Understanding Canada's Due Bill Initiative

Most long term investors will, at some point, likely hold a stock that undergoes a major reorganization such as a stock-split or spin off. It is up to the securities industry to ensure those events are processed correctly in client accounts in a timely fashion. The Canadian securities industry has embarked on an initiative (known as 'Due Bill' tracking) aimed to improve the handling of these events. The end result will harmonize Canadian and U.S. practices and improve the valuation reporting for securities in investor accounts.

Here is an illustration:
An Investor holds 100 common shares of Company ABC, which is trading on the Toronto Stock Exchange @ $100 per share for a total position value of $ 10,000. Company ABC declares a 2-for-1 stock split for shareholders of record February 16th with a payable date of February 24th (the payable date is the date on which the additional shares are paid out by the company, or its agent, to the entitled holders of record). The current practice in Canada is for the ex-date (the date on which purchases of the stock will no longer come with the additional shares) to be 2 business days prior to the record date. In this example, Company ABC will have an ex-date of February 14th. On the ex-date, the market price of Company ABC drops from $100 to $50, to reflect that any new purchases will not come with the additional split shares.

Currently for these types of events the payable date can be several days, or even several weeks after the ex-date. This means there is a timing difference between when the market price of the stock falls to reflect the stock-split and when the additional shares arrive into the investors brokerage account. This leads to a temporary undervaluation of the client's holding in that security. Using the above example, on February 14th (the ex-date) the investor who previously held $10,000 worth of Company ABC (100 shares at $100 per share) will now only show a position value in his account of $5,000 (100 shares at the new market price of $50 per share). It is not until the additional 100 shares are received into the client account on February 24th (the payable date) that the correct position value is reflected (see illustration table below).

By undervaluing the client's true portfolio position a host of issues are raised. For example, if the position was purchased on margin, the client account may now appear to be under margined and a margin-call may be incorrectly issued to the client. Additionally, the performance of the account could also be misstated, leading to client confusion and concern. The situation is particularly problematic if the event straddled month-end and the incorrect valuation appears on the client's month end statement.

To avoid these unfortunate scenarios, Canadian securities firms have had to resort to various workarounds such as manually adjusting client account positions to reflect the shares entitled but not yet received. While these efforts have for the most part allowed these corporate action events to be reported without complications to investors, the workarounds are costly, inefficient, and prone to operational risk.

Adding a further complication is the fact that the U.S. follows a different approach. In the U.S., the ex-date for these eligible events is the first business day after the payable date. This means that, in the case of a stock split, the stock price in the

Illustration: 2-for-1 Stock Split

(current Canadian process)

	Mon Feb 13	Tues Feb 14 Ex-Date		Thurs Feb 16 Record Date		Fri Feb 24 Payable Date
A) Stock price[1]:	$100	$50[2]	$50.10	$50.20	varies	$50.50
B) Number of shares in account:	100	100	100	100	100	200[3]
C) Position value (A*B):	$10,000	$5,000	$5,010	$5,020	varies	$10,100
		Client Account Undervalued				

[1] Stock prices simulated for illustrative purposes
[2] Stock price drops in market to reflect 2-for-1 split
[3] Split shares paid to entitled shareholders

U.S market drops after (or just shortly before) shareholders of record have received their additional shares - thereby alleviating the valuation issues experienced north of the border and hence no need for manual intervention on the part of U.S. securities firms. For their framework to operate successfully, the U.S. utilizes, through their securities depository, an automated system to track any trading done between the record and ex-date. These trades have what is known as a "Due Bill" applied to them to ensure purchasers of the security during this period receive their entitled shares at the expense of the sellers – a process otherwise known as "Due-Bill Tracking".

The U.S. approach creates potential confusion for Canadians investing in Canada's 163 dual-listed securities – among Canada's most widely held and traded. For example, a stock inter-listed on both Toronto and New York that undergoes a stock-split will currently have a different ex-date in Canada and the U.S. – meaning that the shares trade at different prices for a period of time. This leads to investor confusion, possible trading errors and again the need for considerable oversight on the part of Canadian dealers.

The Canadian securities industry is working to harmonize the Canadian process with that of the U.S. by adopting a similar Due Bill framework. For eligible events (on all TSX and U.S. inter-listed stocks), therefore, the Canadian industry will be moving the ex-date to the first business day following the payable date. Additionally, Canada's security depository, CDS Clearing and Depository Services Inc. (CDS) is implementing an automated due-bill tracking system, comparable to that in the U.S., for trades between the record and ex-date. This will ensure that the security will carry the appropriate value in the market place until the entitlement has been paid.

Implementation of Canada's "Due Bill" initiative is planned for February 2012. The initiative will improve the accuracy and timeliness of security valuation in client accounts, eliminate unnecessary costs and risks related to the current manual processes deployed by securities firms and simplify the trade handling of inter-listed stocks as Canadian and U.S. frameworks become aligned. In short, it will bring further efficiencies to better serve Canadian investors.

Q&A

What is a 'Due Bill'?

Due Bills are entitlements (such as additional shares) attached to listed securities undergoing certain material corporate events such as stock-splits or spin-offs. Stocks trading with Due Bills attached obligate the seller to deliver the entitlement to the buyer. Due Bills attach to trades two trading days prior to the record date and come off the day after payable date and allow the security to carry the appropriate market value until the entitlement has been paid.

Who determines whether a security undergoing a corporate event will have Due Bills applied?

Due Bill trading will be determined at the discretion of the Exchange, based on factors relevant to the distribution. For securities inter-listed on a U.S. exchange, if the U.S. exchange implements Due Bill trading for a particular corporate event, TSX expects to also implement Due Bill trading. Due Bills will typically be used when the distribution per security represents 25% or more of the value of the listed security.

How will investors be notified of which securities and corporate events will have Due Bills applied?

TSX will publish a notification for the trading community regarding the ex-distribution date for any listed security, as well as note if there will be Due Bill trading applied to that event. Investment dealers may individually decide on what additional approach to take in notifying their advisors and clients about such information.

What benefits will the use of Due Bills bring to Canadian investors?

For securities undergoing a material corporate event, Due Bill processing will result in accurate and timely reporting of position values in client accounts. It will eliminate some of the manual process currently adopted by brokerage firms reducing risk of error in their reporting to clients. It will also harmonize Canadian practices with U.S. practices which be beneficial in addressing confusion pertaining to the trading of inter-listed securities undergoing a major corporate event.

What corporate actions will be subject to Due Bills?

Due Bills will typically be used when a security announces a distribution representing 25% or more of the value of the listed security. The distribution can take the form of a dividend, stock-split, spin-off and rights/warrant distribution.

Will ordinary dividends be subject to Due Bills?

Ordinary course dividends will not likely have Due Bills applied as the values of such dividends typically do not represent 25% or more of the value of the security. As such, the ex-date for ordinary dividends will continue to be two days prior to the record date.

Will there be any actions required on the part of investors?

Investors holding impacted securities through their brokerage account will not be required to take any special action. The entitlement will continue to be received into the investors account on, or immediately after, the payable date. Any trades that are executed during the Due Bill period will be automatically flagged by the industry to ensure purchasers receive the entitlement and sellers do not.