

Securities Lending in Canada Legal, Regulatory and Tax Issues

3rd Annual CASLA
Conference on
Securities Lending

CASLA | Canadian Securities
Lending Association

Securities Lending in Canada

Legal, Regulatory & Tax Issues

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Agenda

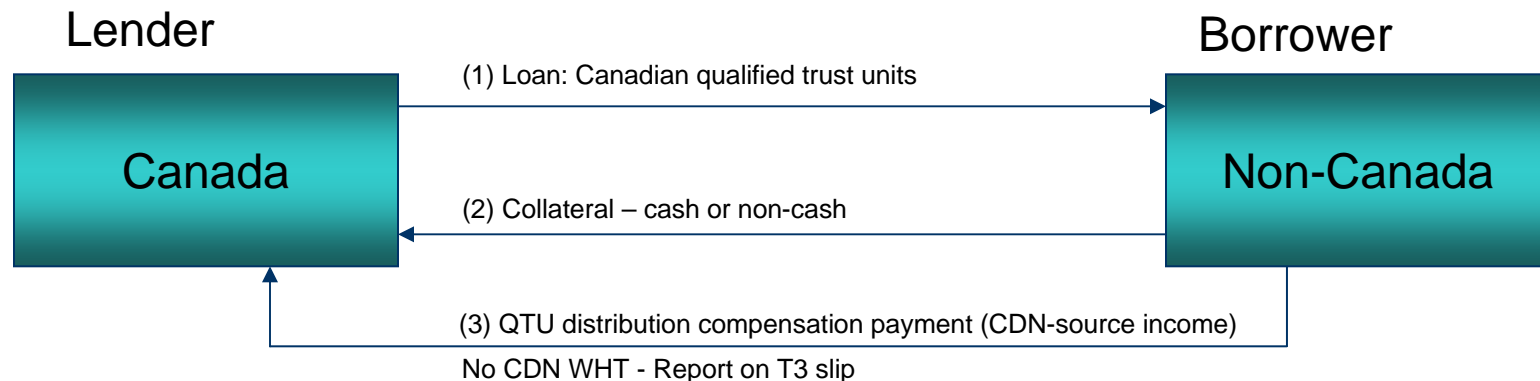
- Canadian Tax Update
 - Christopher Steeves
- EU Financial Transaction Tax Enhanced Cooperation
 - Michael McAuley & William Young
- Recent U.S. Developments in Securities Lending
 - Michael McAuley & William Young
- Canadian Regulatory Update
 - Margaret Grottenthaler

Canadian Tax Update

- Proposed amended definition of “qualified trust unit” in subsection 260(1) of the Income Tax Act (Canada) (“ITA”) to include shares/units of non-Canadian REITs and ETFs from October 24, 2012
- Bill C-48 – At the report stage in the House of Commons

Loan of Canadian Qualified Trust Units

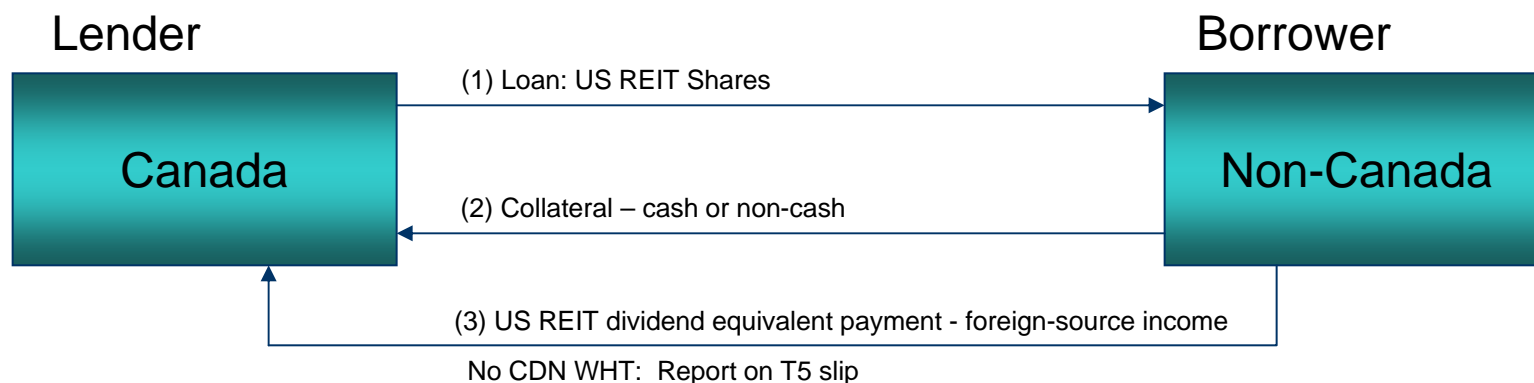
Canadian Lender - Non-resident Borrower - securities lending arrangement



