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Canadian Investment Regulatory Organization
Canadian Securities Administrators

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Dear Sirs/Madams,

Re: Comments with respect to the Canadian Investment Regulatory Organization ("**CIRO**") *Notice 25-0001 – Proposed Amendments Respecting Mandatory Close-Out Requirements* ("**Notice 25-0001**")

We are writing in response to the request for comments by CIRO with respect to the questions set out in Notice 25-0001 published on January 9, 2025. We have responded only to questions 4, 6, 12 and 16.

The views, opinions and recommendations expressed in this letter are solely those of the lawyers whose names are set out at the conclusion of this letter, and are not made on behalf of McMillan LLP, or its clients. We would be pleased to provide further insight and additional details with respect to our submissions, and would welcome the opportunity to engage further with CIRO.

Response to Request for Comments:

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?

The adoption and implementation of the Proposed Amendments would significantly diminish the intended purpose of extended failed trade reports ("**EFTR**"), but we would suggest that instead of repealing the reporting process that CIRO adopt a more meaningful mechanism[1]. A reporting mechanism should be introduced to track and report Participants and Access Persons who fail to close out trades by S+3.

While the Proposed Amendments aim to reduce settlement delays through a S+1 close-out requirement, a S+3 reporting mechanism would function as a control to catch persistent failures, potentially drawing negative regulatory or market attention to constant offenders. This interim period allows time for administrative or operational delays to be resolved without triggering unnecessary reporting, while still capturing persistent settlement failures that warrant regulatory attention.

While the Proposed Amendments are expected to improve settlement timelines, this additional reporting requirement would enhance transparency, market integrity and accountability by identifying dealers with persistent settlement failures and the reason for failures to close out trades. At the end of every month, CIRO should disclose an aggregate report of failed trades by Clearing or Allocated Members that were not closed out by S+3. CIRO is already aware of Clearing or Allocated Members that fail to comply with mandatory close-out requirements, and this information should be made available to the broader market. A public reporting mechanism focused on close-out compliance would provide a more transparent and effective alternative to the current regime.

[1] We note that as outlined in our paper on short selling regulation in Canada, *An Analysis of the Short Selling Landscape in Canada*, and subsequently in our comment letter in response to Joint Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada Staff Notice 23-329 – *Short Selling in Canada*, we believe that the timing of the current EFTR filing requirement is neither reasonable nor in the public interest.

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?

The Proposed Amendments suggest imposing a threshold on the premium to the current market price, whereby Clearing Members or Allocated Members would not be required to purchase securities at a greater price than a certain premium to the current market price to close out a failed-to-deliver position. We note that Regulation SHO does not impose any such premium. The mandatory close-out and pre-borrow requirements under the Proposed Amendments are substantially identical to Regulation SHO in the U.S., which highlights the significance of any departure from Regulation SHO, such as the proposed premium threshold exception. CIRO's proposal for a premium threshold exception does not appear to align with Regulation SHO in the U.S, and this divergence warrants further scrutiny. As such, we make the following observations regarding the proposed premium threshold.

Most shorting activity originates from the clients of Clearing or Allocated Members. CIRO may be concerned that, without a premium threshold, Clearing or Allocated Members may close-out a failed trade at an excessive price and pass the cost on to the client. However, we believe that a premium threshold to the current market price is not an effective tool to address this risk. The premium threshold may operate as an "out" for Clearing or Allocated Members who do not wish to close-out. Clearing or Allocated Members can state that the cost of closing out exceeds the premium and therefore opt to not settle the failed trade.

Instead, a more effective method to address this issue may be to simply implement a rule specifically requiring Clearing or Allocated Members to act fairly in the context of short selling. It is our view that most Clearing or Allocated Members will want to avoid passing exorbitant costs to their clients as a matter of good business practice and to maintain their client relationships. In addition to a registrant's obligation to deal fairly, honestly and in good faith with their client under securities legislation, we also note that the Investment Dealer and Partially Consolidated Rules (the "**IDPC Rules**") already require Regulated Persons (as defined in the IDPC Rules) to "observe high standards of ethics and […] act openly and fairly and in accordance with just and equitable principles of trade" under Rule 1402.[2] However, if CIRO is of the view that an additional regulatory tool is required, we suggest implementing a

[2] Investment Dealer and Partially Consolidated Rules (19 March 2025) at 1402, online (pdf): Canadian Investment Regulatory Organization < https://www.ciro.ca/media/16/download?inline >.

rule in UMIR that *specifically* requires Clearing or Allocated Members to act fairly, honestly and in good faith with their clients when closing out a failed trade. This scheme would also align more closely with Regulation SHO. If the premium threshold seeks to address a different issue or risk, please let us know and we would be happy to provide an updated comment.

