B.1.2 OSC Staff Notice 81-735 Cash Collateral Use for Delayed Basket Securities in ETF Subscriptions

ONTARIO SECURITIES COMMISSION STAFF NOTICE 81-735
CASH COLLATERAL USE FOR DELAYED BASKET SECURITIES IN ETF SUBSCRIPTIONS

May 22, 2024

Introduction

Staff (**staff** or **we**) of the Ontario Securities Commission are publishing this notice to set out our views regarding the use of cash collateral for ETF in-kind subscriptions where one or more securities from a basket of securities comprising payment cannot be delivered on the settlement date (**Delayed Basket Securities**). This issue was brought to our attention in a letter to staff from the Canadian Capital Markets Association (**CCMA**) and the Canadian ETF Association (**CETFA**) dated April 23, 2024 (the **CCMA/CETFA Letter**), which can be accessed through the IFSP eNews article titled "Use of cash collateral for delayed basket securities in ETF subscriptions" that is being published concurrently with this Staff Notice.

At the time of entering into an in-kind subscription agreement for ETF units, a purchaser (i.e., a designated broker or authorized participant) agrees to deliver a basket of specified securities (**Basket Securities**) to an ETF manager in satisfaction of payment for the subscribed ETF units. These purchases are made pursuant to either a designated broker or authorized participant agreement. On occasion, a purchaser may not be able to deliver all of the Basket Securities by the subscription settlement date. Delayed Basket Securities could arise from a mismatch between the settlement cycle of Basket Securities and an ETF's primary market settlement cycle. Delays in deliveries from transactions such as purchases from market participants, sales by their clients, or securities loans recalls, may occur. Other deliver delays may be the result of corporate action events (such as a takeover) where the security has been submitted to a tender process and cannot be released on a timeline to satisfy the delivery obligations. We understand that some fund managers in these situations do not issue the ETF units until all of the Basket Securities are received by the ETF manager. We have been told that these participants view the use of cash collateral as not expressly permitted under section 9.4 of National Instrument 81-102 *Investment Funds* (**NI 81-102**).

The delay in the delivery of the subscribed ETF units (**Delayed ETF Units**) to the purchaser can result in onward market disruptions, including failed trades in the secondary market. To prevent such failed subscription transactions, we understand that other participants choose to employ a cash collateral process to temporarily satisfy the payment obligation until the securities are delivered. This approach allows the ETF units to be delivered to the purchaser on the settlement date. We have been told that these participants interpret NI 81-102 such that cash collateral is permitted under section 9.4 of NI 81-102 as their view is that it is a form of adequate consideration, temporarily replacing the Basket Securities to be delivered at a later date. Furthermore, the arrangement is in certain respects analogous to a securities lending arrangement that is permitted under NI 81-102 in that there is an exchange of collateral. These participants require cash collateral of at least 102% of the obligation and that the cash collateral is marked to market daily. In their view, this approach does not result in the adverse delivery risks to the ETF if the terms of the cash collateral are consistent with certain requirements applicable to securities lending arrangements as set out in subsection 2.12(1) of NI 81-102.

Staff agrees with the second view that using cash collateral to facilitate the issuance of ETF units in the case of Delayed Basket Securities is permissible under NI 81-102 and are of the view that the fund manager should ensure that the use of cash collateral does not adversely affect delivery risks to the ETF.

Purpose

As set out in the CCMA/CETFA Letter, the use of cash collateral as a mechanism to facilitate ETF in-kind subscriptions is a practice used in other jurisdictions, including the United States. It is viewed as a risk management tool, to reduce failed trades and disruptions in the capital markets. An additional benefit of the use of cash collateral is that the purchaser can deliver individual basket securities on an on-going basis through the day, knowing that they will receive ETF units even if there are Delayed Basket Securities. Without cash collateral, the purchaser will postpone delivery until they have collected all of the Basket Securities, typically delivering them at the end of the day because if one security is missing, the ETF unit cannot be issued. The flexibility provided by using cash collateral reduces the risk of settlement failure at the end of the day.

Where the parties agree to the use of cash collateral for ETF in-kind subscriptions in Delayed Basket Securities situations, delivery risks to the ETF should not be increased and the ETF should benefit from the settlement risk being reduced. Staff are of the view that to minimize delivery risks to the ETF, the ETF should ensure that the use of cash collateral is consistent with certain requirements applicable to securities lending arrangements as set out in subsection 2.12(1) of NI 81-102, including that the cash collateral is:

- at least 102 percent of the market value of Delayed Basket Securities,
- provided under a written agreement between the purchaser and the ETF (setting out the terms of the cash collateral, including those described in these bullets),

- transferred by the purchaser to the ETF and immediately available for good delivery,
- received by the ETF either before or at the same time as it delivers the ETF units to the purchaser,
- 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, and
- held by the custodian of the ETF in the name of the ETF.

Staff's views are that the ETF should be entitled to realize on the cash collateral in good faith at any time, and that the cash collateral should be held for not more than 10 business days.

Questions

Please refer your questions to any of the following:

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