- (1) Schematic applies only to a loan of Canadian qualified trust units (“QTU”).
- (2) Fully collateralized/non-fully collateralized rules don’t apply to Canadian lenders.
- (3) QTU distribution compensation payment is treated as Canadian source income and is reportable to Lender on T3 information slip.

Loan of US REIT Shares (prior to Oct. 24, 2012)

Canadian Lender - Non-resident Borrower – Not a “securities lending arrangement”



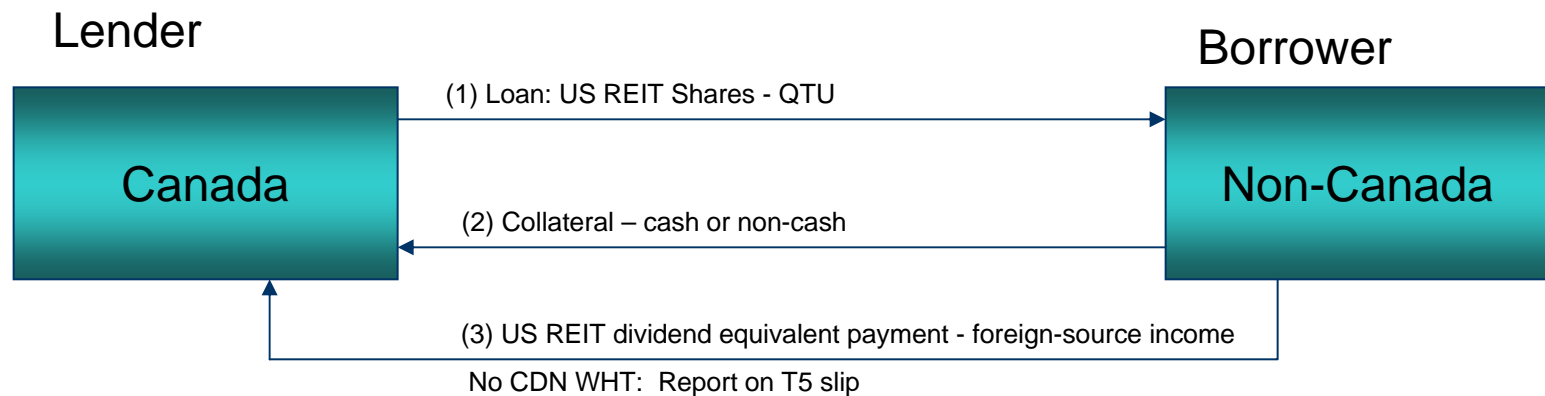
(1) Schematic applies only to a loan of shares of a US REIT. These shares did not meet definition of a “qualified security” under subsection 260(1) of the ITA. Thus, not a “securities lending arrangement” under section 260.

(2) Fully collateralized/non-fully collateralized rules don’t apply to Canadian lenders or loans of securities that are not a “securities lending arrangement”.

(3) Dividend equivalent payment not subject to rules for cross-border “compensation payments” under subsection 260(8). Foreign-source ordinary income for Lender.

