announcement of a possible change in the settlement period until 2004 and focus on achieving STP in Canada. Significantly improving the straight-through processing of securities lending has been identified as a priority area. While the analysis and recommendations here are relevant in the T+3 environment, it is particularly important to make progress in this area so that, in the event that the T+1 settlement date in the U.S. is re-instated shortly after 2004, Canadian industry participants are prepared to move quickly.

**d. SLWG Deliverables and Scope**

The SLWG mandate is to identify, analyze and bring forward to the industry, for discussion and resolution, cross-industry processing issues and challenges related to securities lending to ensure a smooth transition for the move to STP for the Canadian market. SLWG deliverables include:

- Review of processes, policies, regulations, systems and affected participants for STP impact
- Development of approaches/solutions for identified impacts

- Identification of standards, business best practices, benchmarks and progress paths, legal and regulatory requirements, testing and infrastructure readiness
- Identification of approaches/solutions for implementation issues
- Provision of ongoing feedback and support to other related and implementation working groups
- Development of performance-tracking requirements
- Creation of a white paper for industry review and discussion.

Following the change in target from T+1 to STP, SLWG agreed to still include the preparation for T+1 as part of its mandate to ensure that the lending community in Canada is prepared for a new T+1 implementation date as this could be announced as early as June 2004. The Working Group strongly recommends that all securities market participants include T+1 assessments as part of their firm's analysis and plans to bypass steps that may be "throwaways" if T+1 is re-introduced and to obtain the greatest STP efficiencies.

Following the CCMA's announcement to refocus its efforts on STP, the SLWG further clarified its scope to be:

"The electronic processing of a securities loan among all parties involved in the process, on a system-to-system basis, complying with industry rules/regulations and standards."

Within this scope, SLWG determined that its work should include identifying cross-industry process and other improvements associated with securities lending in the following areas:

- Recall management (e.g., recall notification, acknowledgement, resubmission, return, acceptance and termination processes, corporate actions handling when securities are on loan, etc.)
- Standards and best practices, including as regards timelines, documentation and legal agreements, proxy voting and other corporate actions, etc.
- Legislative/regulatory/rules changes that may be advisable
- Communications to interested parties to obtain input and, later, to promote change for greater efficiency.

The SLWG white paper complements the work of, and is supplemented by input from, the CCMA's other committees.

## 2. BACKGROUND

### a. Definitions

**Securities lending** involves the temporary loan of securities for cash or other securities of an equivalent or greater value (collateral) with a contractual obligation to redeliver a like quantity of the same securities at a future date. Collateral may take the form of cash or other securities, such as T-bills, Canada bonds, provincial government debt, letters of credit, convertible instruments or other collateral acceptable to the lender and, for member firms of the Investment Dealers Association of Canada (IDA), the national self-regulatory organization for the securities industry, collateral must meet the requirements set out in IDA Regulations 2200.6, 2200.7 or 2200.8.

Where cash is used as collateral, the lender invests the cash and pays part of the return on the cash to the borrower. This is known as the **rebate**. Where other collateral is used, the borrower pays the lender a **fee**. Both the rebate and fee are negotiated at the time of the transaction and can be amended from time to time during the life of a loan in response to changing market conditions. Fees can take different forms. Under most agency programs, clients lend their securities to a group of borrowers and a set percentage of total revenues is split between the agent and the client. Other programs allow lenders to receive guaranteed lending revenues to stabilize their income stream. A third type of fee is a hybrid: clients are guaranteed a base minimum income level with upside revenue potential based on lending performance.

Loans are generally entered into on an **open** basis. That is, there is no fixed term of the loan, but either the lender or borrower can terminate at will. Typically, a lender terminates a loan by **recalling** the security and the borrower terminates a loan by **returning** the security to the lender. Lenders avoid “daylight” exposure by delivering the securities and redelivering the collateral to the borrower after or simultaneously with the receipt of the collateral or returned securities. Usually, once the loaned security is back in possession of the lender, the collateral is returned to the borrower and the loan cycle is complete. In practice, loans remain outstanding from one day to several months.

The rights of the beneficial owner, lending agent and borrower are governed by lending agreements. The agreement between beneficial owner and lending agent is referred to as a **securities lending agreement**. The contract between the lending agent and borrower is referred to as a **securities borrowing agreement**. Generally, the beneficial owner via the lending agent retains all rights of ownership during the loan, most often described as “distributions” in the agreement. An important feature of a lending contract is the right of the lender to recall the security within the normal settlement timeframe, often for purposes of

exercising an election under a corporate action. The agreement also sets out the expectation regarding, for example, the timing of recalls/repays and the course of action where a recalled security is not delivered on time. In this way, the lender should be able to deliver the security that is on loan to fulfill a sale contract and not impact the lender's ability to trade the security. Typical provisions in a borrowing agreement are: acceptable types of collateral; standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market and margin calls; coupon or dividend payment methods if a security is on loan on a payment date; triggers for loan termination; and acceptable delivery methods for loan securities and collateral. In addition, IDA Regulation 2200.2 requires IDA member firms' securities loan agreements to contain certain minimum provisions, including the rights of each party and remedies in the event of default

Where clients use a lending agent to lend securities on their behalf, there will also be an **agency agreement** between lender and agent setting out roles and responsibilities and other details. It may include: authorizing the institution to offer the securities on loan, providing the authority to reinvest cash collateral, custody and collateral valuation responsibilities, handling of corporate actions, fees or other compensation, recordkeeping, allocation methodology, audit, selection process, etc.

## **b. Market Participants**

Securities lending transactions benefit financial market participants, from large firms down to individual investors, by enhancing the profitability and flexibility of their securities portfolios and facilitating the execution of a broad range of financial transactions. For example, securities lending agreements enhance the liquidity of financial markets by facilitating arbitrage strategies, the hedging of positions and the short-selling of securities.

Typical borrowers of securities include investment dealers, banks, insurance companies, hedge funds and individuals. They borrow for a variety of reasons:

- To establish short positions
- To cover "fails to receive" where clients have sold securities but have not yet delivered them
- To facilitate hedging strategies to mitigate market risk
- To take advantage of arbitrage opportunities
- To manage their balance sheet and funding sources.

Typical securities lenders include custodians lending securities on behalf of their clients, third-party lenders, pension funds, investment funds, mutual funds and investment dealers. They lend securities for a variety of

reasons, including access to low-risk opportunities to increase the return on their holdings and to raise cash.

In addition to lenders and borrowers of securities, there are other interested parties in the securities lending process. For example, the Investment Dealers Association of Canada has a Repo and Funding Committee where industry issues regarding securities lending and repurchase transactions can be addressed. There is currently no equivalent lenders' industry association. In other countries, there are associations of lenders and borrowers, which simplifies discussion of ways to work together to make markets more efficient.

