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

cetfa Canadian ETF Association

By email April 23, 2024

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

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

Dear OSC Staff:

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

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

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

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

In the spring of 2023, the CCMA's Operations Working Group struck the ETF Task Force ("**ETFTF**") to explore matters of concern with respect to ETF's transitioning to T+1. The ETFTF is comprised of subject matter experts in the ETF space and includes representation from banks, non-bank owned investment dealers, custodians, and CETFA. Various issues were raised, ranging in length of time to address. The principal short-term matter that arose at the beginning of the ETFTF's

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

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

discussions was the acceptability of collateral in the subscription/redemption processes for ETF units. This matter was narrowed to focus on cash collateral in the subscription process for Delayed Basket Securities.

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

IMPACTS OF DELAYED BASKET SECURITIES

ETFs do not issue ETF units until payment is received in accordance with the requirements of Section 9.4 of NI 81-102. In the case of Delayed Basket Securities, typical practice is to adopt a conservative interpretation approach - ETF units are not delivered to the AP until all Basket Securities, including all Delayed Basket Securities, are delivered to the ETF. Thus Delayed Basket Securities result in "**Delayed ETF Units**" (ETF units that have not been delivered to an AP, pending settlement of Delayed Basket Securities). Such Delayed ETF Units in turn cause a delay in the onward delivery of such ETF units to market participants who have purchased them in the secondary market. The reasons why Delayed Basket Securities occur are varied but are universal in result – an AP has not received the quantity of Basket Securities it intended to onward deliver to the ETF as part of the in-kind payment for the ETF subscription. As most ETF units purchased by an AP through subscription orders are ultimately sold in the secondary market, delays in the primary market will adversely impact the secondary market such as increasing failed trades.

T+1

Delayed Basket Securities and the attendant incidence of Delayed ETF Units is currently an issue in the Canadian capital markets. However, with the approaching T+1 transition date of May 27, 2024, there is concern that the shortened settlement cycle will increase the incidence of Delayed Basket Securities, resulting in Delayed ETF Units occurring more frequently and increasing the rate of downstream settlement failures.[3] The shortened settlement timeline will make it more challenging to obtain, on a timely basis, all Basket Securities required for an in-kind ETF subscription.

Basket Securities and ETF Primary Market Settlement Cycle Misalignment

For ETFs that are comprised of Basket Securities that settle on a longer cycle than the Canadian standard, settlement cycle misalignment can cause securities to be unavailable for delivery on the ETF unit settlement date. Consider a Canadian ETF on a current T+2 primary market settlement cycle, comprised of 100 Basket Securities, one of which settles on a T+3 basis (typically a non-domestic security). An AP subscribes for ETF units on an in-kind payment basis and proceeds to execute orders to purchase the Basket Securities. On T+2, 99 of the Basket Securities would be received by the AP (assuming no other settlement problems) but one security would

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

not have been received because it settles on T+3. On the date of settlement for the ETF units (T+2), the AP would not have the full in-kind payment. If the AP cannot otherwise obtain the delayed T+3 security, the subscription would not be completed and the AP would be unable to fulfill secondary market agreements with respect to the ETF units. With a move to T+1, the misalignment is worsened. The AP cannot deliver the ETF units into the secondary market (on T+1) as the T+3 securities are not available until at least two business days later.

Other Delivery Delays

Basket Securities and ETF Primary Market settlement misalignment is not the only issue that arises in a shortened settlement cycle. APs are dependent on counterparties to provide timely delivery of securities, resulting from transactions such as purchases from market participants (whether as trade-for-trade bilateral transactions or centrally-cleared through a clearing agency), sales by their clients, or securities loan recalls. Delays in deliveries from these transactions can occur daily and represent typical routine operational challenges.[4] Other delivery delays are a result of corporate action events (such as a takeover) where the security has been submitted to a tender process and the security cannot be released on a timeline to satisfy the delivery obligations. Irrespective of the reason for delivery delays, the ETF subscription transaction will not be completed due to the Delayed Basket Securities.

These types of delayed delivery scenarios occur currently under the T+2 settlement cycle. However, the T+1 settlement cycle will make it more difficult to obtain the full basket of securities for in-kind subscriptions within the one business day after the trade date, simply because there is reduced time to settle trades (only one business day versus the current two business days) in the normal course and there is less time to resolve operational or corporate action issues. In a T+2 environment, an AP has more reaction time to manage its inventory of securities. If on T+1 an AP was anticipating receipt of securities that would be used for the in-kind payment (on T+2) but the securities were not received, the AP has another business day to otherwise obtain the delayed security (such as attempting to borrow the security). However, in a T+1 settlement cycle for the Basket Securities, if a security is not delivered to the AP on T+1, there is little to no time to otherwise obtain the security. If collateral was not used to bridge the Delayed Basket Security, the ETF unit could not be created. The AP would not be able to onward deliver ETF units on a T+1 basis into the secondary market as required.

