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With a copy to:

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Dear Ms. Tam;

RE: Proposed Amendments Respecting Mandatory Close-Out Requirements

National Bank Financial Inc. (NBF) welcomes this opportunity to comment on CIRO's proposed amendments respecting mandatory close-out requirements (the "Proposal"). While we acknowledge that Canada's current short selling regulatory regime differs from that of other jurisdictions, we are deeply concerned that the Proposal, as currently presented, will unnecessarily introduce significant complexity, disruption, and cost to Canadian market participants. Heavily impacted will be large integrated firms such as ours that are active participants in Canadian equity markets and provide securities lending, clearing and trade execution services to other investment dealers and clients.

Among our concerns are the following:

- CIRO's policy response is disproportionate to the effects failed trades and abusive short-selling have exhibited in Canada
- CIRO has significantly underestimated the efforts required by Members that are CDS clearing participants to meet the proposed new requirements
- Duplication with existing regulations and mechanisms
- The high costs and length of time that will be needed by market participants to implement the Proposal

- Certain areas of our markets, such as Exchange Traded Funds and Securities Lending, warrant additional considerations
- The Proposal's potential adverse impact on market functioning
- The risk of regulatory arbitrage resulting from the Proposal

Given our concerns, combined with the lack of evidence to support the need for the Proposal and that regulations and tools already exist to address CIRO's policy objective, **we recommend that CIRO undertake further review before proceeding with the Proposal.**

Should CIRO ultimately determine to move forward with the Proposal we believe several changes are warranted to assist with implementation and ensure its adverse effects on market participants and overall quality of markets are minimized. These include:

- Simplifying the Proposal by aligning the close-out timelines for fail to deliver positions related to short sales, long sales and all Short Marking Exempt (SME) designated orders to no later than three trading days after settlement (S+3).
- Excluding Exchange Traded Funds (ETFs) from the Proposal or otherwise extending the close-out timeline for ETFs to no later than five trading days after settlement (S+5).
- NOT restricting short selling altogether where there is a failure to deliver
- Discontinuing the existing Extended Failed Trade Reporting (EFTR) requirement.
- Revisiting CSA, CDS and exchange rules so that policy objectives of the Proposal are shared across a broader group of market participants and the risk of regulatory arbitrage reduced.
- Providing CIRO dealer members with no less than 18-months after finalization of the rules to comply with the new requirements.

Our comments on the Proposal and responses to questions posed by CIRO are enclosed. We would be happy to meet with you to discuss any portion of our submission.

Sincerely,

"Patrick McEntyre"	*"Nicholas Comtois"*	*"Jack Rando"*
Patrick McEntyre, CFA Managing Director Institutional Equity Electronic Services & Trading	Nicholas Comtois Managing Director Retail Trading Desks	Jack Rando, CFA Chief Advisor Financial Markets Trade Surveillance

NBF Comments and Observations

How Big is the Problem?

A stated objective of the Proposal is to address concerns of "persistent settlement failures" in Canada with a particular focus on fails related to short selling. Our firm's internal reviews and experience reveal that extended failed trades are not pronounced occurrences. At the industry level, CIRO's own Failed Trade Study shows that the fails that do exist are largely centered on certain sectors of our markets and only one-third of CNS extended failed trades are linked to short-selling[1].

If we set aside fail-to-deliver positions resulting from operational issues and focus solely on those stemming from abusive or naked short-selling, we suspect the volume of trades at the center of regulators' concerns could be small relative to total industry settlements.

The Proposal lacks the necessary data or evidence to substantiate CIRO's concerns. We are concerned therefore, that CIRO's policy response is disproportionate to the effects failed trades and abusive short-selling have on Canadian capital markets.

The Proposal Duplicates Existing Regulations and Mechanisms

While mandatory buy-in/close-out rules do not exist as a universal requirement under UMIR, there are several existing regulations or mechanisms in Canada designed to achieve similar policy objectives as the Proposal.

CDS Clearing and Depository Services Inc., and Canadian stock exchanges already have buy-in processes that allow enforcement of the seller's settlement obligations for failed trades.