**c. How a Securities Lending Transaction Works**

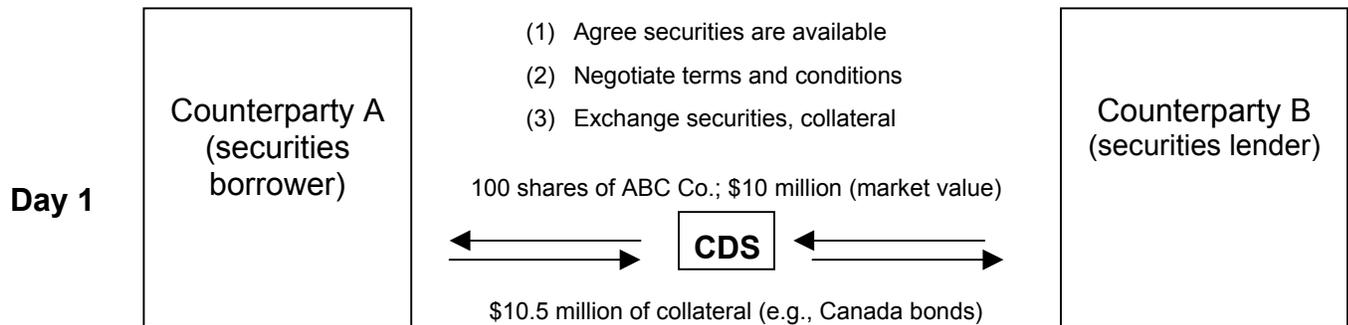
In a typical transaction:

1. The borrower calls the lender to determine if the security required is available to be borrowed
2. The borrower and lender negotiate fee, price, term, collateral and other features of the arrangement
3. Securities are delivered from lender to borrower at the same time as or after collateral is received
4. When the securities are no longer required by the borrower, they are returned to the lender and the collateral is returned either at the same time or after the securities are received. Alternatively, the lender can recall the loan at any time. For example, the underlying client may require the asset to settle a trade or to receive a proxy to vote at an upcoming meeting.
5. Fees or rebates are paid according to an agreed-upon billing cycle and method for all outstanding loans with that borrower, e.g., at the end of the month.

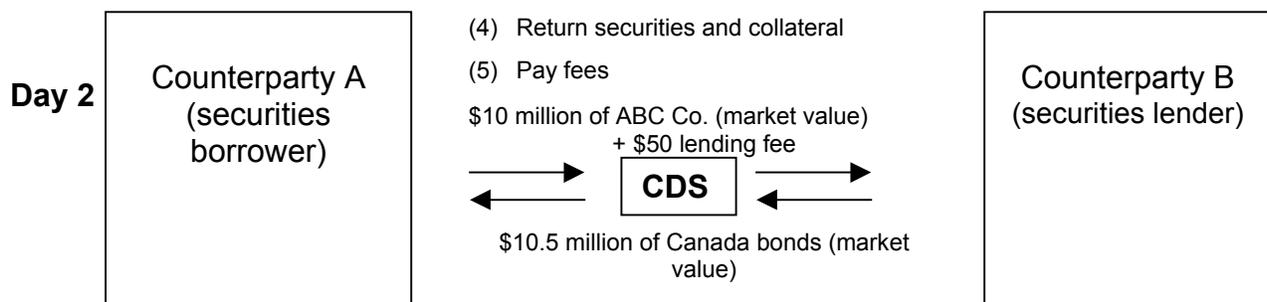
The following depicts a transaction in which Counterparty A (borrower) requires 100 shares in ABC Co. shares (a \$10 million value) to meet a delivery requirement. Counterparty B (lender) provides the required shares in exchange for collateral – Canada bonds – with a market value of \$10.5 million (105 per cent of \$10 million).<sup>5</sup> The transaction (securities loan and collateral transfer) takes place electronically through the Canadian Depository for Securities Limited (CDS), which provides systems platforms for the holding, clearing and settlement of all equities and debt in Canada (a new integrated CDS depository, equity and debt clearing and settlement system called CDSX (formerly System X) is being implemented in 2003, with migration of equities and corporate and other marketable bonds to the new system following shortly afterwards). Rarely, if ever, do securities loans involve physical certificates.

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<sup>5</sup> Source: Bank of Canada Review, *Bank of Canada, 1994-95*



On Day 2, Counterparty B (lender) requests that the shares be returned and the transaction is concluded – Counterparty A (borrower) returns the shares to Counterparty B in exchange for return of the Canada bond collateral and pays a \$50 securities lending fee (\$5 per million per day), usually on the 15<sup>th</sup> of the following month.



Lending fees are based on supply and demand. When occasions arise that demand for a particular security exceeds available supply, fees for hard-to-borrow stocks can represent significant annualized returns. In theory, small cap securities typically generate higher returns than large cap securities. According to the Buttonwood International Group, expected portfolio returns from securities lending depend on a number of factors, such as:

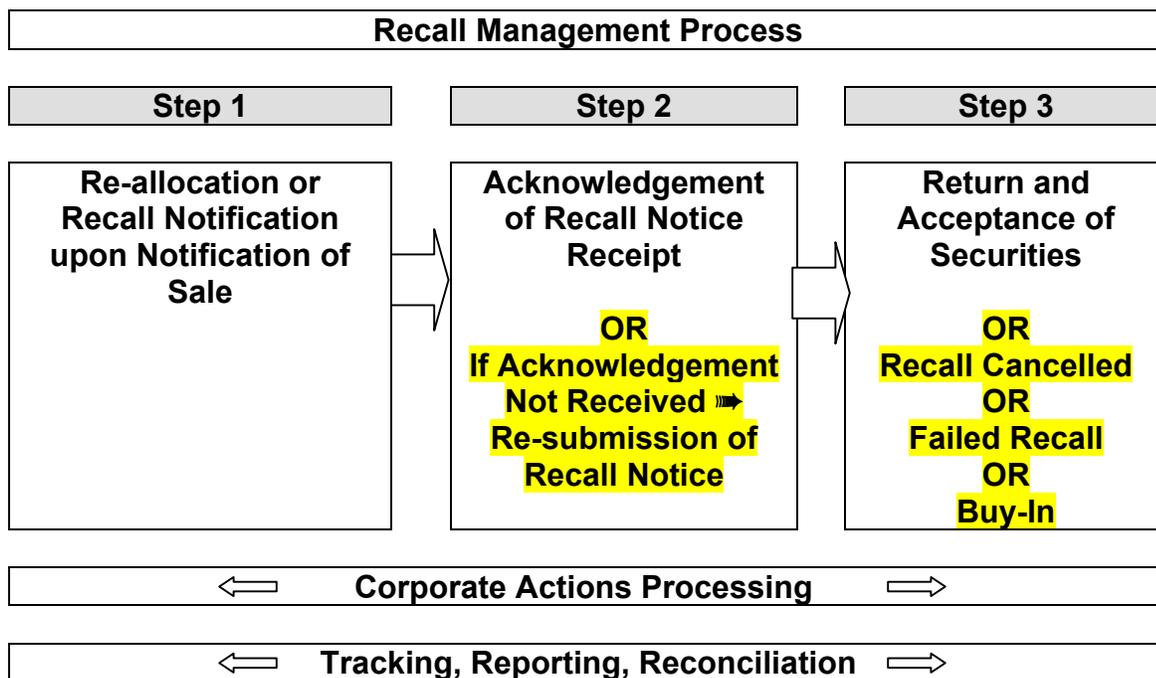
- Individual client portfolio holdings
- International tax laws
- Local market regulations
- Size and mix of government holdings
- Market conditions
- Varied collateral arrangements
- Restrictions on type of collateral
- Number of borrowers.

Most securities lending fees are totally negotiable and dependent upon the actual requirements of particular clients. In agency situations, securities lending income is split between the lending agent and the client.