Mitigation of Fail Risk

A standardized cash collateral process would help to mitigate such delays in the settlement of ETF units and the associated risks, by enabling delivery of ETF units to APs on the original settlement date, and timely onward delivery to other participants and provide consistency for the industry. Such a process would permit an ETF to accept cash delivered by the AP as collateral

[4] With respect to failed trades from clients or other dealers, a dealer must borrow the securities or execute a buy-in within 15 business days of the settlement date [CIRO Investment Dealer and Partially Consolidated Rule 4326]. Dealers are also required to regularly review aged fails and identify the reason for settlement delay [CIRO Investment Dealer and Partially Consolidated Rule 4424(4)].

against Delayed Basket Securities, and deliver the corresponding ETF units to the AP. This increases efficiency in the capital markets and reduces settlement fail risk (both for primary and secondary markets), while also protecting the ETF and investors.

It is noted that it has been reported that globally there will be an increased use of cash collateral and/or cash-in-lieu[5] in the ETF primary market due to the timing changes associated with T+1.[6]

Investment Dealer Capital

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

An alternative to cash collateral is that AP's carry an inventory of Basket Securities or ETF units to cover off potential Delayed Basket Securities. With an inventory of Basket Securities, the AP would be able to complete in-kind payments for ETF units even where expected securities deliveries from counterparties are delayed. However, there are various problems with this alternative. It is not known which securities, and in what quantity, will be unavailable on a given day. The inventory positions would necessarily be vast. The AP could in the alternative carry an inventory of ETF units. However, the quantity to carry is unknown. Furthermore, the AP would have long position on the ETF that would need to be hedged. In either case, an AP's capital has been diverted to fund the inventory positions and there are many associated costs. These costs would ultimately be passed on to investors.

Settlement Efficiency

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

Where the APs can use cash collateral, they will be able to deliver the securities of the basket as they become available, rather than all at once in bulk at the payment deadline with the

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

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

knowledge that they will receive the ETF units whether all of the Basket Securities are delivered or part of the Basket Securities plus cash collateral are delivered. Operationally, this is a more efficient process. Delivering Basket Securities in bulk at the end of day by all APs for all ETFs (which would flow through the clearing agency) would unnecessarily strain processing at the clearing agency and the ETFs' custodians and increase the risk of failed trades.

COLLATERAL IN VARIOUS JURISDICTIONS

United States

In the U.S., the practice of collateral provision for Delayed Basket Securities is publicized, accepted, and well established.[7] As reported to the ETFTF, market participants using the collateral mechanism in the U.S. find that this stabilizes transaction processing and improves the "smoothness" of the market.

Primary market settlement in the US for ETFs is conducted either through continuous net settlement ("**CNS**") at the National Securities Clearing Corporation ("**NSCC**"),[8] or for non-CNS eligible securities, settled on a bilateral basis (manually through The Depository Trust Company).

The bilateral collateral arrangements are governed by agreements between the parties. AP Agreements contemplate two different cash mechanisms to address Delayed Basket Securities, cash-in-lieu or collateral [9]. Under the cash-in-lieu process, the ETF manager will acquire the Delayed Basket Securities rather than the AP providing such securities at a later date and receiving back the deposited cash. Under the collateral mechanism, cash is temporarily provided by the AP. Upon delivery of the Delayed Securities to the ETF manager, the cash is returned to the AP. The collateral is delivered in accordance with "Cash Collateral Settlement Procedures".[10]

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

---

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

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

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

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

> "To the extent contemplated by an AP Agreement, Creation Units will be issued to such Authorized Participant notwithstanding the fact that the corresponding Fund Deposits have not been received in part or in whole, in reliance on the undertaking of the Authorized Participant to deliver the missing Deposit Securities as soon as possible, which undertaking shall be secured by such Authorized Participant's delivery and maintenance of collateral consisting of cash in the form of U.S. dollars in immediately available funds (marked-to-market daily) of 105% or more of the value of the missing Deposit Securities. The AP Agreement will permit the Fund to buy the missing Deposit Securities at any time and will subject the Authorized Participant to liability for any shortfall between the cost to the Fund of acquiring such Deposit Securities and the value of the collateral."[11]

Similar language may be found in other ETF documentation.[12]

There are no U.S. regulatory limitations on the length of time that cash collateral may be held nor are there limitations on the percent of an ETF assets or subscription order that collateral may comprise.