Loan of US REIT Shares (Qualified Trust Unit from October 24, 2012)

Canadian Lender - Non-resident Borrower - securities lending arrangement



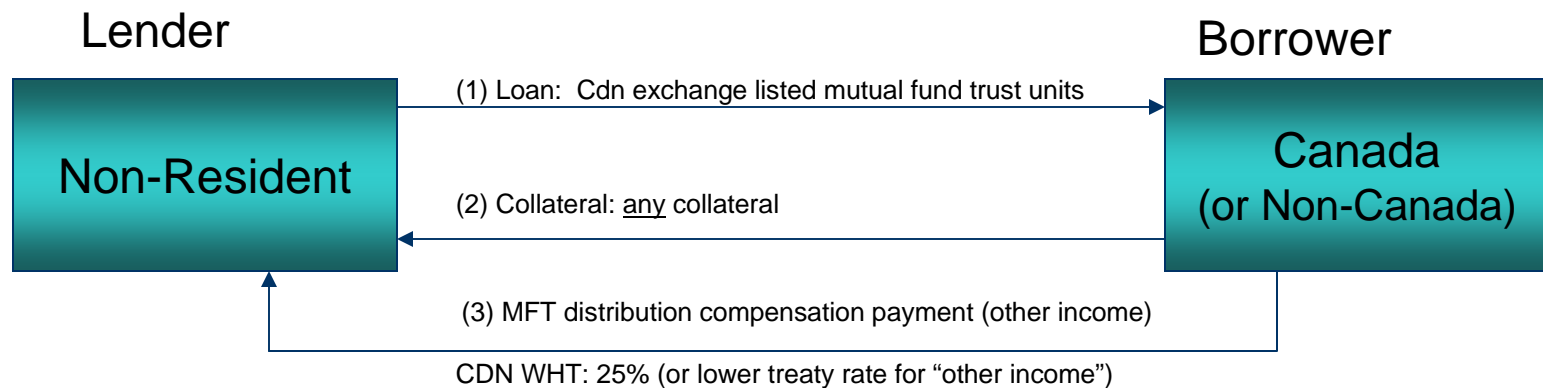
(1) Schematic applies to a loan of shares of a US REIT. These shares meet the amended definition of a “qualified trust unit” under subsection 260(1) of the ITA and the definition of a “qualified security”. Thus, a loan of US REIT shares is a “securities lending arrangement” under section 260.

(2) Fully collateralized/non-fully collateralized rules don’t apply to Canadian lenders.

(3) Dividend equivalent payment not subject to rules for cross-border “compensation payments” under subsection 260(8). Foreign-source ordinary income for Lender.

Loan of Exchange Listed Canadian Mutual Fund Trust Units

Canadian Borrower – Non-resident Lender – securities lending arrangement



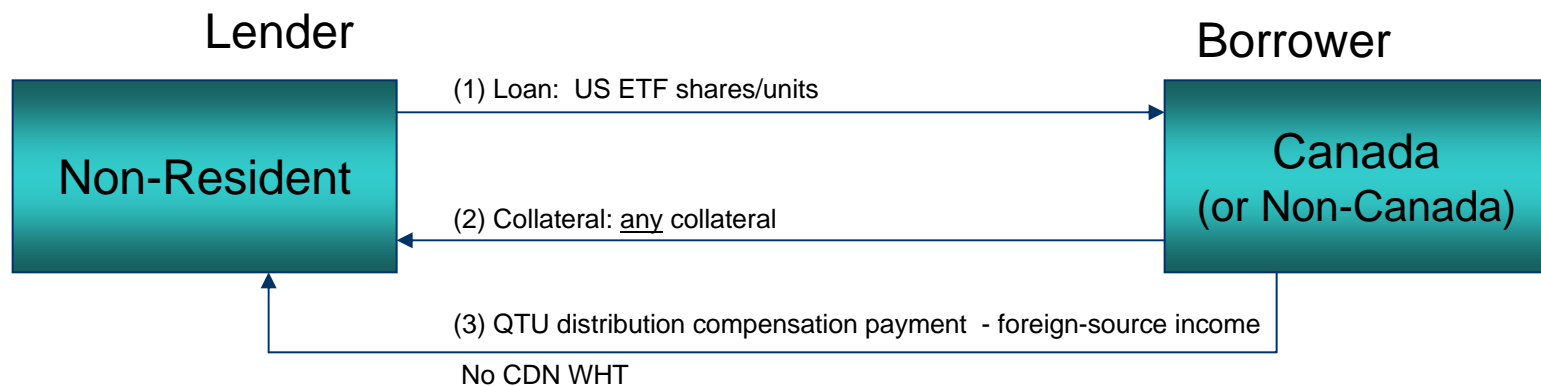
(1) Schematic applies only to loans of CDN "qualified trust units" pursuant to a "securities lending arrangement" under subsection 260(1) of the ITA.