To manage the risk within securities lending transactions:

- All transactions are done under a securities loan agreement, which lays out the rights and obligations of the parties involved. Generally, as noted above, the beneficial owner via the lending agent retains all rights of ownership during the loan, most often described as “distributions” in the agreement.
- Collateral is received for all lending transactions, usually at 102-105 per cent of the market value.
- Positions are “marked to market” each day and collateral is exchanged to keep the collateral at the agreed percentage threshold to ensure that the market value of the securities pledged as collateral is sufficient to cover the market value of the loaned securities.
- Outstanding contracts are reconciled and the “mark to market” process is automated by at least most large lenders and borrowers to reduce the likelihood of error.

The process of recalling securities on loan is the most complex operational aspect of securities lending. The diagram below summarizes the process at a high level. The text in shading highlights additional steps that may have to be taken due to errors or problems often caused by the manual nature of the securities lending process.



A detailed diagram, showing the complexities of the securities lending process, is included in **Appendix C**.

Going forward, some cross-industry alternatives to achieve automation will be undertaken. Virtual matching utilities (VMUs) have been or are being developed that provide or may provide the capability for custodians to

receive pre-matched instructions (where the custodian has been identified as the settlement agent), which can be used for processes such as reviewing loan positions that need to be re-allocated or recalled. At present, VMUs are focussing on regular securities settlements, but could be extended to cover additional securities lending functionality.

Custodians need to receive trade information as soon as possible, so they can prepare to re-allocate securities among their own clients or recall securities on loan if necessary. Accordingly, the proposed CCMA institutional trade processing white paper model (March 2001) included reference to "... an early warning notice that would be sent to a custodian whenever an investment manager entered an expected allocation. However, custodians would need to be careful in the use of the information contained in this notice since it could not be considered 'final' information. The notice would be generated based only on the investment manager's input of an expected allocation and would not have been validated against the notice of execution (NOE) input by the broker/dealer."

The recently issued CCMA institutional trade processing white paper addendum (November 2002) noted that, depending on the VMU, there is the capability for the custodian to receive pre-matched instructions, where the custodian has been identified as the settlement agent, which can be used for processes such as reviewing loan positions that need to be reallocated or recalled. It recommended that each institution set up its profile according to its business and operations model, meaning that if the function is deemed important to the firm, the firm should include it as a requirement in its selection of a VMU.

#### **d. Market Data**

The Canadian securities lending market is growing, as are similar markets in major global financial centres. The expansion in securities lending and related activities around the world reflects the increasing integration of the world's financial markets. The most recent development in Canada is that the mutual fund industry is now able to engage in securities lending due to a change in legislation. Data below, collected by eClientscope, will not fully reflect the impact of this and, based on information from four custodians only, is incomplete. The four custodians, however, are known to be the four largest lenders in Canada and conservatively represent 75 per cent of the lending agent market. The SLWG members consider the data provided to give a representative snapshot of the securities lending market in Canada.<sup>6</sup>

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<sup>6</sup> **Notes**

- These statistics were collected in the summer of 2002 and may not represent lending activity at other times of the year.
- Some respondents did not provide all data requested – in these cases, the results were interpolated where it seemed reasonable.

- **Market Size:**
  - There is \$519 billion in debt and equity securities available for lending.
  - Of this, 56 billion or 11 per cent was on loan during the survey period – **Note:** Securities on loan means collateralized loans and excludes repurchase agreements.
  - Of the assets on loan, 75 per cent were Canadian. Seventeen per cent of loaned securities were money market instruments, 32 per cent were other forms of debt and 51 per cent were equities.
  
- **Market Participants:**
  - There are an estimated 400 beneficial owners who participate in securities lending programs with approximately 10 lending agents in Canada, although this may represent some double counting. Over 75 per cent of securities lenders are Canadian.
  - There are estimated to be as many as 100 borrowers. Seventy-two per cent of borrowers are non-Canadian.
  
- **Notification Methodology:**
  - While 99 per cent of trade/sales notifications are done electronically on a system-to-system basis (although this does not give an idea as to how many are error-free and do not require data enrichment, meaning this does not identify what percentage of notifications are truly STP), in stark contrast, only one per cent of recall notifications are done in this way, with 99 per cent undertaken by fax or phone.
  
- **Notification Timing:**
  - Fifty-two per cent of sales notifications are received on T, 38 per cent on T+1 and 10 per cent on or after T+2.
  - There is an average of just under two days between recall notification and delivery.
  
- **Other Data:**
  - There are an estimated 4,200 re-allocations per month, of which 224 result in recalls. This means that only an estimated five per cent of sales notifications result in a recall.
  - Of the 224 recalls, 10 or less than five per cent were cancelled.
  - There are 20-30 missed recalls a month – about 10 per cent – that do not settle on time.

- 
- Questions not answered by a sufficient number of respondents are not included.
  - Some categories were combined where warranted.
  - No extrapolation has been made for other lenders.
  - No double-counting adjustments have been made for borrowers or lenders using more than one securities lending agent.

e. **Comparisons with the U.S.**

The general securities lending process in the U.S. is similar to that in Canada, although, in Canada, most securities lending is done through agents. As well, volumes are considerably higher both in actual terms and proportionally in the U.S.

For this reason, the U.S. SIA's Securities Lending Subcommittee developed an extensive white paper (and follow-up white paper released on January 17, 2003) on improvements required in the securities lending market in the U.S., viewable at [www.sia.com/Key Issues/STP](http://www.sia.com/Key%20Issues/STP). Notably, the U.S. is looking at an automated recall management system (ARMS) and proposed business and functional requirements of a system or systems that, according to the U.S. Securities Lending White Paper, would:

- Issue recalls through a centralized hub
- Acknowledge or reject a recall
- Manage the recall process and track recall performance
- Update the ARMs for the termination of a recall that is cancelled, returned or bought in
- Track the status of open recalls after the recall expiration date
- Uniquely identify each recall with a specific reference number
- Timestamp original recalls to provide an audit trail of the notification
- Automatically update outstanding recalls as a result of mandatory corporate actions
- Be available to non-U.S. participants in the securities lending and borrowing market.

The U.S. Securities Lending Subcommittee is continuing with its efforts to develop an ARMS and improve the functioning of the securities lending market despite the fact that T+1 is not being actively pursued. Refer to **Appendix D** for a summary of U.S. T+1 securities lending white paper recommendations and feedback.

### **3. CHALLENGES/PROBLEMS WITH CURRENT SYSTEMS/ PROCEDURES FOR SECURITIES LENDING**

Most of the challenges and problems with today's securities lending systems and procedures in moving to STP/T+1 are similar, but not identical, to the processing challenges faced in the institutional and retail markets generally. They include, but are not limited to:

- a. Manual processes, duplication of or unnecessary effort and the need to reduce reliance on paper
- b. Need for standards/best market practices as regards timing, format and action – incentives/compliance mechanisms to achieve adherence to standards and market practice
- c. Legal/regulatory impediments, including the fact that participants in the securities lending market are regulated by differing bodies
- d. Need for effective communications.

There may also be other considerations not captured here.

The sections below highlight issues specific to securities lending in each of the above areas.

