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April 10th, 2025

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In care of:

Theodora Lam
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Dear Ms. Lam:

Re: Proposed Amendments Respecting Mandatory Close-Out Requirements – Notice 25-0001

BMO Nesbitt Burns Inc. (BMO NBI) appreciates the opportunity to respond to the Canadian Investment Regulatory Organization's (CIRO) Proposed Amendments Respecting Mandatory Close-Out Requirements, published on January 9, 2025 (Consultation). BMO NBI supports the introduction of the mandatory close-out requirements for failed trades. However, we recommend CIRO provide exemptions for market making activity in Exchange-Traded Funds (ETFs) because of the unique settlement challenges relating to the ETF creation process.

The amendments proposed by the Consultation would inherently predispose ETF market making transactions to the proposed close-out and pre-borrow requirements. ETFs with internationally listed underlying securities, in particular, are negatively impacted. ETF sponsors may require in-kind subscriptions depending on the ETF. In-kind subscriptions are more common when the underlying securities are internationally listed, especially in jurisdictions with longer settlement periods than Canada.

When market makers receive orders for Canadian-listed ETFs with internationally listed underlying securities, particularly those with T+3 settlement or longer, they generally place creation orders with ETF sponsors the following trading day due to subscription cut-off times. Factors such as corporate actions or public holidays in other jurisdictions may cause delays in the market maker delivering the basket of securities to the sponsor. Consequently, market makers may not receive creation units to be able to fulfill delivery requirements even on the third trading day after the settlement date for the initial ETF order. The Ontario Securities Commission (OSC) has previously provided relief to fund issuers including ETF sponsors to allow delayed delivery to address similar settlement challenges.¹ Further, OSC Staff Notice 81-735 regarding cash collateral use for delayed basket securities in ETF subscriptions² reiterated the unique issues associated with ETF creation.

Consequently, we recommend exempting ETF market making from the proposed mandatory close-out requirements due to the unique settlement constraints relating to in-kind ETF subscriptions. Maintaining the current approach to ETF market making ensures the orderly functioning of capital markets while providing flexibility to market participants.

Failure to provide relief from the mandatory close provisions for ETF market making activity could have several negative consequences, including making it necessary for ETF market makers to maintain higher cash reserves to allow for delivery of cash collateral for delayed basket securities. This will disincentivize dealers from engaging in market making and could in turn impact market liquidity.

In addition, s.2.3 of the Consultation proposes that failure to close-out the failed position within prescribed timelines would trigger pre-borrow requirements for all future short sales in the security at issue until the fail-to-deliver position has been reduced to a net flat or net long position. In the context of ETF market makers, the pre-borrow requirement would apply to its trading for its own account or for any of its clients. As described above, market makers may be unable to fulfill settlement requirements due to reasons beyond their control. The pre-borrow requirements in this context are unreasonably punitive and will have a significant negative impact on market makers, disincentivizing them from taking on this role.

Applying the proposed mandatory close-out requirements to ETF market making may hinder the efficient functioning of the ETF market in Canada rather than achieving CISO's regulatory objectives. The mandatory close-out requirements may create additional delays in delivering subscribed ETF units to purchasers, further disrupt the secondary market, leading to further trade failures, and disincentivize market participants from conducting ETF market making activity. We believe an exception to the proposed requirements would not undermine the policy objectives underlying the introduction of more robust requirements around failed trades, including providing more effective control of manipulative activities like abusive short selling, and as a means to mitigate broader systemic problems. ETF market making activity is undertaken to satisfy the market maker's obligations to provide a market for the particular ETF.

¹ *AGF Investments Inc. et al.*, 44 OSCB 3954

² https://www.osc.ca/sites/default/files/2024-05/sn_20240522_81-735_cash-collateral-use.pdf

In addition, as discussed above, the OSC has granted exemptive relief to address these types of settlement challenges in the past.

The current proposal does not seem to provide a viable exemption for ETF market making. Section 2.2.2 of the Consultation provides that a fail-to-deliver position that is attributable to transaction(s) by a person with Marketplace Trading Obligations (as defined in the Universal Market Integrity Rules) when acting in their security of responsibility would be required to be closed out no later than the third trading day after the settlement date. However, as discussed above, this timing may not be sufficient to address the unique settlement challenges associated with in-kind ETF creation. Market makers may also be unable to benefit from the “Deemed to own” exemption described in s.2.2.3 of the Consultation because the creation activity typically occurs after the short sale has taken place.

To reiterate, BMO NBI supports the introduction of mandatory close-out requirements for failed trades. However, given the unique settlement challenges associated with ETF creation, we recommend exempting ETF market making activities from the mandatory close-out requirements.

Sincerely,

A handwritten signature in black ink, appearing to be 'D. Moore', written in a cursive style.

Dave Moore,
Managing Director Capital Markets Compliance and CCO BMO Nesbitt Burns Inc.
BMO Capital Markets