(2) Fully collateralized/non-fully collateralized rules do not apply to loans of QTU.

(3) A CDN QTU distribution compensation payment is usually treated as "trust income" with a source in Canada regardless of the residence of the borrower and is subject to CDN withholding tax at the rate of 25%, unless a lower treaty rate or an exemption applies. **Note: Sovereign tax immunity generally does not apply to QTU distribution compensation payments. Under Article XXI (Exempt Organizations) of the U.S. tax treaty, U.S. pension fund lenders are exempt only on interest and dividend income; however, the tax rate for trust income distributions to U.S. residents under Article XXII (Other Income) is reduced to 15%.**

U.S. Exchange-Traded Fund (“ETF”) Shares/Units (From October 24, 2013)

Canadian Borrower – Non-resident Lender – securities lending arrangement



- (1) Schematic applies only to a loan of US ETF shares, which shares meet the amended definition of “qualified trust units” under subsection 260(1) of the ITA, effective from October 24, 2012, and is a “qualified security”.
- (2) Fully collateralized/non-fully collateralized rules do not apply to loans of QTU.
- (3) Prior to 10/24/2012, an ETF dividend equivalent payment made by a Canadian Borrower to a non-resident Lender could arguably be characterized as a payment of income from Canadian sources that may be subject to Canadian withholding tax at the rate of 25%, unless a lower treaty rate or an exemption applied. From 10/24/2012, under proposed sourcing rules for QTUs under subsection 260(8), the character and composition (including source) of this compensation payment are same as actual underlying payment. Thus, generally, foreign-source income for Lender and not subject to Canadian withholding tax.

EU Financial Transaction Tax Background

- Sept 2011 – European Commission proposed EU financial transaction tax (“FTT”) – fails to receive required assent of EU member States.
- Updated proposed Directive adopted on Feb 14, 2013 regarding EU FTT as it is to be implemented under “enhanced cooperation” for 11 member nations.
- The EC foresees implementation of this proposal in the 11 member states (“FTT Member States”; each an “FTT Member State”) as early as 1 January 2014.
- The FTT Member States are: Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.

EU Financial Transaction Tax Global Reach

- EU FTT is far reaching and, if implemented as proposed, will have a significant effect on financial transaction businesses and clients worldwide, not just in the EU.
- FTT of not less than 0.1% would apply to certain securities lending and borrow, repo and reverse repo transactions, even if executed entirely outside the Member States.
- For example, a securities lending transaction that takes place through a lending agent in Canada or the U.S. would be subject to FTT if it involves one or more of the following factors: (1) loaned securities issued in any FTT Member State, (2) a lender that is a resident of any FTT Member State, or (3) a borrower that is “established” in any FTT Member State (including a US or Canadian branch of a financial institution established in any FTT Member State).

EU Financial Transaction Tax Scope - Financial Transactions

- Purchase/sale of securities and other financial instruments (including shares/units in collective investment funds)
 - Including all intra-group transfers
 - Repo and securities lending
 - On-market and “over the counter”
- Derivatives
- Material modifications- each “material modification” of a taxable financial transaction should be considered a new taxable financial transaction of the same type as the original transaction. Ex.: Stock loan reallocation.

EU Financial Transaction Tax

Certain Financial Transactions Excluded

Excluded transactions include:

- Primary market transactions:
 - Capital raising transactions (shares/bonds)
 - Issuance of government bonds
- Spot currency transactions
- Transactions by central banks and clearing houses (but, doesn't preclude taxation of a central bank's counterparty)

EU Financial Transaction Tax

Taxable Amount

- For securities and other financial instruments, greater of:
 - consideration paid or owed for the transfer, and
 - arm's length market price
- For derivatives: notional principal amount

EU Financial Transaction Tax Tax Rate

- For securities and other financial instruments:
 - not less than 0.1 %
- For derivatives:
 - not less than 0.01 %

EU Financial Transaction Tax

Scope – Focus on Financial Institutions

- At least one party to transaction must be “established” in an FTT Member State (“FTT MS”), and
- A financial institution established in an FTT MS is a party to the transaction acting:
 - for its own account, or
 - for the account of another person, or
 - in the name of a party to the transaction
- As we shall see, the “established” principle is broader than it first appears.

