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Re: CIRO's Request for Comments – Proposed Amendments Respecting Mandatory Close-Out Requirements (25-0001) issued on January 9, 2025

The **Canadian Independent Finance and Innovation Counsel (CIFIC)** appreciates the opportunity to provide comments to CIRO and the CSA on CIRO's proposed amendments to the Universal Market Integrity Rules (UMIR) and Investment Dealer Partially Consolidated Rules (IDPC) respecting Investment Dealer member mandatory close-out requirements.

The Canadian Independent Finance and Innovation Counsel represents national Investment Dealers and their industry's position on securities regulation, public policy, and industry issues. We represent notable CIRO-regulated Investment Dealers in the Canadian securities industry.

Deemed to Own

We support the proposal regarding "deemed to own" securities and believe that delivering the security as soon as all restrictions on delivery have been removed, and no later than thirty-five (35) calendar days after the trade date, is appropriate and should include exercises of cashless stock options and warrants.

We agree that certain UMIR provisions, as stated in the proposal, should be amended to reflect the deemed-to-own exemption.

Issues with Short Selling in Canada

CIRO states the following:

CIRO and the CSA have heard concerns of persistent failures to settle and that the current voluntary buy-in procedures in Canada are too lax and could contribute to a negative perception of capital markets in Canada, which in turn could deter otherwise interested parties from listing or investing in Canada. Based on our analyses at this time, CIRO and the CSA are of the view that proposing a mandatory close-out requirement would be helpful to Canadian regulators to better understand if this approach would be appropriate to strengthen our regulatory framework.

While we recognize the concerns raised in the bulletin, namely the persistent failures to settle and the perception by some that Canada's voluntary buy-in procedures are too lenient, we do not believe that short selling presents a major issue in the Canadian marketplace, and we believe this would be borne out by proper analysis.

As previously mentioned, we are supportive of the proposed carve-out for "deemed to own" positions, which we consider to be a thoughtful adjustment that acknowledges the practical realities of certain market transactions. However, beyond this change, the consensus across industry participants appears to reflect a general preference for maintaining the status quo.

In cases where settlement fails to occur, there are most often legitimate explanations, frequently administrative in nature, that warrant reasonable time allowances for resolution. The majority of these instances are benign and do not pose any systemic threat to market integrity. In this context, we believe the existing rules are largely fit for purpose, particularly if enhanced with targeted carve-outs for securities such as warrants and stock options, which require additional administrative processing time. Imposing new regulatory requirements, and the associated cost

and operational burdens of addressing a problem that has neither been evidenced nor quantified would be unwarranted and inefficient.

However, one area where reform may be justified and, indeed, necessary, is in Canada's junior markets, where damaging and manipulative short selling occurs.

Short Selling in Junior Markets

While this issue is virtually non-existent in the senior markets such as the TSX, where liquidity is abundant, securities are widely borrowable, and manipulation is difficult, the same cannot be said for junior exchanges like the TSXV and the CSE.

In these markets, illiquid securities are being targeted by short sellers (often hedge funds), resulting in the artificial suppression of prices. We believe CIRO must urgently investigate potential instances of market manipulation within the junior equities markets. A particularly concerning practice involves market participants that hold long positions in warrants with strike prices that exceed the current market price of the underlying security. When these participants initiate or increase short positions in the underlying stock, it is evident that there is no genuine intention to exercise the warrants. This is what should be viewed as a short sale: covering the short position with future acquisitions in underwritings or market transactions rather than through the exercise of these warrants confirms this intent. The result of this practice is an exertion of downward pressure on the share price, an action that undermines fairness and investor confidence. We contend that such behavior constitutes a form of market manipulation and merits regulatory scrutiny and enforcement.

This activity not only harms retail and institutional shareholders but also impairs the ability of small-cap issuers to access capital, which is a foundational element of capital formation in the Canadian markets.

This is particularly concerning given that many of these securities are not readily borrowable in the volumes being shorted, and that, when they are, borrowing costs are often prohibitive. The question must therefore be asked: *how is it possible that such short selling is occurring at scale, when settlement on T+1 (in some jurisdictions soon to be T+0) supposedly requires a reasonable expectation of delivery?*

This suggests a failure of enforcement and a potential loophole in the existing framework. While we recognize that adopting a full-scale Regulation SHO-style rule would address this issue by enforcing stricter settlement discipline and curtailing abusive short selling, such a shift would represent a significant and costly operational overhaul for the industry without increased benefits. The remedy should be proportional to the problem.