CIRO also has several existing requirements relevant to short selling including:

- All short-sale orders must be appropriately marked as "short" or "short-marking exempt"
- Prior to order entry, any short-sale must have a 'reasonable expectation' to settle[2]
- "Extended Failed Trades" be reported to CIRO
- Short-sale restrictions and pre-borrow requirements associated with Extended Failed Trades
- The reporting of aggregate short positions of each individual account by Participants and Access Persons
- Ability for CIRO to designate a security as a "Pre-Borrow Security"
- Ability for CIRO to designate a security as a "Shor Sale Ineligible Security"

Has CIRO, therefore, concluded that the above measures have not adequately addressed concerns surrounding failed settlements and abusive short-sale practices? If so, are there ways to further enhance some of the above measures before proceeding with the Proposal? For example, while

[1] IIROC Failed Trade Study, December 2022

CIRO can designate a security as a “Pre-Borrow Security" or “Short Sale Ineligible Security”, we note that no security is currently designated in either category by CIRO and we see no record of any such prior designations.[3]

Additionally, CIRO only recently on April 6th implemented gatekeeper and supervisory amendments pertaining to reasonable expectation to settle[4]. CIRO should take some time to see what effects these amendments will have on addressing policy concerns.

Aligning Canada’s Framework with the U.S. Approach Does Not Alleviate the Implementation Challenges for Industry.

The interconnectedness of Canadian and U.S. markets and our industry’s familiarity with Rule 204 of Regulation of Short Sales (“RegSHO”) are rationale provided by CIRO for aligning the Proposal with the U.S. approach.

We are concerned, however, that the Proposal rests heavily on a misconceived notion that replicating RegSHO in Canada would translate to seamless implementation of the Proposal.

Not all Canadian market participants impacted by the Proposal are active in the U.S. These firms will have little familiarity with RegSho and will need to develop a necessary understanding of what the Proposal means for them or their clients. For these firms, new systems and processes will need to be developed from the ground up to meet the Proposals.

While our firm can look to leverage some of the systems, controls and procedures implemented to meet our RegSHO obligations, the Proposal takes things to a significantly different level. Our Canadian trade volumes, including short-sales, are multiple times greater than our U.S volumes so our solutioning for the Proposal must be scaled accordingly.

Where some CIRO members may currently be utilizing manual or semi-automated processes to meet RegSHO, those processes will likely not suffice to meet the Proposal. At our firm new automated solutions need to be developed along with new reports and added supervisory controls.

In summary, a copy-paste of our RegSHO processes and systems will simply not suffice in meeting the Proposal’s requirements. Specifically, we will need to develop processes and solutions that are considerably more automated and robust than what we have in place for RegSHO.

Industry Costs are Expected to be High and Implementation Times Long

The Proposal imposes material change on the regulation of short sales as well the dealers’ broader clearing and settlement operations. Given the size of our firm’s trading and clearing business and our interconnectedness with large numbers of market participants we will need to develop a new comprehensive framework to meet the requirements of the Proposal. Systems, processes,

[3] CIRO's list of Pre-Borrow Securities is available here. CIRO's list of Short Sale Ineligible Securities is available here.

[4] See CIRO Rules Bulletin 24-0349

controls, documentation, and personnel will all be impacted. Automation and timely reporting of information to our internal teams will be essential.

Where services are being provided by us to other dealers, contractual review and probable revisions will be required to ensure accountability and that service level agreements and compliance requirements are properly described. To provide some perspective, National Bank Independent Network (NBIN), provides a host of clearing, securities lending and settlement services to over 400 independent firms and processes 40,000 trades per day. NBIN will need to evaluate the impact of the Proposal on each of these clients and re-paper the relationship accordingly- a significant undertaking.

Our supervisory framework governing all our trading, settlement, and lending activity would be heavily impacted and require changes to our written policies, procedures and controls. Implementing the Proposal will, therefore, be a large-scale initiative for our firm that needs to be resourced accordingly.

