NATIONAL BANK FINANCIAL INC.

April 15, 2024

BY ELECTRONIC MAIL

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Dear Sirs and Mesdames:

RE: National Bank Financial Inc.'s Comment Letter regarding CIRO's Proposed Amendments to Fully Paid Lending Rules and Guidance

National Bank Financial Inc. (NBF) has been offering its fully paid lending (FPL) program since 2020 across three divisions: National Bank Financial Wealth Management (NBFWM) (full-service channel), National Bank Direct Brokerage (NBDB) (direct investor channel), and National Bank Independent Network (NBIN) (carrying broker to CIRO registered introducing brokers (IBs) and custodian/executing broker for portfolio managers (PMs[1]) and Investment Fund Managers (IFM).

NBF welcomes the opportunity to provide feedback on CIRO's proposed amendments to FPL rules and Draft Guidance. Through our experience administering the program, we have identified key areas where CIRO's proposed amendments can be further refined to enhance the efficiency and accessibility of FPL programs including:

1. **Streamlining Risk Disclosure and Reporting Requirements:** To ensure retail investors can make well-informed decisions, CIRO must align the risk disclosure in its Draft Guidance with the actual risks of FPL, focusing on material risks rather than remote or speculative risks. Additionally, consolidating communication updates within monthly statements would enhance efficiency and reduce administrative burdens.

[1] For the purposes of this letter, the term "portfolio manager" or "PM" refers to a firm or individual (as appropriate in the context) that is duly licensed or registered with the relevant Canadian authorities to provide discretionary portfolio management services for their retail client's managed account.

2. **Simplified Onboarding of PM clients:** CIRO's oversight of the unique relationship between PMs and their clients raises significant concerns about preserving this bond. To safeguard access to FPL programs and maintain the advantages of discretionary management, we advocate for exemptive relief from direct client involvement requirements.

3. **Simplified Onboarding of PM and IB firms:** The current onboarding process for IB and PM client firms is cumbersome and non-automatic, prompting a call for a streamlined, expedited procedure that aligns with regulatory standards and minimizes operational burdens on smaller retail-focused firms.

4. **Addressing Short-selling Misconceptions:** CIRO's stance on short-selling and securities lending is misleading and may hinder investor participation. We advocate for the removal of misleading disclosures and the adoption of neutral language to educate investors on the benefits of securities lending while dispelling misconceptions.

5. **Reforming Collateral Requirements**: CIRO should allow the use of high-quality non-cash collateral without requiring exemptive relief and standardize collateralization rates across market classes. This would enhance operational efficiency and reduce administrative burdens for market participants while ensuring adequate protection for retail lenders.

6. **Expanding Securities Eligibility:** CIRO should broaden eligible securities to include fixed-income assets, offering retail clients increased diversification and revenue streams within securities lending programs.

7. **Integrating Client Risk Tolerance:** Rather than treating risk tolerance as a standalone factor, CIRO should integrate it into clients' comprehensive profiles, proposing a more efficient approach to client restrictions in securities lending that aligns with industry standards and minimizes operational challenges.

NBF also endorses and adheres to the recommendations outlined by the IIAC.

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1. Streamlining Risk Disclosure and Reporting Requirements

Our experience administering the program over the past years has revealed the adverse effects of over-disclosure, excessive reporting, and cumbersome processes on FPL program accessibility for retail clients.

RISK DISCLOSURES

While it's essential to inform retail investors about potential risks, over-disclosure can lead to excessive caution, potentially dissuading investors from participating in the program despite it aligning with their risk tolerance.

Therefore, risk disclosure must strike a balance – it should be comprehensive yet proportional to the actual risks involved in the program. This approach best allows clients to weigh the genuine risks associated with securities lending against the overall benefits of participation. To achieve this balance effectively, the focus should be on the material risks of the FPL program. Determining which risks necessitate disclosure and specifying the details to include should involve an assessment of their probability or likelihood of such risks materializing.

We believe that CIRO's current approach in the Draft Guidance may be counterproductive; listing all potential risks without distinguishing between material and speculative ones could exaggerate risk exposure and potentially overshadow firms' risk management efforts.