Regarding whether an exception should be granted to allow close-outs to be executed off-marketplace, we would suggest a cautious approach. Rule 6.4(1) of UMIR requires that all trades take place on a marketplace. Rule 6.4(2) sets out eleven exceptions to this rule. Practically, allowing participants to close-out a position off-marketplace may be a suitable alternative in instances where closing out on the marketplace on commercially reasonable terms is not possible. However, it is our position that such a practice should be rare. Participants should be required to close-out on the marketplace where possible for efficiency and transparency purposes. Therefore, we suggest that, to the extent this exception is implemented, it be limited to circumstances where the Clearing Member or Allocated Member can demonstrate, if prompted, that the close-out could not be executed on a marketplace on commercially reasonable terms. Any other grounds for allowing this exception can be explored after the Proposed Amendments have been implemented and data can be gathered on the potential benefits of expanding the exception.

As an aside, we note the language pertaining to commercially reasonable terms and premium limits has not been incorporated into the Proposed Amendments to UMIR and the IDPC Rules. We assume this was inadvertent.

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?

While harmonizing Canadian close-out requirements with Rule 204 of Regulation SHO is a positive step, it remains uncertain whether this alignment alone is sufficient to address the impact of fail-to-deliver positions in Canada. Given key differences in market size, liquidity, and sector composition, Canada's approach to short selling regulation should consider the distinct features of its own capital markets. A thorough analysis of failed trade data, liquidity effects, and investor confidence – supported by increased transparency and disclosure from CIRO – will be essential in assessing whether additional measures are necessary to uphold market integrity.

Since Canadian markets differ from those in the United States, Rule 204 in Regulation SHO may not be entirely suitable if short selling has a more significant impact in Canada. The decision should be guided by empirical data and market trends specific to Canada. If fail-to-deliver positions are more frequent or disruptive, stricter penalties – such as restricting short selling in affected securities until broker-dealers close out positions – may be necessary to maintain market stability.

Notice 25-0001 noted that current trade failure rates in Canada are roughly the same as those in the U.S. before the implementation of Rule 204 of Regulation SHO, after which the U.S. saw a decrease in failures-to-deliver.[3] However, to make a more complete comparison, we believe it is important to look beyond trade failure rates and also consider the reasons behind failed trades and their impact on the market. This broader analysis would provide a more meaningful understanding of how trade failures affect each market and ensure a more accurate comparison between the two.

While the percentage of fail-to-deliver positions in Canada is relatively low, it is not clear whether these failures are often driven by repeat offenders who integrate such practices into their short selling strategy. As a result, Reg SHO close-out requirements may exhibit a diminished deterrent effect in Canada, where failure-to-deliver positions could be more likely to be the result of deliberate actions rather than unintentional occurrences. This is particularly relevant given that Reg SHO's close-out requirements include carve-outs, such as extended settlement deadlines in certain circumstances, which could potentially be leveraged by these actors to bypass the rules.

Moreover, Canada's market size and structure may amplify the effects of failed trades, requiring stronger close-out requirements. Canada's smaller market, with fewer large-cap companies, makes Canadian stocks more vulnerable to volatility caused by short selling and failed trades. Heavily shorted stocks in a smaller market can lead to sharp price declines due to lower liquidity. Price swings in stocks with lower trading volumes increase volatility and make the market itself less stable. U.S. markets, on the other hand, have a much broader range of companies, greater liquidity, and higher trading volumes, which can absorb short-selling pressures more effectively.

The Canadian stock market further differs from U.S. markets due to the heavy concentration of stocks in certain sectors, such as energy, mining, and financials, which are prone to sharp price fluctuations, making them even more susceptible to the effects of short selling[4]. Additionally, retail investors account for a larger share of total trading volume in Canada, increasing their exposure to the impacts of short selling compared to their U.S. counterparts.

Should empirical data reveal that these characteristics of Canadian markets contribute to a noticeable increase in volatility or market instability, it would warrant further consideration of more stringent regulations in relation to fail-to-deliver positions. A first step toward making this determination would be for CIRO to publish a study and analysis of the data it currently holds on short selling activity and failed trades. Such study and analysis should then be

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[3] Notice 25-0001 noted that, when Regulation SHO was introduced in the U.S. in 2004, trade failure rates were around 1%, similar to current levels in Canada, and after implementing temporary mandatory close-out rules through Rule 204, failures-to-deliver in equity securities dropped by 56.6%.

[4] Failed Trade Study (December 8, 2022) online (pdf): Canadian Investment Regulatory Organization https://www.ciro.ca/media/3744/download?inline=1

updated on a yearly basis, allowing for a clearer understanding of their impact on market dynamic.

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.

We find a six-month implementation period following the publication of the final amendments to be reasonable. In our view, the Proposed Amendments, as currently drafted, primarily constitute an operational change rather than a technological one, meaning Investment Dealer Members would not need to implement or adopt new technology. The most time-consuming aspect for participants is likely to be the addition of reporting requirements for allocated trades. However, if a member already has a reasonable expectation to settle, then compliance with the Proposed Amendments should not pose a significant burden.

If you wish to discuss any aspect of this letter, we would encourage you to contact any one of the following lawyers who would be pleased to speak to you at your convenience:

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