As such, we urge CIRO to conduct a focused investigation into this practice, including how trades are being executed and settled in the absence of borrowable supply in the junior markets, and to determine whether existing rules are being circumvented, or whether targeted amendments could more effectively address the issue without imposing unnecessary burdens on the broader market. In other words, we urge caution against adopting an approach that is disproportionate to the issue at hand, and instead recommend a surgical, data-driven approach that preserves market efficiency while reinforcing fair and orderly trading in Canada's junior markets.

Substantive Evidence – No Issues with Short Selling in the Senior Markets

As previously mentioned, we do not believe that short selling presents a major issue in the Canadian marketplace. Given this context, we believe that implementing mandatory close-out requirements in Canada, in alignment with Rule 204 of Regulation of Short Sales (Regulation SHO) in the United States, may be unnecessarily burdensome. Before enacting such measures, which would impose significant operational and compliance obligations on Clearing Members, Allocated Members, Investment Dealers, and Trading Dealers, we strongly urge the regulators to provide substantive evidence in the form of research and analysis demonstrating that short selling is, in fact, a significant problem requiring regulatory intervention. Regulation should not be a solution in search of a problem.

Significant Burden

The back-and-forth reporting requirements that would accompany mandatory close-out provisions are likely to be highly onerous. If any such reporting requirements are to be implemented, they must be structured in a user-friendly format and facilitated through an efficient medium to minimize administrative burden.

Furthermore, the Proposed Amendments could have significant implications for Investment Dealers and investors, including:

- **Operational and Systemic Adjustments:** Investment Dealers engaged in the sale of listed securities would need to undertake substantial system and operational upgrades, as well as develop and implement new policies and procedures to:
 - Monitor and track fail-to-deliver positions.
 - Buy or borrow shares within specified timelines to close out fail-to-deliver positions and bring them to a net flat or net long position.
 - Prevent short selling without pre-borrowing in cases where fail-to-deliver positions remain unresolved.
 - Require clients or traders to make pre-borrow arrangements where necessary.

- **Increased Transaction Costs for Investors:** Investors may be required to buy or borrow shares to close out fail-to-deliver positions within strict timelines or pre-borrow shares prior to engaging in short selling where failures to close out have occurred. These requirements could significantly increase transaction costs and reduce market efficiency.
- **Compliance and Procedural Adjustments for Non-Participant Investment Dealers:** Investment Dealers that are not Participants would need to revise internal processes and policies to ensure they have a reasonable expectation of settling short sales by the settlement date before order entry.

Proportionality and Efficiency

Given these anticipated impacts, we urge the regulators to carefully weigh the necessity and proportionality of these proposed measures. Any new requirements should be supported by clear and compelling data demonstrating the extent of settlement failures and their impact on market integrity. Additionally, regulators should ensure that any new reporting and compliance frameworks are designed to be as efficient and non-disruptive as possible.

Industry Position

Based on the above, the Investment Dealers we represent believe that **CIRO should not proceed with the proposal at this time** and should further analyze the current market conditions relating to short selling in Canada based on the current Canadian regulation.

Implementation Timeline

The Investment Dealers we represent believe that a period longer than 180 days would be required after the publication of a Notice of Approval if, despite our comments, the proposed changes were to be implemented. Investment Dealers have indicated that 18 months may be needed to comply with the proposed requirements.

Consultation Questions

Question 1

To what extent do Investment Dealer Members currently use CDS Participants for clearing and settlement that are not Investment Dealer Members? It is important that we assess the risk of regulatory arbitrage, as the Proposed Amendments would become a CRO requirement that would only affect Investment Dealer Members that are within CRO's jurisdiction.

Would the Proposed Amendments create an incentive for Investment Dealer Members to seek entities that are not regulated by CRO for clearing purposes, and/or create disadvantages for Investment Dealer Members that currently offer clearing and settlement?

CIFIC Response: We acknowledge and appreciate CRO's thoughtful consideration of the potential risk of regulatory arbitrage that could arise if the Proposal were to apply solely to CRO Members that are CDS participants for clearing and settlement. However, we do not have any additional information to offer on this matter at this time.

Question 2

Do Clearing Members, or Investment Dealers that could be allocated a fail-to-deliver position from a Clearing Member, currently have the books and records in place to close out in a timely manner pursuant to the proposed timelines? This would require the tracking of a CNS fail-to-deliver position to one of the following in order to determine the applicable close-out timeline:

- Short sales or trades resulting from SME orders that do not relate to persons with Marketplace Trading Obligations when trading in securities for which that person has obligations: S+1
- Long sales: S+3
- Persons with Marketplace Trading Obligations when trading in a security for which that person has obligations: S+3
- Deemed to own: T+35

CIFIC Response: Books and records in the industry currently provide the fundamental framework for closing out or allocating failed trades. However, CRO must be aware that significant enhancements would need to be implemented, as well as new processes, to ensure timeliness and accuracy of close outs.