#### **a. Manual Processes/Reliance on Paper**

##### **i. Recall Notification**

The recall of loaned securities is triggered by a number of different situations. Some examples include: i) the underlying securities have been sold, ii) the securities need to be redelivered so that the client can vote or take other action in relation to the securities (given the difficulties involved, some clients have instituted standing instructions to recall all positions for all meetings) or iii) an IDA member firm, which has lent securities, determines it has a segregation deficiency and, therefore, must recall those securities to correct the deficiency as required by IDA Regulation 2000.9.

Lenders receive notification of securities sales or other circumstances requiring loaned securities to be recalled in a variety of ways. These can be via electronic file transfer, fax or phone. This happens typically on trade date (T) or T+1.

Once the lender has received the notice, the lender tries to re-allocate the loan from a different account. This can happen on the books of the lender without requiring a recall. If re-allocation is not possible, the lender must recall the security from the borrower. This happens typically on T+1 or later. Under most securities lending agreements, the borrower is required to return the securities within the normal settlement cycle (e.g., three days following recall notification for

equities). If the lender receives notification of sale on T+1 and is able to issue the recall notice on the same day, the borrower still would not be required to return the security until four days following the original trade date. This potential timing mismatch introduces fail and buy-in risk.

Today, a large number of trade instructions are still received by fax. Therefore the trade has to be manually entered into a custody system before there is an indication that a loan exists against the position. The other method in today's real-time or "good-time" (within 20-minutes) intraday environment, may be a batch file containing trade instructions, in most cases from the previous day. Not having the trade instructions in a timely fashion by electronic means prevents STP. Having incomplete trade details or having to manually enter instructions into a system prevents a timely recall of a position to complete settlement.

As notice to borrowers of recalls is usually given by fax or phone, sometimes with a follow-up phone call, the process is subject to delays and errors in transcription or misunderstanding, is potentially time consuming and is certainly inefficient.

There will be time wasted (i) between trade and trade notification (as noted above, 50% of the time, lending clients notify lending agents on T, 35% on T+1 and 15% on or after T+2), (ii) between trade notification and issuance of a recall (there is generally less than an hour spent between receipt of trade notification and sending the recall notice – the time necessary to identify if re-allocation is possible) and (iii) between recall and acknowledgement. This further contributes to the possibility of timing mismatch.

A mitigating factor in the current market is that recalls can be done on a same-day basis, for example, in an emergency situation where trade notification is received very late, but, should the settlement cycle be shortened to T+1, higher volumes may not be able to be accommodated.

## **ii. Recall Acknowledgement**

There is currently no across-the-board acknowledgement process, which leads to missed recalls, re-submission of recall notices, cancellations and amendments. The standard practice of taping lines means that, while the process is error-prone, there is back-up to confirm what happened. However, the tighter timeframes that may be set for STP and would be set for T+1 would increase the risk of errors and reduce the time available for corrections.

## **b. Incomplete Industry-wide Standards/Best Practices**

### **i. Recall Management**

While timing would assume greater importance in a T+1 environment, timing is still important in a T+3 environment. Current processes are governed by market practice and by legal agreements specifying particulars about the loan of securities.

Regarding market practice, the deadline for recall notices for same-day delivery is 11:30 a.m. for bonds and 2:30 p.m. for inter-dealer cross-border equities transactions (3:00 p.m. in Canada ); notices received later are effective the following business day.

Legal agreements specify the timing of the return of loaned securities and the remedies in the case of default. For IDA member firms, IDA Regulation 2200.2 requires that all securities loan agreements contain certain minimum provisions that address the rights of each party and the remedies available to them in the event of a default. While the wording often links the return to the settlement cycle of the underlying asset, others specify T+3. Even though legal agreements specify timelines for the return of a loan, currently, there are time lags in the trade information transfer process from the investment manager to the custodian and in terms of how quickly (either manually or on an automated basis) the trade notifications get posted to the custody system. The requirement for more timely, accurate and efficient processes that are impacted by or may impact the recall process will be a challenge in a STP world with shorter settlement cycles.

Also, while standards and market practices (e.g., timelines, message content) are set out to varying degrees in lending agreements, there is little consistency across the marketplace in Canada, although there are standard forms of lending agreements. While manageable bilaterally in the current environment, as volumes increase, this will become more challenging and will be inconsistent with U.S. practice when Canada is moving to effectively operate in the North-American marketplace.

In some cases, recalls notified by fax identify the default liability and responsibility of the parties involved. For IDA member firms, IDA Regulation 2200.2 requires that all securities loan agreements contain certain minimum provisions that address the rights of each party and the remedies available to them in the event of a default.

One consequence of a failed recall is a buy-in. It is important to note that there is an online buy-in notification in CDS's Securities Settlement Service (SSS) (soon to be part of CDSX), but functionality is limited to Continuous Net Settlement (CNS) activity. Anyone can be bought in, but to buy in, participants must be members of an exchange.

## **ii. Proxy Management**

Proxies and other corporate actions are complex and risky when the securities are in the custodian's possession; with the securities lending component added, potentially involving several brokers, the associated risk and liability has increased substantially. Further complexities are added when securities are lent to non-Canadians or Canadians borrow foreign securities, although these eventualities should be covered in the related legal agreements between counterparties

The obligation to recall loaned positions to receive a proxy for voting rights is based on individual client requirements as set out in the legal agreement governing the securities lending arrangements. Each firm has its own systems and processes to identify when to recall a position based on announced annual meeting record dates. There are challenges in this process in the T+3 environment, but they are outside the scope of this paper. Some would be addressed by having a central mandated entitlement reporting hub as set out in the October 2002 Corporate Actions and Other Entitlements White Paper and by having standards and best practices for entitlement reporting.

## **iii. Other Corporate Actions**

During the life of a loan, the underlying asset or security loaned may be involved in a number of events where an entitlement is due. If the underlying asset pays a dividend or interest payment, the lender, on behalf of the beneficial owner (see Section 2.a, Definitions) is entitled to receive the proceeds from the borrower on the payable date and the beneficial owner retains the right to collect all entitlements (excluding proxies) on the assets. The proceeds are posted to the underlying beneficial owner's account at their respective custodian. The underlying asset may also be involved in a corporate action event ranging from name changes and mergers to tender offers (see CAWG white paper for more details on corporate action events).

If the event is mandatory and no decisions are required, such as a name change, the borrower will return the new asset at the conclusion of the loan or at the time of the exchange. For example, if during the loan ABC Co. changes its name to XYZ Co., then upon the return of the loan, the appropriate number of XYZ Co. shares are returned; the number of shares may differ if the name change was other than a one-to-one exchange. This exchange is co-ordinated between the corporate actions and the securities lending groups of both parties (lender and borrower) so that the transactions are properly reflected on the books of the custodian as a corporate action.

If the asset is involved in a tender offer or bid to acquire the shares, the underlying beneficial owner has the right to submit his or her shares to the offeror. The lender will attempt to recall the loan to fulfill the

beneficial owner's request to tender the shares prior to expiry of the event. If the borrower is unable to return the securities in time, the lender issues a direction to the borrower to tender the shares on the beneficial owner's behalf. At this time, the borrower acknowledges receipt of the direction and, by doing so, takes on the liability for ensuring that the shares are tendered for the appropriate proceeds, which can be a combination of cash and/or other securities as described in the offering circular. The borrower will then return to the lender the applicable proceeds when they are received from the depository. The loan is either re-allocated or wound up at that time on a real-time or close-to-real-time basis.