Drawing on our experience in implementing our RegSHO solution, as well as other recent regulatory initiatives, and adjusting for the Proposal's scope and scale we estimate implementation costs across our various impacted business lines could total in the range of $3 to $5 million and require at least 18 months time[5]. Given our current unknowns these estimates could be on the lower end.

Additional Considerations Required for Exchange Traded Funds (ETFs)

The process of creating and redeeming ETFs and the associated clearing and collateral settlement considerations will make complying with the close-out requirements for ETFs by S+1 a significant challenge. Some ETF creates, such as for fund-of-fund or internationally focused ETFs, can take several days. Furthermore, ETF settlement failures may not represent the same policy concerns as fails in securities of individual issuers given that the value of ETFs is derived from the market prices of the underlying basket.

The U.S. has recognized the uniqueness of ETFs and has provided some relief respecting their close-out requirements by permitting dealers to use ETF conversion activity to meet the purchase requirement of their close-out rules[6]. A simpler approach for Canada would be to either exclude ETFs from the UMIR close-out rules or extend the prescribed time frame for closing out to S+5.

How the Proposal Can Be Improved

Should CIRO ultimately determine the need to proceed with the Proposal then several amendments should be considered. Specifically, to help with industry implementation and reduce overall confusion in the marketplace we believe the Proposal needs to be simplified and sufficient time be given to industry to undertake necessary preparations.

[5] In addition to our RegSHO implementation we considered other recently implemented initiatives such as T+1 and the MX Client Identifier and scaled accordingly to size our cost estimate for the Proposal.
[6] See SEC No-Action Letter dated April 2017

In a T+1 settlement environment the S+1 closeout timeframe, and the associated notifications/reporting, will be particularly challenging to operationalize. Aligning the close-out timelines for fail to deliver positions related to short sales, long sales and all Short Marking Exempt (SME) designated orders to no later than three trading days after settlement (S+3)(and no later than five trading days (S+5) for ETF's) would help considerably in this regard while still contributing to CIRO's policy objective.

As later detailed in our letter, the risk of regulatory arbitrage stemming from the Proposal also needs to be addressed. This requires collaboration between CIRO, CSA, CDS and the exchanges.

CIRO dealer members that are clearing and settlement participants of CDS will be most impacted by the Proposal and will need time to plan, schedule, build and test for this initiative. Accordingly, they should be afforded no less than 18-months after finalization of the rules to comply with the new requirements.

Recommended Next Steps for CIRO

The implementation of a mandatory close-out regime in Canada, as outlined in the Proposal, will have a significant impact on market participants and the way in which our markets function. In the absence of convincing evidence to illustrate the impact trade failures and abusive short-selling are having on Canadian capital markets broadly, we are concerned that the Proposal is an extreme policy response by CIRO. **We recommend that CIRO undertake further review and consultation before proceeding with the Proposal.**

Responses to Consultation Questions

- **Should the Proposal apply to ALL CDS clearing and settlement participants (not just CIRO Investment Dealer Members)**

  We appreciate that CIRO is considerate of the risk of regulatory arbitrage that could exist should the Proposal only apply to CIRO Members that are CDS participants for clearing and settlement.

  One area at risk of regulatory arbitrage is stock loan activity. This is a service offered by some CIRO Members as well as some non-CIRO members that are clearing participants of CDS. The impact of the Proposal to our stock loan activity is that it will restrict our ability to lend out securities, or to do so as efficiently as we do today, possibly forcing stock borrowers to go to non-CIRO members. By reducing competition in this space, the Proposal risks increasing costs to investors and damaging the quality of our collateral finance market.

  CIRO should work collaboratively with the CSA to determine how the policy objectives of the Proposal can extend across a broader group of market participants, putting all securities lenders on equal footing.

- **Do dealers have the books and records necessary to be able to close out or allocate failed trades within the timelines prescribed?**

  The Proposal requires CDS clearing firm participants to track and close-out fail-to-deliver positions at the CNS level. Because CNS nets all buys and sells in each security for each CDS participant, we cannot easily determine which customer's trades contributed to the CNS fail position.