Question 3

We propose to allow Clearing Members to allocate all or a portion of the fail-to-deliver position to another Investment Dealer Member as long as that allocation is made in a reasonable and timely manner. Would the recent move to T+1 settlement affect the ability of Clearing Members to make allocations, or the ability of Allocated Members to close out under the specified timelines? Would Clearing Members have enough information from CDS or their own books and records to conduct allocations in a timely manner, and if not, what types of information would be required?

CIFIC Response: The move to T+1 increases the challenge of meeting the obligations of the proposed amendments.

Question 4

Under the Proposed Amendments, we would expect the majority of trades in listed securities to be settled or closed out prior to ten days past settlement date, which is the current reporting timeline for extended failed trades. Given the proposed close-out requirements would apply to all sales, should we consider repealing or narrowing the reporting requirement for extended failed trades on Participants and Access Persons?

CIFIC Response: If CIRO does indeed proceed with the proposal despite industry responses, current reporting requirements should be repealed to avoid duplication.

Question 5

Given that Investment Dealer Members may use different entities for clearing and trading purposes in Canada, would the proposed notification and reporting requirements ensure a consistent application of close-out and pre-borrow requirements similar to the regulatory framework under Regulation SHO? What are the operational or technical challenges associated with the proposed reporting or notification requirements?

CIFIC Response: The Investment Dealers we represent are of the view that CIRO should refrain from proceeding with the proposal at this time, given the considerable operational and technical challenges it presents, coupled with the absence of any compelling or material issues in the Canadian marketplace that the proposal meaningfully addresses.

Question 6

What are some relevant factors or considerations when ensuring purchases made on a marketplace to close out a fail-to-deliver position are being executed using reasonable commercial terms in a manner that is consistent with market integrity?

For example, should there be an exception to allow the purchase of securities made to close out fail-to-deliver positions to be executed off-marketplace in order to minimize potential market disruptions? Would the ability to conduct off-marketplace trades only benefit certain Investment Dealer Members that are able to find their own counterparties away from the marketplace? Would there be a greater benefit to the market to require these trades to occur on a marketplace for transparency purposes?

CIFIC Response: Execution off-marketplace could be helpful in the case of liquid securities. However, the issue at hand concerns illiquid or hard-to-borrow securities. Another alternative should be provided for Investment Dealers to comply with the amendments if CIRO proceeds with the proposal.

Question 7

To assist with our monitoring capabilities at CIRO, we are considering the use of a new marker for purchases executed on a marketplace for the purpose of closing out a fail to deliver position. While this marker would only be used for regulatory purposes and would not be publicly disseminated, we would like to seek feedback on whether there are any operational challenges faced by executing Participants in terms of implementing such a marker.

CIFIC Response: The Investment Dealers we represent do not support a new marker. Every new marker has a cost for the Investment Dealers we represent. Every system update would need resource allocation and a financial budget. Once again, we must reiterate that CIRO should further investigate the true “issue” with short selling in Canada before proceeding with this proposal. The industry does not believe that there is a systemic issue in our market.

If CIRO does implement a new marker, they should consider one that distinguishes directional short sales (true short sales) from those that are marked “short” due to administrative delays. Much like when CIRO created the short-marking exempt (SME) marker, the directional short sales must be separated from the administrative short sales for this to be transparent and relevant to investors.

Question 8

Are there any common practices that are currently in place that may raise issues in complying with closing out under the specific timeframes or with the pre-borrow requirements as set out in the Proposed Amendments?

8a) Would the use of average price or accumulation accounts affect the ability of Investment Dealer Members to close out in a timely manner as required by the Proposed Amendments, and if so, how?

8b) Would the use of the SME marker for trades that are not executed by a person with Marketplace Trading Obligations in respect of their security of responsibility affect the ability of Participants to close out in a timely manner or pre-borrow as required by the Proposed Amendments, and if so, how?

CIFIC Response: The Investment Dealers we represent have no comments to offer at this time.

Question 9

To facilitate the operation of a close-out framework in Canada, we are proposing reporting and notification requirements as set out above. We are requesting comment on whether Investment Dealer Members anticipate any challenges with the proposed reporting and notification requirements, and if so, please specify.

CIFIC Response: The Investment Dealers we represent are of the view that CIRO should refrain from proceeding with the proposal at this time, given the considerable operational and technical challenges it presents, coupled with the absence of any compelling or material issue in the Canadian marketplace that it meaningfully addresses.