We support the IIAC's suggestions for amending the Draft Guidance, particularly in removing sections that may contribute to over-disclosure and proposing alternative language for certain sections to provide a clearer, more balanced perspective. In conjunction with the IIAC's recommendations, we offer alternative wording in Section 4 below concerning Section 1.4.1: Market risks of the Draft Guidance. Furthermore, we are of the view that Section 1.4.6: Conflicts of interest within the Draft Guidance is redundant, as this issue is commonly addressed by firms across various contexts and not specific to FPL.

REPORTING BURDEN

Dealers are currently required to promptly notify clients via confirmations or notices when securities are loaned, terminated, or when there are changes to applicable fees and rates. However, feedback from clients involved in NBF's in-house FPL programs and those of independent dealers through NBIN suggests that this communication is burdensome and lacks utility at the current frequency. These confirmations and notices are frequently sent daily, drawing retail investors' attention away from more comprehensive monthly reports and leading to decreased investor engagement. Furthermore, this communication requirement deviates from existing reporting standards for retail clients, particularly when contrasted with riskier investment options like margin use, where clients are not formally notified of interest rate fluctuations. This inconsistency is further highlighted by the decision in the derivatives modernization proposal, where the daily reporting obligation for options was eliminated following feedback received.

Given these considerations, we propose that CIRO eliminates the requirement for "prompt" confirmations and notices and instead consolidates these notifications within the monthly statement. This adjustment would ensure that clients receive relevant information in a more concise and timely manner without detracting from their attention or engagement, while also reducing operational costs and the administrative burden on firms.

2. Simplified Onboarding of PM clients

CIRO's proposed amendments do not distinguish whether retail clients have appointed a PM to manage their investment portfolios on a fully discretionary basis or not. We believe that PM clients should be able to rely on this trusted relationship for all decisions related to their participation in the program.

Under the current proposed amendments, discretionary managed account clients are unable to leverage this fiduciary relationship for the full management of their portfolios, potentially leading to their exclusion from FPL programs due to PMs' concerns about added administrative burdens.

The proposed amendments mandate that:

- The firm must seek instructions from the client regarding securities to exclude from the FPL program and their maximum risk tolerance.
- The firm must directly sign a securities loan agreement with the client.
- The firm must obtain signed risk disclosure acknowledgments and provide comprehensive documentation explaining all applicable risks.
- The firm must provide clients with confirmations containing all required details for each loan transaction.

We respectfully urge CIRO to grant exemptive relief from these direct client involvement requirements for discretionary managed accounts. The PM's client relationship model is fundamentally incompatible with such direct involvement, and imposing these requirements may hinder client access to FPL programs.

Requiring a PM's clients to bear the responsibility of reading and attesting to detailed risk disclosures and issuing instructions regarding securities lending would undermine the primary benefits of appointing a PM. Clients entrust PMs with decision-making authority precisely to alleviate themselves of such burdens.

While we acknowledge the unique risks associated with securities lending, we believe PMs are best positioned to disclose these risks to clients through simplified FPL disclosures integrated into their existing client documentation. Therefore, FPL-specific risk acknowledgments should not be required from retail clients if securities lending falls within the scope of their investment or portfolio management mandate with their PM.

Ultimately, we believe that requiring discretionary managed account clients to sign additional standalone risk disclosure documents will not achieve CIRO's goal of transparency and heightened client awareness. Instead, such requirements may deter willing participants in the FPL Program. Detailed standalone risk disclosures, even if provided in plain language, could confuse and frustrate PM clients, who do not face similar requirements for other investment products covered by their PM's Investment Policy Statement (IPS) and Investment Management Agreement (IMA). On this point, we note that with respect to a portfolio manager's discretion to invest in certain types of products or use certain types of trading strategies (such as subscribing to an OM fund per Regulation 45-106), the retail client is not required to provide signed risk disclosure acknowledgements with respect to *each* such product or trading strategy (for example, based on an issuer's full risk disclosure documents). Instead, the retail client is only obligated to sign the IPS and IMA client documents provided by the PM, which documents contain high-level descriptions of the key risks relating to the investment and general portfolio management activities undertaken by the PM on behalf of its retail client.