EU Financial Transaction Tax

Definition of “Financial Institution”

Definition is broad and includes (among other persons):

- banks, investment firms, insurance companies,
- investment firms, organized markets, credit institutions,
- collective investment undertakings and their managers,
- pension funds and their managers,
- special purpose entities,
- other undertakings,
- institutions, bodies or persons carrying out certain financial activities.

EU Financial Transaction Tax

Meaning of “Established”

- What does it mean to be “established” in an FTT MS?
- Notion of “establishment” is based on the “residence principle” supplemented by elements of the “issuance principle”, which was added to strengthen anti-relocation.

EU Financial Transaction Tax Liability for payment of FTT

- For each transaction, FTT payable by each financial institution that is liable for FTT.
- FTT is payable to the tax authority of the FTT MS in the territory of which the financial institution is established or “deemed to be established”, on condition that this institution is party to the transaction, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction.
- Joint and several liability.

EU Financial Transaction Tax Parties Are FIs in Different FTT MS

- If two financial institutions, as parties to a financial transaction or acting in the name of parties to transaction, are established in different FTT MS, each such MS may charge FTT for the same transaction, at the rate each FTT MS has set.

EU Financial Transaction Tax

Cross-FTT Zone Transactions

- If one party to a financial transaction is located in the territory of a State which is not an FTT MS, the transaction is not subject to FTT in an FTT MS, unless the other party to the transaction is established in an FTT MS.
- In that case, the FI that is not established in an FTT MS will be deemed to be established in its counterparty's FTT MS and the transaction becomes taxable in the FTT MS.
- In other words, each party to the transaction is deemed to be established in the FTT MS.

EU Financial Transaction Tax

The “Residence Principle”

- An FI is deemed to be “established” in an FTT MS with respect to a securities lending transaction it conducts if FI:
 - is authorized to conduct SL transactions in the MS
 - is “passport” to conduct SL transactions in the MS
 - is registered in the MS
 - has a permanent address or usual residence in MS
 - has a branch in the MS
 - is a counterparty to a transaction in the MS
 - is a foreign branch of MS (e.g., Montreal branch of French bank)

EU Financial Transaction Tax

The “Issuance Principle”

- The issuance principle applies even if none of the parties to the transaction would have been “established” in an FTT MS; parties are “deemed” to be established in an FTT MS if trading in financial instruments issued in that MS.
- Example: Loan of French shares from CDN lender to US borrower. Both lender and borrower are deemed to be “established” in France for FTT purposes.
- EC rationale: By complementing the residence principle with an issuance principle, it will be less advantageous for EU FIs to relocate activities and establishments outside the FTT jurisdictions, since trading in the financial instruments subject to taxation under the latter principle and issued in the FTT jurisdictions will be taxable anyway.

EU Financial Transaction Tax Established in a Participating MS

- *Article 4 (Establishment)*
- 1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
 - (a) it has been **authorised** by the authorities of that MS to act as such, in respect of **transactions covered** by that authorisation;
 - (b) it is **authorised or otherwise entitled to operate, from abroad, as financial institution** in regard to the territory of that Member State, in respect of **transactions covered** by such authorisation or entitlement;
 - (c) it has its **registered seat** within that Member State;
 - (d) its **permanent address** or, if no permanent address can be ascertained, its **usual residence** is located in that Member State;

(continued next slide)

EU Financial Transaction Tax Established in a Participating MS (cont.)

- (e) it has a **branch** within that Member State, in respect of transactions carried out by that branch;
- (f) it is **party**, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, **to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c), (d) or (e)**, or with a party established in the territory of that Member State and which is not a financial institution;
- (g) it is **party**, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, **to a financial transaction** in a structured product or one of the financial instruments referred to in Section C of Annex I of Directive 2004/39/EC **issued within the territory of that Member State**, with the exception of instruments referred to in points (4) to (10) of that Section which are not traded on an organised platform.

EU Financial Transaction Tax

Meaning of “Authorised”?