If the borrower is a U.S. resident and there are certain restrictions based on residency, the borrower is obligated to fulfill the beneficial owner's request. For example, if Canadian residents can only receive exchangeable shares and U.S. residents only common shares, it is the U.S. borrower's responsibility to fulfill the request.

### **c. Rules and Regulations**

Securities lending is subject to varying legislation and regulation in different jurisdictions in Canada.

Regulations published by the Office of the Superintendent of Financial Institutions (OSFI), the federal pension regulator, state that collateral is based on "street practice." Section 2.c of OSFI guideline B4 (dated September 1996) states that, to manage the risk within securities lending transactions:

"The amount of collateral taken for securities lending should reflect the best practices in local markets. In Canada, the current market practice is to obtain collateral of at least 105 per cent of the market value of the securities lent. Management is expected to ensure that the margin of collateral in excess of market value of securities lent is appropriate at all times. This margin should provide adequate protection against volatility and liquidity problems that may arise for securities lent and for securities held as collateral. Both loaned and collateral securities should be "marked to market" at least daily. Shortfalls in the amount of collateral should be rectified immediately."

On the other hand, National Instrument 81-102, Mutual Funds, specifies collateral requirements of 102 per cent of the market value of securities lent.

The IDA also provides some regulation over the cash and securities transactions its member firms enter into. IDA Regulation 2200 – Cash and Securities Loan Transactions and 2000.9 – Correction of Segregation Deficiencies: Securities Loans, set minimum requirements for acceptable

securities loan agreements, timing for buy-ins, acceptable collateral, penalties for non-compliance and recall procedures to correct segregation deficiencies associated with securities on loan, respectively.

Research continues regarding the differing legislation among jurisdictions.

**d. Communications Challenges**

Given the lack of an industry-wide association or other forum for borrowers and lenders to assist in promoting new systems/procedures and standards/best practices, discussion and communication of improvements is challenging. Also, obtaining industry statistics on which to base recommended changes is difficult.

**e. Other Considerations**

**i. Retail Clients**

Retail clients can effectively be securities lenders, but do not lend their securities directly or independently. For example, many retail investors hold mutual funds and the mutual fund portfolio manager may lend the investors' securities. As well, broker/dealers may lend partially paid securities in margin accounts. There do not appear to be any material differences or special requirements for dealing with retail, as opposed to institutional, clients regarding securities lending.

**ii. Securities Lending of Non-Canadian Assets/to Non-Canadians**

Additional challenges are faced in the case of loans of non-Canadian assets and to non-Canadian borrowers. Complexities include different time zones, languages, legal systems, currencies, etc.

Just as when Canadian securities are lent to foreign borrowers, the foreign borrowers must abide by Canadian rules, when borrowing from foreign lenders, Canadian players must abide by foreign rules, which may ultimately mean T+1 in the case of the U.S.

As noted above, legal agreements will seek to address timing and other issues that may arise.

#### **4. ANALYSIS/OPTIONS/PROPOSED SOLUTIONS TO REACH STP/T+1 FOR SECURITIES LENDING**

##### **a. Manual Processes/Reliance On Paper**

- i. Recall Notification**
- ii. Recall Acknowledgement**

It is unlikely that a solution as formal as the ARMS concept in the U.S. is required in Canada due to lower volumes and different market practices, e.g., in the U.S., it is understood that loans are often linked to specific collateral whereas in this country, Canadian practice is to pool collateral by borrower, meaning any linking of a specific loan to collateral is not immediately necessary and would mean massive changes in process and systems.

This said, CDS's current systems allow securities lending processing (set-up of loans, pledge and collateral), although not everyone uses the functionality to its fullest. CDS's new system, in the final stages of implementation with conversion to follow in 2003, will also allow outbound messaging for new entry and modify notifications, as well as limited settlement notifications, when implemented. Although inbound messaging is not in scope for CDSX implementation, inbound messaging functional requirements will be prioritized following the business conversion in 2003. A securities lending service is within CDS's role and could leverage off participants' existing networks.

Today, CDS allows an automated means of affirming items pledged. This is currently done by counterparties using ELTRA on-line and, for debt, using CDSX. To achieve true STP, the Canadian marketplace needs a means for lenders and borrowers to take results from CDS, compare them to in-house data and return a system-generated affirm message immediately in real-time. This would eliminate the manual affirm and provide better productivity gains and steps towards STP (and T+1) than additional recall functionality.

As an interim solution, CDS participants could examine the functionality that exists today to see if it can be used as a short-term solution, with procedural and bilateral agreements that have the lender set up the actual transaction to recall the loan (this is current practice, although both borrower and lender can set up a loan) and thus be used as the recall notification instead of a fax. The back office, rather than traders, would be notified of a recall first, (as per current operational procedures).

Going forward, there are two options to consider:

1. CDS could be used as a recall messaging hub without any specific security lending functionality. Messages could be passed between borrower and lender participants within CDS. This would involve using the current “Interlink” messaging infrastructure within CDS, which would have to be modified to accommodate “SWIFT-like” messaging for pledge messages, assuming CDS participant support, but would not have any specific functionality to link to securities lending systems. This would replace the current “phone-fax-phone” industry recall/acknowledgement process as a start. As there are no standard messages for securities lending, Canada should adopt the ISO 15022 standards.
2. CDS could look into modifying the current CDS pledge system more extensively; as well, accounting for corporate actions would have to be examined. The benefits of this are that both the loan transfer, collateral movement and messaging could occur through CDSX.

Transactions with foreign borrowers would likely be handled as currently.

**Recommendation #4.a.i and 4.a.ii. – Recall Notification/  
Acknowledgement:**

1. Eliminate faxing.
2. Investigate a messaging hub through CDS or another supplier.
3. Investigate links with the U.S. ARMS or multiple ARMS (possibly a link through the Depository Trust and Clearing Corporation (DTCC)).

**b. Incomplete Industry-wide Standards/Best Practices**

**i. Recall Management**

**Recommendation #4.b.i – Standards and Best Practices for Recall  
Management:**

1. By December 2003, establish a standard requiring that notice of recalls and acknowledgements be made electronically (the goal is 80 per cent of recalls will be made electronically by June 2004 and 100% by December 2004)
2. Encourage industry participants to review legal wording of their borrowing and lending agreements to ensure that the timing of the return of loaned positions is tied to the settlement cycle of the underlying asset.
3. Work to assess proposed industry standards and best practices including implications of rules and practices in the context of CDS’s new equity and debt clearing platform, CDSX.

4. Consider standard wording regarding the right to close out and buy in, timing and details of a recall notice, etc.

## **ii. Proxy Management**

### **Recommendation #4.b.ii – Standards and Best Practices for Proxy Management**

Encourage market participants to identify whether any securities lending standards and best practices are required regarding proxy management.

## **iii. Other Corporate Actions**

### **Recommendation #4.b.iii – Standards and Best Practices for Other Corporate Actions**

Encourage market participants to identify whether any securities lending standards and best practices are required regarding other aspects of corporate actions.

## **c. Rules and Regulations**

### **Recommendation #4.c – Rules and Regulations**

Encourage market participants and stakeholders to identify whether any securities lending rules and regulations are required or should be changed to further improve efficiency of the securities lending market.