  While the Proposal does not require us to close-out at the individual failed trade level, it will still be necessary for us to develop systems and reports to track fails at the individual client/account level so that we can correctly identify clients for which we need to take action such as allocating all or a portion of the fail-to-deliver position or requesting make pre-borrow arrangements. This is particularly important where one participant (a carrying broker) is clearing and settling for multiple dealers (introducing brokers) as we should not adversely impact all dealers by the settlement failure of one dealer within the clearing process.

  This will require us to make enhancements to our systems and internal reports so that we can better reconcile trade date and settlement date positions, and which clients were directly responsible for any fails. This information will be necessary to develop automated solutions related to the Proposal such as allocation algorithms.

  We also need to ensure that our systems of books and records are updated accordingly so that we can maintain a proper audit trail of any close-outs or allocated fails so that we can issue the necessary reporting and notifications to CIRO or market participants.

  In summary, while our books and records contain the foundational building blocks for closing-out or allocating failed trades, material enhancements will be required and new processes introduced to ensure timeliness and accuracy of our required actions.

- **What are the operational and technical challenges associated with the proposed reporting or notification requirements?**

  Under the Proposal, if we were to allocate a fail to another dealer we would need to:

  - provide an allocation report to CIRO detailing the identity of the allocated members and all the trade particulars.
  - notify any of our investment dealer clients for who we clear if we have failed to close out on time and when the purchase or borrow of securities has been made to close out the position so that they are aware that they could become subject to pre-borrow restrictions for future short-sales in the affected security.
  - Provide CIRO with a copy of the above notification sent to investment dealer clients that clear and settle through us.

  To meet the reporting and notification requirements above a vast amount of information compiled from different systems from within our firm would have to be reconciled so that we can properly determine our reporting and notification requirements.

In a T+1 settlement environment this is especially challenging as the S+1 close-out period affords us little time to generate, review and act on these reports and produce notifications.

To illustrate, currently for our RegSHO operations we are compelled to begin conducting our fail analysis on or before settlement date (i.e. even before the trades have technically failed) so that we can be able to provide notice to clients or dealers of our intention to close-out at S+1 if they do not make delivery. These predictive analytics of our settlement date positioning will need to be replicated for our Canadian solution.

The Proposal also requires that if a clearing member or Allocated Dealer is using an executing broker, they would have to notify the executing broker of any failures to close-out so that the executing broker is aware of pre-borrow restrictions on future short sales in the affected security. As an executing broker our firm is likely to be a recipient of such notifications and must, therefore, implement controls to ensure we respect pre-borrow restrictions placed on us.

- **How does the Proposal impact the current reporting for extended failed trades (EFTR)?**

  The Proposal's intended aim is to ensure that failed settlements are remedied in a timely manner, typically significantly prior to the ten days past settlement prescribed in CIRO's EFTR framework. We do not see a policy rationale, therefore, for continuing with both the Proposal and current EFTR reporting. If CIRO decides to proceed with the Proposal the EFTR framework should be discontinued, freeing up resources for CIRO members to devote elsewhere.

- **Are there market integrity concerns raised by the mandatory close our requirements. For example, should the purchase of securities made to close out be allowed to be executed off-marketplace to minimize potential market disruptions?**

  The purchase of securities off-marketplace made to close out a fail should be permitted. While this mechanism can be helpful in closing out liquid securities readily available in the marketplace, it will have limited utility with respect to illiquid or thinly traded securities where finding a position within the tight timelines will be difficult.

- **CIRO is contemplating a new order marker to identify purchases made on a marketplace for the purpose of closing out a fail to deliver position. Are there any operational challenges faced in introducing this new marker?**

  In recent years we have worked with our service providers to successfully introduce several new order markers. The challenges have varied depending on the complexity of the marker, particularly the number of systems and databases needed to feed correct information to the marker.

  The challenge we see with the new marker contemplated in the Proposal will be to correctly map purchases made on a marketplace directly with the fail to deliver that propagated the order. Back office and front office systems will need to be integrated to accomplish this. We

therefore expect this order marker to pose challenges and would contribute to the extended implementation period we think necessary for this Proposal.