Europe

The Central Bank of Ireland issued a report on ETFs in 2017 that included reference to collateral for Delayed Basket Securities.[13] ETFs that are under the Undertaking for Collective Investment in Transferable Securities contain the flexibility in their prospectuses for collateral for Delayed Basket Securities. At the time of the report it was noted that European ETFs typically function on a cash (delivery versus payment) basis compared to the predominant in-kind (free of payment) basis for creations in the U.S. and as such, the collateral mechanism for Delayed Basket Securities is not typically used in Europe.

While Europe is still on a T+2 settlement cycle, European Fund and Asset Management Association's reply to the European Securities and Markets Authority's call for evidence on shortening the settlement cycle highlights the benefits of funds moving to T+1.[14] It would be expected that issues such as Delayed Basket Securities would arise when Europe moves to T+1, possibly increasing the use of collateral as a mitigation against increased failed transactions.

Canada

In Canada, there is no centralized collateral facility for ETFs and until such a facility is operational, collateral use would be left to bilateral arrangements governed by contract between the parties

---

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

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

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

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

(akin to the non-CNS eligible securities process in the U.S.). Similar to the U.S.'s 40 Act, NI 81-102 is silent in regards to the use of collateral for Delayed Basket Securities.

WHY SOME FIRMS ARE UNCERTAIN AS TO CASH COLLATERAL PERMISSIBILITY

As noted there is uncertainty in the industry as to the permissibility of cash collateral for Delayed Basket Securities. While the lack of collateral references in the 40 Act has not dissuaded firms from using cash collateral in the U.S., there is hesitancy for some firms operating in Canada since NI 81-102 has very prescriptive provisions relating to the form of acceptable consideration to be delivered for the purchase of ETF units, the timing of such delivery, and the process required if the delivery of the consideration is not completed within the time period prescribed.

> **NI 81-102**
> **…**
> **Delivery of Funds and Settlement**
> **9.4 (1)** …
> **(2)** Payment of the issue price of securities of a mutual fund must be made to the mutual fund on or before the second business day after the pricing date for the securities by using any or a combination of the following methods of payment:
>
> (a) by paying cash in a currency in which the net asset value per security of the mutual fund is calculated;
>
> (b) by making good delivery of securities if
>
> (i) the mutual fund would at the time of payment be permitted to purchase those securities,
>
> (ii) the securities are acceptable to the portfolio adviser of the mutual fund and consistent with the mutual fund's investment objectives, and
>
> (iii) the value of the securities is at least equal to the issue price of the securities of the mutual fund for which they are payment, valued as if the securities were portfolio assets of the mutual fund.
>
> …
> (4) If payment of the issue price of the securities of a mutual fund to which a purchase order pertains is not made on or before the second business day after the pricing date or if the mutual fund has been paid the issue price by a cheque or method of payment that is subsequently not honoured,
>
> (a) the mutual fund must redeem the securities to which the purchase order pertains as if it had received an order for the redemption of the securities on the third business day after the pricing date or on the day on which the mutual fund first knows that the method of payment will not be honoured; and
>
> (b) the amount of the redemption proceeds derived from the redemption must be applied to reduce the amount owing to the mutual fund on the purchase of the securities and any banking costs incurred by the mutual fund in connection with the dishonoured cheque.

As reflected above, the provisions in NI 81-102 do not refer to cash delivered as collateral for the delivery of portfolio securities, and accordingly, certain firms are unsure of whether such cash collateral is permitted.

Some firms have questioned whether the absence of a collateral reference in s. 9.4 means cash collateral is not permitted or whether, similar to the 40 Act, NI 81-102 simply does not provide for this level of detail in the drafting. Rather than make an incorrect conclusion on the regulatory intent, in the absence of regulatory clarification, some firms have chosen to adopt a conservative approach and not permit cash collateral for Delayed Basket Securities.[15]

