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Re: Proposed Amendments Respecting Mandatory Close-out Requirements

The Canadian Security Traders Association, Inc. (CSTA) is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling, and trading of securities (mainly equities). The CSTA represents over 850 members nationwide and is led by Governors from each of four distinct regions (Toronto, Montreal, Prairies and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world. This letter was prepared by CSTA Trading Issues Committee (TIC) representatives with various areas of market structure expertise. It is important to note that there was no survey sent to our members to determine popular opinion. The views and statements provided below do not necessarily reflect those of all CSTA members or of their employers.

We thank you on the opportunity to comment on the proposed amendments respecting mandatory close-out requirements. As noted, the proposed requirements are the culmination of a series of publications related to short selling activity in Canada. The CSTA TIC understands the industry's concern. However, we question the extent of the perceived problem being addressed with respect to the high cost of the measures being proposed to remedy it. CIRO's Failed Trade Study from 2022 concluded that there was only inconclusive evidence of any correlation between settlement issues and short selling, and that no work was conducted to establish and cause-and-effect relationships between them." We

suggest that further study on this topic is needed before such a mandatory close-out regime be implemented.

Given the lack of evidence illustrating abusive short selling behaviour, we prefer a "do no harm approach" to Canada's short selling regime. Instead, we suggest regulators make better use of existing tools by increasing enforcement of current buy-in rules before creating new costly requirements.

Notwithstanding this broad objection, and somewhat limited in scope to the institutional trading focus of our constituents, we will attempt here to provide some broad commentary on the best approach to these proposed rules, after which we will answer the specific questions put forth that such as fit our purview.

We agree the burden to monitor and enforce penalties for extended failed trades correctly belongs with the Clearing Member / CDS Participant. Clearing Members are best positioned to monitor, allocate, and potentially close out failed trades. We also agree applying a pre-borrow requirement on all shorts sales, all the time, across all Investment Dealers, would be unreasonably punitive. In the case of extended failed trades, a mandatory pre-borrow requirement within the offending Clearing Member would certainly discourage further naked short selling across its clients, even while also being heavy-handed.

We think the proposed timelines to enforce mandatory close outs are reasonable, though the implementation costs are likely far greater than anticipated. We agree it would be overly burdensome to act on each extended failed trade; CIRO should instead favour monitoring the net fail-to-deliver situation at each CDS Participant. We urge CIRO to collaborate with other regulators to limit the potential for regulatory arbitrage and to pull all CDS Participants in scope of this proposal.

What follows is our response to CIRO's 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 CIRO requirement that would only affect Investment Dealer Members that are within CIRO's jurisdiction.
Would the Proposed Amendments create an incentive for Investment Dealer Members to seek entities that are not regulated by CIRO for clearing purposes, and/or create disadvantages for Investment Dealer Members that currently offer clearing and settlement?

Yes. We are concerned with the potential for regulatory arbitrage across CIRO and non-CIRO firms.

We suggest CIRO collaborate with other regulators as needed to bring all parties responsible for clearing equity trades, including all CDS Participants, into scope.

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

We can't quantify the readiness of Clearing Members and Investment Dealers. The indication from many CSTA TIC members' firms is that tracking and allocating fail-to-deliver positions will be a considerable burden for Clearing Members. This burden would be even greater in the case CDS Participants need to assign buy-ins to third party Investment Dealers. Further, significant automation of these new processes would be needed for such scale as we anticipate would be needed. Estimates of implementation costs varied across TIC members but all were in the magnitude of multiple millions of dollars and timelines were uncertain.

Additionally, all SME orders should be treated with the same timelines as a long-sale close-out, regardless of marketplace trading obligations. SME order types are crucial to ongoing liquidity provision and, by definition, the SME-tagging dealers cannot know if they going to finish their day long or short, so assigning different potential close-out timelines on these sales would be confusing and have a significant negative impact on liquidity.

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?