## **d. Communications Challenges**

### **Recommendation #4.d – Communications**

Once feedback on this white paper is received, work with the IDA, custodians and others to ensure endorsement and communication of standards and best practices.

### 3. GOING FORWARD

#### a. Proposed Implementation Schedule

Below are key milestones in the SLWG's efforts to rationalize the securities lending process:

- **March 15, 2003:** Receive feedback on the white paper
- **May 31, 2003:** Publicize any amendments to white paper recommendations
- **June 15, 2003:** Formulate detailed standards and best practices recommendations on who should do what by when in terms of data quality, message protocols and timing and identify any rule changes required to pass to the Standards and Best Practices Working Group and Legal/Regulatory Working Group
- **December 31, 2003:** Work with SROs, associations, etc. to achieve industry-wide agreement on standards and best practices
- **June 2004:** Make 80 per cent of recalls and acknowledgements electronically
- **December 2004:** Make 100 per cent of recalls and acknowledgements electronically
- **June 2005:** Meet 100 per cent of securities industry institutional trade processing standards (e.g., trades matched on T to facilitate initiation of a recall on T).

A detailed project plan is included in **Appendix E**.

#### b. Request for Comments

Addressing the problems described here will involve a combination of systems development and operational process improvements.

To move ahead, the SLWG and CCMA need feedback from you and other stakeholders in the securities industry that are impacted by the current securities lending process. Specifically, we:

- Seek comments on the perceived benefits and challenges of, and proposed solutions for, a move to STP from the perspective of securities lending in Canada, within the context of a North-American market
- Solicit feedback to support the development of industry standards and processes, an effective regulation/rules framework and communications options that will allow for a smooth transition from the current, mainly manual, environment to STP

- Request input on the proposed work schedule.

**Please send your written comments on the above via e-mail, fax or mail by March 15, 2003, to:**

Ms. Savie Fiorini  
Chair, Securities Lending Working Group  
c/o: Ms. Rosa Sosin  
Canadian Capital Markets Association  
10<sup>th</sup> Floor, 85 Richmond Street West  
Toronto, Ontario, Canada M5H 2C9  
E-mail: [info@ccma-acmc.ca](mailto:info@ccma-acmc.ca)  
Tel: 1 416 815-2046  
Fax : 1 416 365-8700.

**c. Expected Next Steps**

Comments received from interested stakeholders will be shared with the SLWG and, if appropriate, other working groups, so that the proposed procedures, legislative/regulatory/rule changes, communications required and implementation steps can be finalized. An unattributed summary will be publicized via the CCMA Web site so that respondents can be assured that their input has been heard.

The comments will be analyzed and the proposed model refined, with any significant points of disagreement to be discussed by the Canadian Capital Markets Association Board of Directors and/or the relevant industry association(s).

A final plan, as well as dissemination and implementation steps, will be publicized in 2003. In the interim, the CCMA will begin work to address the challenges identified in this paper. Individuals interested in participating in this initiative are invited to contact the CCMA at the coordinates above.

## **SUMMARY OF RECOMMENDATIONS**

### **a. Manual Processes/Reliance On Paper**

#### **Recommendation #4.a.i and 4.a.ii. – Recall Notification/Acknowledgement:**

1. Eliminate faxing.
2. Investigate a messaging hub through CDS or another supplier.
3. Investigate links with the U.S. ARMS or multiple ARMS (possibly a link through the Depository Trust and Clearing Corporation (DTCC)).

### **b. Incomplete Industry-wide Standards/Best Practices**

#### **Recommendation #4.b.i – Standards and Best Practices for Recall Management:**

1. By December 2003, establish a standard requiring that notice of recalls and acknowledgements be made electronically (the goal is 80 per cent of recalls will be made electronically by June 2004 and 100% by December 2004).
2. Encourage industry participants to review legal wording of their borrowing and lending agreements to ensure that the timing of the return of loaned positions is tied to the settlement cycle of the underlying asset.
3. Work to assess proposed industry standards and best practices including implications of rules and practices in the context of CDS's new equity and debt clearing platform, CDSX.
4. Consider standard wording regarding the right to close out and buy in, timing and details of a recall notice, etc.

#### **Recommendation #4.b.ii – Standards and Best Practices for Proxy Management**

Encourage market participants to identify whether any securities lending standards and best practices are required regarding proxy management.

#### **Recommendation #4.b.iii – Standards and Best Practices for Other Corporate Actions**

Encourage market participants to identify whether any securities lending standards and best practices are required regarding other aspects of corporate actions.

**c. Rules and Regulations**

**Recommendation #4.c – Rules and Regulations**

Encourage market participants and stakeholders to identify whether any securities lending rules and regulations are required or should be changed to further improve efficiency of the securities lending market.

**d. Communications Challenges**

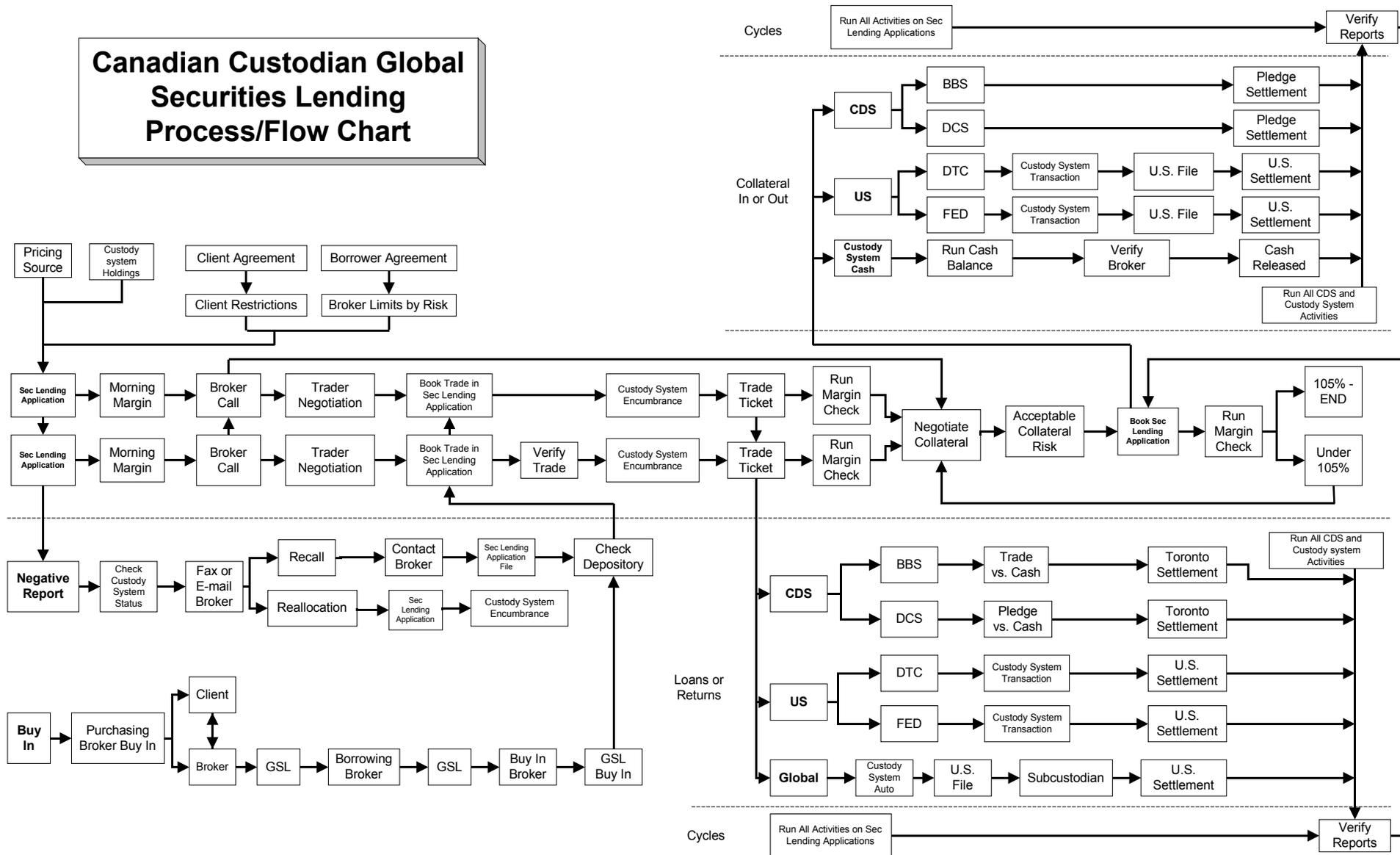
**Recommendation #4.d – Communications**