WHY SOME FIRMS BELIEVE CASH COLLATERAL IS PERMISSIBLE

As reflected in the discussion of NI 81-102 above, payment of the issue price for ETF units may be in cash, securities, or a combination of both. In some circumstances at the time of subscription, an AP may agree to pay cash for ETF units. In other situations, it may be agreed that Basket Securities will be delivered as payment (i.e. an in-kind payment, cash is not anticipated). If for some reason the AP is unable to deliver the agreed-upon Basket Securities, the subscription will be a failed trade and will need to be unwound pursuant to Section 9.4(4) of NI 81-102 unless the AP delivers another form of adequate consideration – either by (a) a cash-in-lieu delivery made as a replacement payment, or (b) cash collateral delivered as a temporary replacement with an agreement to deliver the Basket Securities at a later date. A cash-in-lieu payment is not optimal for either the AP or the ETF, since the original trade will need to be rebooked as a cash trade (causing an accounting and administrative burden for both parties) and the Basket Securities that are delayed will not be delivered by the AP, requiring the ETF to instead acquire the Basket Securities in the market (potentially at a different price than that at the time of subscription, causing further accounting, administrative and funding complexities). Where the ETF has to acquire the Basket Securities, a matter of delayed settlement is converted into an investment issue for the ETF. Further, the ETF will incur trading costs to purchase the Basket Securities and the AP will be required to reimburse the ETF for such costs. Whether cash is received under (a) or (b), we submit that the cash delivered is considered to be cash payment as permitted under s. 9.4. The cash is held in the ETF's account without any security interest being granted to the AP – it is wholly within the control of the ETF.

POLICY RATIONALES FOR COLLATERAL

Firms see no policy reason why the Canadian regulators would determine that cash collateral should not be used for Delayed Basket Securities. The acceptance of cash collateral for Delayed Basket Securities is in the interest of the markets, their participants and investors. This mechanism does not give rise to investor protection concerns and does not impact how investors transact in the secondary market. It avoids the use of other costly solutions (such as increased AP securities inventory) and mitigates against market disruptive forces where ETF units are not created (such as negatively impacting price integrity of the ETF units). A collateral process allows

[15] An ETF cannot release units into the CDS account of a purchasing dealer until full consideration has been delivered to the custodian on behalf of the ETF in accordance with the terms of NI 81-102.

subscriptions to settle on a timely basis and reduces failed trades. The acceptance of cash collateral for Delayed Basket Securities as payment for ETF units does not import additional risk to ETFs or the markets and should be permitted. There would be no reason or need to unwind purchase orders –ETFs would be whole, without loss.

Additionally, we submit that the result is similar to a situation in which an ETF lends the securities it receives as payment immediately back to the subscribing AP - in each situation, the ETF would hold an amount of cash that exceeds the value of the securities it is waiting to be delivered.

Under the provisions of NI 81-102, the collateral that is permissible for securities lending is more expansive than which is currently proposed for Delayed Basket Securities.

> **NI 81-102**
> **…**
> **Securities Loans**
> …
>
> 6. The collateral to be delivered to the investment fund is one or more of
>
> (a) cash;
>
> (b) qualified securities;
>
> (c) securities that are immediately convertible into, or exchangeable for, securities of the same issuer, class or type, and the same term, if applicable, as the securities that are being loaned by the investment fund, and in at least the same number as those loaned by the investment fund; or
>
> (d) irrevocable letters of credit issued by a Canadian financial institution that is not the counterparty, or an affiliate of the counterparty, of the investment fund in the transaction, if evidences of indebtedness of the Canadian financial institution that are rated as short term debt by a designated rating organization or its DRO affiliate have a designated rating.

Collateral for Delayed Basket Securities is proposed to be only cash at the present time. This is primarily to avoid dual leg mark-to-market issues that can arise with non-cash collateral (such as permitted under the securities lending provisions).[16] However, if the industry is able to implement tracking and valuation mechanisms as used for securities lending, collateral types as outlined in the securities lending provisions should also be permissible for Delayed Basket Securities in future (as noted, payment for ETF units may be cash, securities, or a combination thereof).

OTHER POLICY CONSIDERATIONS

It is the view of the industry that further restricting cash collateral use for Delay Basket Securities beyond the governance parameters as described in this letter and Appendix 1 would

[16] Both the securities lent and securities received as collateral would need to be tracked on a marked-to-market basis.

unnecessarily constrain the intent of risk mitigation and operational efficiency. The industry has agreed to Operational Guidelines (outlined in Appendix 2) which cover additional aspects of the proposed cash collateral process. As the longer-term view is to create a centralized-collateral facility, any imposed thresholds should not unduly constrain the industry.