In summary, exemptive relief from direct client involvement requirements in fully paid securities lending programs for discretionary managed accounts is warranted. This approach aligns with the client relationship model, preserves the key benefits of discretionary management, ensures transparency and client awareness, and leverages the expertise of portfolio managers in effectively managing risks.

3. Simplified Onboarding of PM and IB firms

Under current proposed amendments, eligibility of IB and PM client firms of dealers offering FPL program is not automatic. Historically, the non-objection process has proven to be cumbersome, characterized by inconsistent and prolonged exchanges with CIRO, deterring IBs and PMs firms from participation, ultimately to the detriment of retail investors. It is also essential to acknowledge the increased operational costs and administrative burdens that the current onboarding process imposes on smaller retail-focused firms, without necessarily enhancing investor protection.

We echo the IIAC's position that a new and expedited process is needed, whereby registrants already offering leverage accounts and not subject to any early warning, can proceed to offer FPL in accordance with rules and without notification requirements. CIRO's Guidance could instead refer to the following requirements as necessary prior to client onboarding, and both CIRO and the CSA can stipulate that participation may be placed on hold if any concerns arise following an audit:

1. Registrant/Member in good standing (not in early warning)
2. For PMs only: no issues or conflicts relating to compensation that would hinder them from including FPL in their discretionary mandate

3. Securities loan agreement with borrower
4. Risk disclosure acknowledgment
5. Revised client agreements (such as the Relationship Disclosure Document)
6. Updated client communications (such as monthly statements)
7. Within 6 months of FPL program launch: Revised policies and procedures relating to the FPL program, including updated operational processes.

4. Addressing Short-selling Misconceptions

In the Draft Guidance, CIRO highlights one of the objectives of securities lending as facilitating strategies like short selling. At the same time, CIRO mandates that firms disclose potential market risks associated with securities lending, specifically mentioning that "*short selling could potentially put downward pressure on the long-term value of the client's long security position*."

However, numerous sources have shown that short selling does not inherently cause market volatility, lower security prices, or create a lack of transparency in securities lending[2]. Given the lack of evidence demonstrating any detrimental impacts on security pricing, the above-cited disclosure should be removed.

Moreover, falsely asserting that (a) securities lending facilitates short selling and (b) short selling negatively impacts the pricing of said security significantly affects investors' decision-making regarding participation in the program. Many investors perceive securities lending as akin to betting against oneself, as it involves facilitating short selling strategies that can potentially drive down the price of their securities. This perception has already dissuaded retail clients from opting into securities lending, as evidenced by discussions on platforms such as Reddit.

Therefore, the above-cited disclosure needs to be removed, in favor of more accurate language such as FINRA's short-selling disclosure requirement: "*that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales*".

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[2] Committee on Capital Markets Regulation – Short Selling's Positive Impact on Markets and the Consequences of Short-Sale Restrictions: "A common criticism of short selling is that it exacerbates crises by artificially depressing stock prices during a market decline. **If this concern were valid, then increased shorting activity should correspond closely with negative returns. The shorting activity would be destabilizing since it would contribute to an accelerating downward spiral in prices. However, Bailey and Zhang (2013) find the opposite effect.** Short selling volumes are typically higher on days with positive returns than on days with negative returns, showing that short sellers do not increase short positions when stock prices fall (which would exacerbate declines), but rather when they rise."
Bank of Canada – Canadian Securities Lending Market Ecology
The Effects of Stock Lending on Security Prices: An Experiment - KAPLAN - 2013 - The Journal of Finance - Wiley Online Library : "While the supply shocks significantly reduce market lending fees and raise quantities, we find no evidence that returns, volatility, skewness, or bid–ask spreads are affected. The results provide novel evidence on the impact of shorting supply and **do not indicate any adverse effects on stock prices from securities lending**."

Additionally, we encourage CIRO to adopt a more neutral and balanced/educational stance regarding potential impacts of securities lending/short selling in its Draft Guidance – acknowledging both the benefits and risks. CIRO should emphasize that the primary objective of FPL is not to facilitate short selling but rather to enhance market liquidity and efficiency through improved price discovery and facilitated hedging activities.