Significant systems implementation would be required to monitor and manage failed delivery and mandatory close-outs between Clearing Brokers and other Investment Dealers. Cases of a Carrying Broker to Introducing Broker relationship would exacerbate timelines and overall burden of maintain such compressed timelines on mandatory buy-ins

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?

Yes. We suggest reporting failed trades by CDS Participant, by type and duration as described in question two.

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?

Regulators should monitor Clearing Brokers for net fail-to-deliver situations and Clearing Brokers should be incentivized to monitor and manage the settlements of their Investment Dealer clients. If the penalties for net fail-to-deliver situations are punitive enough, it ought to provide a strong incentive for Clearers to remedy failed trades before they become extended failed trades. The pre-borrow requirement also incentivizes Investment Dealer clients to shop around for the best, most competent Clearing Broker since only the Clearing Brokers with frequent net-fail-to-deliver situations would have mandatory pre-borrow.

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?

Close outs should be done on a marketplace, immediately after the end of continuous trading to minimize disruption. Regarding the process and mechanism used to facilitate the close out of an extended failed trade, we have a few ideas and look forward to working through more formal proposals on this aspect of the rules' implementation.

Some TIC members have suggested modeling the close out trade auction similar the TSX Price Movement Extension (TSX PME). The TSX PME is used attract additional liquidity to the TSX Market on Close facility in cases where the Calculated Closing Price exceeds certain boundaries. The TSX PME is a familiar process, and there is considerable overlap between TSX participants and Clearing Members. Any Clearing firm that is not a Investment Dealer and a TSX participant could appoint a delegate to help executed the close out.

Messages communicating mandatory close out auctions would be sent out before market open on trade date and the close out auction itself would begin immediately after the regular 4:00pm auction. These close out message might state the side, shares, and an indicative price. Participants would then submit limit orders to fill the shares for the next 10 minutes. The indicative price would be punitive relative to

auction price (e.g., 5% worse than the official closing price). Since the close out must be filled, the indicative price would be continuously disseminated at more and more adverse prices until a contra order(s) is found. This process would encourage participants to buy shares in the closing auction and provide liquidity back to the close out. The close out price would not impact the official closing price at the exchange nor would it be included as "last sale".

There are sure to be further details to work out in such a new mechanism and CSTA TIC members look forward to contributing to any working group as may be appointed for its design.

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.

Any trades related to close outs should be public, tagged as special terms, and executed after the close of continuous trading. We discussed some ideas around how this auction might be structured in our response to Question 5.

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?

a) Yes – the use of average price or accumulation accounts would exacerbate the already challenging process of allocating failed delivery to specific clients, especially in the case of an Introducing Broker –Clearing Broker relationship.
b) The SME marker should invoke timelines consistent with long-selling, regardless of the marketplace trading obligations of the member for that security. Liquidity provision in Canada is provided by a network of dealers and non-dealer clients and inconsistent application of the mandatory close-out would advantage some liquidity providers over others.

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?

Yes, requiring pre-borrow for dealers with fail to deliver positions in a given security is reasonable. However, prohibiting short selling altogether for any member would be unnecessarily onerous and serve ultimately to harm liquidity and trading conditions.

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?

Yes, given the intent of this proposal, consolidation of the rules seems appropriate.

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.

The benefits of the proposal are limited. Evidence of broad-based naked short selling is scant and systematic failure to deliver securities is not a pervasive problem in Canadian markets. Estimates of the costs for implementation of such a regime are varied, but all TIC Members agreed they would be on the order of several millions of dollars per member. The overall cost of this proposal seems meaningfully out of line with the potential benefits.

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.

We suggest being flexible on the implementation date based on the feedback of those most impacted. Hard timelines will only become understood as vendors develop their own implementation plans.

The CSTA TIC believes we all have a collective interest to protect and preserve a Canadian equity market that is fair and efficient for everyone. We thank you for the opportunity to comment on the Proposed Amendments Respecting Mandatory Close-out Requirements. We would be happy to continue the discussion in-person or virtually.

CSTA TIC