Hold Periods Thresholds

As noted in this letter, in the U.S., there is no limitation period for the holding of cash collateral. A similar approach is proposed by the Canadian industry. For ETFs that decide to participate in the Canadian proposed cash collateral process, the ETF can realize on the collateral (after providing notice) when it determines in good faith it is in the best interest of the ETF. Forcing realization of collateral outside the considerations of the normal course of business is not ideal. While establishing a maximum time threshold for holding cash collateral to cover a majority of Delayed Basket Securities scenarios may be possible, it could exclude outlier situations (such as complex corporate action events or hard to locate/borrow securities). Anecdotally, where cash collateral is used, there have been no situations where Delayed Basket Securities were not ultimately delivered to an ETF. Both APs and ETF managers desire delivery of the Delayed Basket Securities and are willing to wait until they become available. Furthermore, the risk associated with an absence of a hold period threshold is minimal or non-existent – the ETF receives cash collateral in excess of the Delayed Basket Securities which would be daily marked-to-market.

To the extent that a maximum time threshold was to be imposed, it would need to account for the realization notice provided to APs and non-business days (holidays [such as the Christmas period containing three statutory holidays and a half-day of trading on the business day before December 25] and weekends). It should be sufficient in length to accommodate longer delivery delays.

Cap Value Thresholds

The imposition of a maximum value that an ETF may accept in terms of cash collateral for Delayed Basket Securities is likewise an area that the Canadian industry believes is not necessary. It is not an approach followed in the U.S. It would require additional monitoring and potential systems builds and adds complexity to the process. As valuation is dynamic based on pricing, the parties could be placed into fluid situations where valuation fluctuates above and below a cap creating uncertainty as to whether cash collateral would be accepted on a particular day.

To the extent that a maximum cap threshold was to be imposed, there does not appear to be a policy reason to have a threshold lower than that used for securities lending (i.e. 50% of the ETF's net asset value, as per s. 2.12(1)12 of NI 81-102).

EXAMPLE OF CASH COLLATERAL USE

An example may help outline the desired clarity for cash collateral permissibility. Assume an ETF is comprised of 5 underlying Basket Securities (A, B, C, D, and E). The AP places an order for 1,000 units of the ETF. At the time of order on the pricing date, the AP anticipates having all of the Basket Securities available for delivery on the settlement date. The AP and the ETF manager agree that payment will be 1,000 shares of A, B, C, D, and E. However, on settlement date, the AP is waiting for receipt of 1,000 shares of security E from another counterparty. Assume that on the pricing date (the date of the purchase order) that 1,000 shares of security E has a market value of $1 million. Being unable to remit payment as agreed to as per the purchase order/trade ticket, and the AP and ETF manager having previously agreed to a cash collateral mechanism for Delayed Basket Securities, the AP delivers securities A, B, C, D and the cash collateral for 1,000 shares of security E to the ETF manager and the ETF units are delivered to the AP. Assuming a haircut of 2% for this example, and assuming there was no market price change in security E between the pricing date and the settlement date, the cash collateral provided on settlement date is $1,020,000. There is no re-ticketing of the purchase order.

Delayed Basket Security Increases in Value – Impact

Assume that the market value of security E changes so 1,000 shares is now worth $1,010,000. The AP tops up the cash collateral with an additional mark-to-market amount of $10,000 plus the 2% haircut on that amount ($200). The ETF manager now has $1,030,200 of cash for the pending 1,000 shares of security E. If it is determined that the 1,000 share of security E will not be delivered, the ETF manager can use the cash collateral and purchase the 1,000 shares of security E for $1,010,000). The ETF manager would return the excess cash collateral it possesses (i.e. $20,200 less expenses associated with purchasing the 1,000 shares) to the AP.

Alternatively, if the AP is able to deliver the 1,000 shares to the ETF manager prior to the ETF manager deciding to acquire the 1,000 with the cash collateral itself, the AP makes such delivery and the ETF manager returns the cash collateral it was holding to the AP (in this case, $1,030,200).[17]

Cash plus Securities Payment

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

If however the AP was not able to use cash collateral, the purchase transaction would fail, and would continue to fail until 1,000 shares of security E were delivered or the purchase order cancelled in accordance with NI 81-102. If 1,000 shares of securities A, B, C, D had been delivered in anticipation of settlement, they would need to be returned to the AP on purchase order cancellation. This adds operational burden to the process.

---

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

Comparison to Securities Lending

Assume the AP made the full in-kind payment of the Basket Securities and then the ETF loans back to the AP 1,000 shares of security E valued at $1,000,000 plus the 2% haircut. The ETF holds $1,020,000 in cash and waits for the return delivery of security E. This is the same result in the first example described earlier. The value of cash held by the ETF is exactly the same.