- “1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
 - (a) it has been **authorised** by the authorities of that MS to act as such, in respect of **transactions covered** by that authorisation;”
 - Query: If a Canadian bank is “authorised” to engage in securities lending and repo transactions in an FTT MS, perhaps through its UK branch, is the bank *deemed* “established” in that MS with respect to all such transactions it conducts globally? Probably not the intent of Directive, but clarity needed.

EU Financial Transaction Tax

Effect of Passporting?

- “1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
- (b) it is **authorised or otherwise entitled to operate, from abroad, as financial institution** in regard to the territory of that Member State, in respect of **transactions covered** by such authorisation or entitlement;”
- Query: If a Canadian FI establishes a separate banking entity in the UK, one that is “entitled to operate from abroad” (e.g., passported) to engage in securities lending and repo transactions in an FTT MS, is the UK entity *deemed to be* “established” in that MS with respect to all such transactions it conducts globally? Probably not intent.

EU Financial Transaction Tax Examples – Residence Principle

- **Example 1:** CDN Lender/US Agent/CDN Borrower/HK Loaned Shares.

No connection with an FTT MS. FTT does not apply.

- **Example 2:** Same as Example 1, except Agent is a US branch of a German bank.

FTT ought not to apply, but intent of Directive not clear.

Worse case result: Agent is deemed to be established in Germany under the “residence principle”, as it is operating through a foreign branch of a German bank, an FTT MS. Both the CDN lender and borrower are deemed to be established in Germany and are subject to EU FTT charges in Germany.

EU Financial Transaction Tax

More Examples - Reallocation

- **Example 3:** US Article XXI Lender/US Agent/CDN borrower/CDN Loaned Ordinary Shares.

No connection with an FTT MS. FTT does not apply.

- **Example 4:** Same as Example 3, except loan of CDN Ordinary Shares is reallocated to a French pension fund Lender.

The reallocation (substitution of counterparty) may be viewed as a “material modification” and a new loan under the Directive. If so, a reallocation to a French pension fund would mean that the CDN borrower is deemed to be established in France at the time of the reallocation and the borrower would be viewed as subject to EU FTT in France. [Borrower may be less than understanding if it becomes contractually liable for FTT under the terms of the Securities Lending Agreement with the US agent because Agent reallocated the loan to a lender in an FTT MS.]

EU Financial Transaction Tax

Example – Multiple Lenders

- **Example 5:** Multiple Lenders (CDN 900 shares; France 100 shares)/UK Borrower/US Loaned Shares.

FTT applies to a portion of the loan to extent of shares on loan from the French Lender. For this portion (10%), UK borrower is deemed to be established in France. Canadian lender should not be subject to EU FTT.

Caveat: UK borrower deemed to be established in an FTT MS. See Art. 4, 1(a), (b); slides 19-22.

EU Financial Transaction Tax Example – Issuance Principle

- **Example 6:** CDN Lender/CDN Agent/CDN Borrower/Spanish Loaned Shares.

FTT applies. Loan of shares issued by a company in an FTT MS. CDN Lender, Agent and borrower each is deemed to be established in Spain. Because of this link, Lender and Borrower will have to pay EU FTT in Spain.

How is this FTT to be paid? Spanish custodian?

EU Financial Transaction Tax Example – Loan of ADR Shares

- **Example 7:** CDN Lender/CDN Agent/CDN Borrower/ADR (Belgium) Loaned Shares.

In the context of the “issuance principle” in the Directive, if the ADRs representing Belgian shares are “sufficiently linked” to an FTT MS (Belgium in this example) in which the issuer is located, the CDN Lender, Agent and Borrower will each be deemed to be established in Belgium. Because of this link, Lender and Borrower will have to pay EU FTT in Belgium.

How is this tax paid? ADR depository bank?

EU Financial Transaction Tax

Example – Loan of ETF Shares

- **Example 8:** CDN Lender/CDN Agent/CDN Borrower/US ETF Loaned Shares (30% of assets in ETF consist of shares issued in FTT Member States).

Sufficient link to FTT MS? Does FTT apply to FMV of underlying assets of ETF in FTT MS at time of loan?
TBD.

[Note: Under a proposed legislative amendment to the definition of a “qualified security”, a share of a US ETF should generally be classified as a “qualified security” and a loan of such a security by a Canadian resident will be a “securities lending arrangement” within the meaning of section 260(1).]