Question 10

Is the extended close-out timeline of T+35 calendar days appropriate for deemed to own securities, or should we consider a shortened close-out timeline for these transactions?

CIFIC Response: The extended close-out timeline of T+35 calendar days is appropriate for deemed-to-own securities. We refer you to the administrative delays explained and detailed in our previous comment letter dated April 12, 2024, regarding cashless stock option and warrant exercises.

Question 11

Are there other situations that would warrant an extended close-out timeline, and if so, what other exceptions should we consider?

CIFIC Response: The Investment Dealers we represent have no comments to offer at this time.

Question 12

SEC Rule 204 in Regulation SHO allows broker dealers that have not closed out fail-to-deliver positions to continue short selling as long as they pre-borrow for themselves or their clients in the affected security. Would this outcome be appropriate for Canada, or should we consider restricting short selling altogether where there is a failure to deliver?

CIFIC Response: Restricting short selling altogether where there is a failure to deliver would only harm the efficiency of the capital markets, as short selling enhances both the liquidity and the integrity of the markets. Imposing restrictions on short selling due to failures to deliver has the potential to undermine market quality. The proposed pre-borrow requirement for future short sales linked to fail-to-deliver positions should address market integrity concerns, making a complete restriction on short selling unnecessary.

Question 13

Given that we are proposing extending the requirement for a reasonable expectation to settle to Investment Dealer Members that are not Participants, should we also consolidate this requirement in the IDPC Rules, rather than having separate requirements in both UMIR and IDPC Rules?

CIFIC Response: The Investment Dealers we represent believe that the requirements should be included in both UMIR and IDPC Rules.

Question 14

Have we identified all the proposed provisions that will materially impact clients, investors Investment Dealer Members, marketplaces or CIRO in our Impact Assessment? If not, please list any other proposed provisions that you believe will materially impact one or more parties and why.

CIFIC Response: As previously mentioned, we believe that CIRO should not proceed with this proposal until the results of an extended analysis on the impact of short selling have been considered.

Question 15

Overall, do you agree with CIRO's qualitative assessment of the benefits and impacts of the Proposed Amendments? Please provide reasons for your stance.

CIFFIC Response: The Investment Dealers we represent do not believe that the benefits of the Proposed Amendments would outweigh the costs to comply. Any benefits are difficult to assess as, for the industry, there is no fundamental issue with short selling in Canada.

Question 16

We are proposing an implementation period of no less than six months after the publication of the final amendments, and request feedback on what implementation period would be appropriate to provide applicable Investment Dealer Members with sufficient time to make the changes necessary to comply with the Proposed Amendments.

CIFFIC Response: The Investment Dealers we represent have indicated that a period of 18 months would be needed to comply, if this proposal were to go forward.

Conclusion

We commend CIRO for its efforts to protect investors, which involves preserving the integrity of the Canadian capital markets. However, strengthening the regulatory framework and harmonizing CIRO's approach to "potentially match those practices adopted in other jurisdictions" should only be undertaken when issues are identified in our markets.

In the end, if this proposal were to be implemented, firms, in order to avoid the associated administrative burdens and costs, would essentially have to amend their internal practices to limit the administrative grief and only permit clients to sell stock that is in their accounts and cleared. Anything outside of "deemed-to-own" securities would require a pre-borrow, the cost of which would be passed along to the client in some form. There would certainly also be an impact on delivery-against-payment (DAP) or receipt-against-payment (RAP) trade settlements and in institutional accounts, where issues often occur.

As previously mentioned, the Investment Dealers we represent are of the view that **CIRO should refrain from proceeding with the proposal** at this time, given the considerable operational and technical challenges it presents, combined with the absence of any compelling or material issue in the Canadian marketplace that is being meaningfully addressed by it.

However, **we do urge CIRO to conduct a focused investigation into the questionable practices in the junior markets**, including how trades are being executed and settled in the absence of borrowable supply in these markets, to determine whether existing rules are being circumvented, and whether targeted amendments could address the issue without imposing unnecessary burdens on the broader market.

Thank you for considering our comments on this important proposal.

As always, we are available to discuss the content of this submission further, address any concerns you may have, or provide additional information as needed. Your feedback is invaluable to us, and we are committed to ensuring that we all achieve our objectives effectively and efficiently.

Please feel free to contact me at annie@cific.co with any questions, comments, or to schedule a call to discuss any aspects of the letter or explore potential next steps. We look forward to our continued collaboration on this matter.

Sincerely,

A. Sinigagliese

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