We agree with CIRO that this proposed new marker should only be used for regulatory purposes and not displayed on the marketplace.

- **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?**

  Under the Proposal, if we can demonstrate the fail related to our Marketplace Trading Obligations for that security we would have three days after settlement date to close out (S+3). However, other orders that we mark as short order exempt (SME) that are not part of our Marketplace Trading Obligations would be closed out by one day after settlement (S+1).

  The Proposal, therefore, requires us to introduce an added level of supervision to ensure that any reliance on the S+3 close-out timeframe is strictly for SME marked orders related to our Marketplace Trading Obligations.

  UMIR permits the use of the SME marker for various trade scenarios other than trades related to our Marketplace Trading Obligations, including certain automated orders, arbitrage accounts and facilitation trades. These other trading scenarios also contribute to efficient market functioning and, therefore, justifications can be made to extend the S+3 close-out timeline to all SME marked orders.

  Replicating the S+3 close-out timeline across all SME orders would also simplify the controls required in this area.

- **Are there situations, other than 'deemed to own securities', that would warrant an extended close-out timeline?**

  As per our earlier comments, we think that the S+1 close-out timeline proposed for Exchange Traded Funds is problematic and needs to be extended. Additionally, the S+1 close-out timeline may be a challenge for some structured products, such as closed-end funds, where buying or borrowing a security within a short time frame may not always be possible.

- **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 be appropriate for Canada, or should CIRO consider restricting short selling altogether where there is a failure to deliver?**

  Short selling promotes liquidity, facilitates price discovery, reduces portfolio risk and helps bring markets into equilibrium. Short selling, therefore, serves a very important role in the efficient functioning of our capital markets. Restricting short selling where there is a failure to deliver will jeopardize the quality of our markets.

The Proposal's pre-borrow requirement on future short sales related to failed-to-deliver positions should be sufficient to address market integrity concerns. We do not believe it appropriate, therefore, to restrict short-selling altogether when there is a fail-to-deliver position.

- **Is the proposed implementation period of no less than six months appropriate?**

  For many of the reasons previously outlined in our letter, the time involved in implementing the systems, procedures, reports, and supervisory controls necessary to fulfill the Proposal's requirements will be lengthy.

  Given our large Canadian settlement volumes, we would need to build automated solutions to meet the Proposal's requirements. We need ample time to design, resource and build these solutions. Additionally, the Proposal represents holistic change to current Canadian practices, as such, will require that time be devoted to educating impacted staff, clients and counterparties on how the Proposal impacts them.

  Based on our experience in implementing our RegSHO framework, which is at scale significantly smaller than what is covered under the Proposal, as well as considering other recently implemented projects, we believe a minimum of 18 months be given to develop and implement the policies, procedures, systems, controls, reports, and other solutions necessary to comply with the Proposal. Even then it will also require us to prioritize this initiative over other competing priorities so we can re-direct staff and resources accordingly.

- **Overall, do you agree with CIRO's qualitative assessment of the benefits and impacts of the Proposal?**

  CIRO acknowledges that the Proposal will, among other things, require Investment Dealer Members to:

  - Monitor and track fail-to-deliver positions
  - Buy or borrow shares to close out the failed positions within the prescribed timeframes
  - Make pre-borrow arrangements where appropriate
  - prevent short-selling without pre-borrowing for failed positions that have not been closed-out.
  - Implement a comprehensive supervisory system

  We are concerned that CIRO has not properly recognized the time and resources required by CIRO Dealer Members that are clearing and settlement participants of CDS to implement the Proposal.

  Among CIRO's policy objectives are tackling naked short selling and eliminating extended failed trades. It is debatable how severe a problem those issues represent to Canadian capital

markets. We are concerned, therefore, that the policy approach CIRO is contemplating may be extreme and in need of additional review before proceeding further with the Proposal.

Given the expected high number of industry resources that will need to be directed at meeting the Proposal and the potential disruption it may cause it is uncertain that the benefits of the Proposal outweigh the costs that will be collectively incurred by market participants.