COLLATERAL GOVERNANCE

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

Under such a collateral process:

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

The industry has also agreed that the Delayed Basket Securities cash collateral mechanism should be optional. Parties should not be required to agree to cash collateral use; however, they may do so at their discretion by entering into agreements meeting the framework parameters and in accordance with regulatory guidance. Generally, the mechanism is to be an exception-based solution, where the AP has been unable to source the Basket Securities. Cash collateral would be used as a tool to resolve Delayed Basket Securities, not for other purposes (such as backstopping a securities lending program where the AP decides to loan securities after an in-kind subscription rather than using the securities as payment).[18]

We believe the collateral process should be standardized, with agreed upon governance and procedures such as recommended in this letter, and otherwise permit flexibility to account for negotiation of business terms between the parties.

REQUEST FOR GUIDANCE AND PUBLICATION

The industry submits it is important to obtain clarity regarding cash collateral for Delayed Basket Securities since the ability to make use of the mechanism requires consensus between three

[18] The economics of such a strategy may render such a practice unlikely in any event. A haircut is applied to the cash collateral.

parties in each instance – the ETF manager, the Authorized Dealer and the custodian. Without direction as to a common view that should be adopted by the industry as to the compliance of this solution with NI 81-102, this mechanism may be available only to certain industry participants depending on the parties to any subscription of Units and the legal advice they receive. Many industry participants wish to utilize this mechanism, but of course only to the extent it complies with NI 81-102. It may be difficult to arrive at consensus amongst the required parties depending on the level and nuance of legal analysis each such party has undertaken to consider this issue.

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

Thus the question to OSC staff: "***Can an ETF accept the delivery of cash, to be held by the fund as collateral until Delayed Basket Securities are delivered by an AP, to satisfy the requirements of section 9.4 of NI 81-102?***" We submit this as an issue of regulatory interpretation that needs to be resolved for the comfort of the industry broadly. Accordingly, we are requesting regulatory guidance in a written form that can be relied on by the industry at large.[19]

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

Yours sincerely,

"Keith Evans"

Executive Director
Canadian Capital Markets Association

"Michael Cooke"

Chair
Canadian ETF Association

[19] This could be a standalone guidance notice such as an OSC Staff Notice, a CSA Staff Notice, or another medium that the securities regulatory authorities see fit.

APPENDIX 1

(a) The collateral:

- has a market value equal to at least 102 percent of the market value of Delayed Basket Securities,[20]
- transaction is made under a written agreement that implements these Appendix 1 requirements,[21]
- transferred by the purchaser is immediately available for good delivery under applicable legislation,[22]
- is received by the ETF either before or at the same time as it delivers the ETF units,[23]
- is marked to market on each business day, and the amount of collateral in the possession of the ETF is adjusted on each business day to ensure that the market value of collateral maintained by the ETF in connection with the transaction is at least 102 percent of the market value of the Delayed Basket Securities,[24] and
- is held by the custodian an account in the name of the ETF.

(b) All dividends, interest, and distributions attributable to Delayed Basket Securities and received by an AP are to be promptly remitted to the ETF by the AP.[25]

(c) The ETF is entitled to realize on the collateral in good faith at any time with appropriate notice to the AP.[26]

[20] Modelled on s. 2.12(1)5.(b) of NI 81-102.
[21] Modelled on s. 2.12(1)2. of NI 81-102.
[22] Modelled on s. 2.12(1)4. of NI 81-102.
[23] Modelled on s. 2.12(1)5.(a) of NI 81-102.
[24] Modelled on s. 2.12(1)7. of NI 81-102.
[25] Modelled on s. 2.12(1)9. of NI 81-102.
[26] This is similar to provisions in U.S. Authorized Participant Agreements. It also includes the concepts in s. 2.12(1)8.

APPENDIX 2

Operational Guidelines	
1. Minimum notice to Authorized Participants to realize on cash collateral	• Three (3) business days • Notice may be given after the settlement date; realization occurring no earlier than notice date plus three (3) business days.
2. Delivery of cash collateral	• Through CDS Clearing and Depository Services Inc.
3. Currency of cash collateral	• In the currency of the trade
4. Deadline of delivery of cash collateral	• Target delivery by 3:30 p.m. ET on settlement date. • Later delivery of cash collateral (up until payment exchange - currently 4:00 p.m. ET) addressed on a best efforts basis
5. Timing of cash collateral return	• Upon delivery of Delayed Basket Securities, cash collateral to be returned as soon as possible (typically same day)