Once feedback on this white paper is received, work with the IDA, custodians and others to ensure endorsement and communication of standards and best practices.

**SECURITIES LENDING WORKING GROUP MEMBERS**

<b>Name</b>	<b>Company</b>
Savie Fiorini (Chair)	CIBC Mellon Global Securities Services
Judith Robertson (Vice-chair)	Independent
Barbara Amsden	The Canadian Depository for Securities Limited (CDS)
Ann Degeer	The Bank of Nova Scotia
Lionel De Mercado	TD Securities
Nino Guercio	Capital Corp Canaccord
Michael Kehoe	Ontario Municipal Employees Retirement System (OMERS)
Allan Laurent	RBCDS Investments
John Loynd	BMO Nesbitt
Warren Maynard	CIBC Mellon Global Securities Services Company
Charles Murray	State Street Securities Finance
Malcolm Park	Scotia Capital
Steve Pesner	eClientscope
Peter Petsopoulos	TD Securities
Susan Pike	RBC Global Services
Stephen Proctor	BMO Nesbitt Burns
Katrina Rempel	BMO Nesbitt Burns
Satinder Sando	BMO Nesbitt Burns
Ross Smellie	Deutsche Bank
Doug Thompson	Scotiabank
Jenny Tsouvalis	OMERS
Paul White	TD Securities
Darren McKall	Ontario Securities Commission (Observer)

# Canadian Custodian Global Securities Lending Process/Flow Chart



## **U.S. T+1 SECURITIES LENDING WHITE PAPER RECOMMENDATIONS AND FEEDBACK**

Below is a summary of the content of, and feedback on, the U.S. T+1 securities lending white paper developed by the joint Risk Management Association (RMA)/Securities Industry Association (SIA) Securities Lending Subcommittee. It describes issues within the seven steps associated with securities lending and recommends systems solutions and standards to address them.

### **Step 1: Reallocation/Pairing and Recalls Notification**

When notified of a sale by a beneficial owner, a lender identifies whether shares from another lending client can be reallocated to the loan and, if not possible, sends a recall notice – typically by fax – to the borrower requesting the securities’ return. Current business practice requires that the recall notification be sent by 3:00 p.m. Eastern time for the recall to be effective the day sent; if sent after 3:00 p.m., the recall is deemed to have an effective date of the next business day. The recall period is usually the standard settlement period in the market for the security being recalled. **Manually producing and transmitting the recall notice and the lack of standards for recalls (see Step 5 below) are potential points of failure in this process.**

### **Step 2: Acknowledgement**

Receipt of a recall notice from the borrower is currently acknowledged in one of two ways.

- Actively by the borrower acknowledging receipt of a recall by return fax or phone call
- Passively, where the sender uses the fax receipt as acknowledgement of the recall notice being sent.

**Manually acknowledging notice receipt and inconsistent acknowledgement methods are other potential failure points in the process.**

### **Step 3: Re-submission Process**

The re-submission process involves re-sending the original recall notice from lender to borrower, typically because the lender did not receive acknowledgement from the borrower that it received the original recall notice. Disputes between lender and borrower regarding the expiration date of the recall may arise where the lender will expect the recall to expire as if it had been sent the previous day, while the borrower may want expiration to be based on the full settlement cycle from the resubmission date. **Re-submission adds a redundant step and the potential for disputes is another potential failure point.**

### **Step 4: Return and Acceptance Process**

If securities are available to be re-borrowed, the borrower returns the securities to the lender by the specified recall expiration date. The lender may not realize that securities being returned are after the lender’s daily return deadline for a recall and may reject or “DK” (“don’t

know”) the return. **The lack of a standardized mechanism to identify securities being returned in response to a recall is a point of failure.**

### **Step 5: Termination Process**

In approximately five to 10 per cent of securities loans, securities lent are illiquid. In these cases, the borrower may not be able to obtain the securities quickly enough, resulting in a failure to return the securities by the recall expiration date. This triggers the termination process, which can happen in one of three ways:

- 1) Cancellation – There are no standardized recall cancellation procedures. **A point of failure is the potential for recalls that are no longer valid to appear to be open.**
- 2) Recall fail – Where a recall has failed but is left open, the lender may assess penalties on the borrower for the failing recall but no other action is taken beyond waiting for the securities’ return.
- 3) Buy-in – Where a failed return results in a buy-in, the lender may send a separate notification of its intent to buy in the position while the recall is failing. Alternatively, the original recall notice also serves as the notice of intent to buy in if the security is not returned by the recall expiration date. **Lack of standardization in this area is another potential point of failure.**

### **Step 6: Corporate Action Notices Process**

There is currently no automated, formal mechanism to provide borrowers with notification of corporate action events and pass liability involving recalled securities. **Inconsistent modes of notification of corporate actions and liability are potential points for failure in the securities lending process.**

### **Step 7: Recall Management Process**

Supporting recall management are a series of processes, including tracking open recalls, reconciling DKs, providing recall management reporting, etc. **The lack of a standardized mechanism for tracking open recalls, reconciling DKs or providing recall management reporting are further potential points of failure.**

### **Proposed Automated Recall Management Systems (ARMSs)**

The committee recommends the use of ARMSs or centralized hubs as the way to address the risk of errors through manual processing. Lenders would issue, manage and track recalls and borrowers would acknowledge or reject the recall through the centralized hub. Ideally, ARMSs would be updated to terminate a recall that is cancelled, returned or bought in; track the status of open recalls after the recall expiration date; identify each recall with a specific reference number; timestamp original recalls to provide an audit trail of the notification; automatically update outstanding recalls as a result of mandatory corporate actions; and be available to non-U.S. participants in the securities lending and borrowing market.

Automating the recall process will eliminate the need for re-submission and the resulting delay and risk.

ARMSs will reduce or eliminate DKs through the use of a recall reference number known to both the borrower and lender that the borrower would include in its delivery order.

ARMSs would update open recalls on the effective date of the corporate actions in the case of mandatory events. In the case of voluntary events, further work is needed to identify the role ARMS could play in communicating liability and elections.