When addressing the risks, CIRO should confront misconceptions surrounding short selling and securities lending, such as the notion that they inherently depress the value of securities. By highlighting empirical evidence and studies showcasing the overall benefits of securities lending to both borrowers and lenders, CIRO can help dispel these misconceptions. Ultimately, by presenting accurate and balanced information, CIRO can help investors understand the positive effects of securities lending on market dynamics and weigh them more effectively against potential risks.

5. Reforming Collateral Requirements

Firstly, the current proposed amendments stipulate that the use of non-cash collateral is restricted and requires exemptive relief:

- 4624 (2): *The collateral can be cash or, **when so permitted by the Corporation**, debt securities with a margin rate of 5% or less.*
- Draft Guidance @ 2.5 Collateral: *In exceptional circumstances, CIRO may permit the use of qualified securities as collateral and only when it is satisfied that the clients' interests are not compromised*.

CIRO should recognize high quality non-cash collateral (such as high-grade government bonds or Canada, provincial, or US sovereign government-guaranteed products) as eligible collateral assets without the need for exemptive relief.

Secondly, in the proposed amendments, CIRO establishes the collateralization rate to 102% for cash collateral and 105% for non-cash collateral.

We believe that the collateralization rate should be uniform across market classes given that there is no justification for setting a higher collateralization rate for non-cash collateral compared to cash collateral. The lower collateralization rate is a sufficient buffer to manage counterparty credit risk and safeguard lenders in the event of borrower default. As well, standardizing the collateral requirement across all market classes would ensure operational efficiency for market participants, eliminating the need to manage multiple collateral thresholds for different asset classes. This would also streamline operations and reduce administrative burdens.

Should CIRO choose to maintain the collateral requirements at 102% and 105%, firms should be granted sufficient time to adapt their systems and processes. We support the IIAC's suggestion of a two-year transition period to ensure that market participants can seamlessly adjust to the new requirements without disruptions.

In conclusion, we strongly believe that by adopting a lower streamlined collateral standard across market classes, CIRO can foster a more efficient and competitive securities lending market while ensuring adequate protection for lenders.

6. Expanding Securities Eligibility

CIRO should expand the types of securities eligible for lending by adhering to the *Income Tax Act*'s definition of qualified security, which would make fixed-income securities eligible for lending.

The current exclusion of fixed-income securities from securities lending represents a missed opportunity for retail clients to capitalize on potential revenue streams derived from lending these assets. Bonds, treasury bills, and other fixed-income instruments constitute a significant portion of investors' portfolios and can generate additional income when lent out to borrowers.

Incorporating fixed-income securities into securities lending programs would significantly broaden the spectrum of lending opportunities available to retail clients. This expansion would not only promote diversification, but also enhance risk management in their investment portfolios and empower retail investors to access supplementary returns on their investments, thereby bolstering their financial well-being.

7. Integrating Client Risk Tolerance

We concur with the IIAC’s recommendation, as outlined in section 7 of their letter, regarding the consideration of risk tolerance in securities lending within the broader context of a client’s overall risk assessment. Instead of treating risk tolerance as a standalone item where clients assign an arbitrary percentage as their maximum threshold for lending, it would be more effective to integrate it into the client's comprehensive risk profile. This approach is often misunderstood by clients and poses challenges for dealer firms to monitor efficiently. We believe that requiring clients to identify securities they wish to exclude from securities lending is a simpler and more efficient method.

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Conclusion

We trust that CIRO will carefully consider the constructive suggestions we have provided regarding these critical topics.

By refining key aspects of the FPL rules, CIRO can advance transparency, accessibility, and efficiency in securities lending, thereby benefiting retail investors and contributing to the integrity of the capital markets. We look forward to continued collaboration with CIRO to advance these objectives and ensure the continued success of fully paid lending programs in Canada.

Sincerely,

"Mike Tocheri" SVP and Managing Director, NBIN Head of Trading, One Wealth Trade Desk	*"Mario Merola"* Managing Director Global Securities Finance	*"Joanna Lozowik"* Senior Manager NBIN Compliance