### **Proposed Standards for Recall Notification**

ARMS are only part of the solution. An ARMS will only be truly effective if standards are established or reaffirmed for the recall notification process:

1. **Sale notification from beneficial owner:** Beneficial owners should continue the practice of trade notification to agent lenders and meet future notification standards based on the institutional transaction processing and STP/T+1 standards/codes of practice recommendations.
2. **Recall issuance method:** Recalls should be issued using ARMS to enhance efficiency in the processing and tracking of recalls.
3. **Transmission deadlines:** The deadline for transmission of a recall notification in the current T+3 environment should be 3:00 p.m. Eastern time for U.S. domestic securities. Recalls received after that time will be considered and treated by ARMS as next-day notification (deadlines for the T+1 environment would be established once the trading and daily settlement timeframes for T+1 are determined).
4. **Recall period:** The recall period should be, as currently, the recall date plus the standard settlement cycle.
5. **Recall notification acknowledgement:** Acknowledgement of the recall notice by the borrower should be passive – the borrower should be assumed to have accepted the recall if it is not actively rejected.
6. **Rejection standards:** A borrower should reject or “DK” a recall notice within one hour from the time of receipt if incorrect, providing a rejection notice that contains reasons for the rejection (e.g., discrepancies regarding share quantity or security). The recall should remain valid until the recall issuer validates the DK and cancels the recall. Lenders should research outstanding DK notices and cancel recalls where appropriate as soon as possible, with assistance from ARMS reporting.
7. **Expiration of recall period:** A recall is considered to have failed if it has not been settled or cancelled by the expiration of the recall period. As the lender updates the status of the recall in the ARMS using automated or manual means, the lender may determine the form and timing of penalties for the borrower who fails to deliver the recalled securities.
8. **Termination of recall:** Until a recall is terminated by a cancellation, return of the recalled security or buy-in, the recall will continue to age and a list showing outstanding recalls should be reviewed regularly to avoid prolonged fails in the market.
9. **Cancellation of recalls:** To avoid having to accept a return, a lender who wishes to cancel a recall should do so before the borrower has initiated the process for returning

the securities. For example, if a return is pending at the U.S. Depository Trust Company, the lender should not DK the securities even if the return is completed after the lender has cancelled the recall and after its typical daily return cut-off to protect the borrower who took action (e.g., re-borrowed securities) to complete the recall. The principle may not apply to securities on which a corporate action is pending depending upon the procedures adopted in response to the work of the SIA Corporate Actions Subcommittee.

10. **Return of Recalled Security:** A loaned security that is returned in response to a recall should be transacted under a DTC reason code distinct from normal loan returns. The committee proposes the use of a specific DTC reason code to be determined at a later date. The recall issuer then closes out the recall on the ARMS through either manual entries or automated uploads from its systems.
11. **Buy-ins:** ARMS should be used to communicate the intention to buy in and buy-in execution details.
12. **Corporate Actions:** Mandatory corporate actions affecting securities that have been recalled should be updated through an automated process executed by the ARMS. Voluntary corporate action elections by the beneficial owner on a security that is on loan should be relayed to the borrower according to standards being developed by the SIA Corporate Actions Subcommittee.

### SECURITIES LENDING WORKING GROUP PROJECT PLAN

CCMA Project Plan as of January 15, 2003																							
ID	Task Name	% Compl	Pred.	2002				2003				2004				2005				2006			
				Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4
1	INSTITUTIONAL TRADE PROCESSING WORKING GROUP (ITPWG)	19%		██████████				██████████															
111	RETAIL TRADE PROCESSING WORKING GROUP (RTPWG)	15%		██████████				██████████															
225	DEMATERIALIZATION WORKING GROUP (DWG)	32%		██████████				██████████															
299	CORPORATE ACTIONS WORKING GROUP (CAWG)	21%		██████████				██████████															
353	SECURITIES LENDING WORKING GROUP (SLWG)	28%		██████████				██████████															
354	Monitor Securities Lending White Paper	86%		██████████				██████████															
355	Identify resources to lead securities lending initiatives	100%		4/1	4/12																		
358	Develop securities lending charter, identifying goals and outcomes	100%	355	4/15	4/26																		
357	Conduct review/analysis of CCMA and SIA positions	100%	356	4/29	6/7																		
358	Collect and analyze supporting statistics	100%	357SS	4/29	9/13																		
359	Identify areas of current and desirable best practices and standards	100%	357SS	4/29	9/13																		
360	Conduct analysis and issue identification, liaise with SROs, LRWG, SIA	100%	357SS	4/29	9/13																		
361	Develop securities lending white paper incorporating issue resolution recommendations	100%	3FF,360FF	4/29	10/25																		
362	Issue securities lending white paper for ITPWG approval	0%	361		10/28																		
363	Receive comments and revise securities lending white paper	100%	362	10/29	11/22																		
364	Issue securities lending white paper for internal CCMA comment	100%	363		1/22																		
365	Receive comments on securities lending white paper	100%	364	11/25	2/20																		
366	Resolve outstanding issues, revise securities lending white paper	100%	365	12/23	1/17																		
367	Obtain CCMA Board approval to issue securities lending white paper	0%		1/23	1/31																		
368	Issue securities lending white paper for public comment	0%	367		1/31																		
369	Receive comments on securities lending white paper	0%	367	2/3	3/28																		
370	Prepare summary of comments received on securities lending white paper	0%	369	3/31	4/25																		
371	Post comments received on securities lending white paper on Web site	0%	370		4/25																		
372	Identify amendments to securities lending white paper	0%	368	4/28	5/23																		
373	Issue amendments to securities lending white paper if any	0%	372		5/23																		

**CCMA Project Plan as of January 15, 2003**

ID	Task Name	% Compl	Pred.	2002				2003				2004				2005				2006	
				Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2
374	Establish Standards and Best Practice/Regulations	0%																			
375	Formulate standards and best practices recommendations for SBPWG	0%	367					2/3			6/13										
376	Send SLWG standards and practices to SBPWG	0%	360																		
377	Liaise with LRWG to have identified regulation changes initiated	0%	368,373FF					2/3			6/13										
378	Send LRWG final list of regulatory changes required	0%	377																		
379	Monitor Implementation of Securities Lending Regulations and Standards of Practices and Processes	0%																			
380	Work to have standards of practices set by SROs	0%	367SS					2/3													
381	Monitor development, ratification of regulation, codes of practice changes by responsible bodies	0%	380SS									6/16			6/30						
382	Identify metrics to monitor implementation progress	0%	38+36 wks													2/23			6/30		
383	Monitor implementation of new processes	0%	381																	7/1	6/28
384	Monitor implementation progress	0%	381,382																	7/1	6/28
385	LEGAL/REGULATORY WORKING GROUP (LRWG)	18%																			
458	COMMUNICATIONS AND EDUCATION WORKING GROUP (CEWG)	21%																			
605	STANDARDS AND BEST PRACTICES WORKING GROUP (SBPWG) Note: Defer to 2003 post-Core Group deliverable review	0%																			
627	STREET-TESTING AND CONVERSION WORKING GROUP (SCWG) Note: Defer to 2003 post-Core Group deliverable review	0%																			
643	End of CCMA current planning horizon	0%																			6/30