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Dear Sirs/Mesdames,

Re: Comments with respect to the Canadian Investment Regulatory Organization ("**CIRO**") Notice 24-0003 – *Proposed Amendments Respecting the Reasonable Expectation to Settle a Short Sale* (the "**Proposed Amendments**") and Notice 24-0004 – *Proposed Guidance on UMIR Requirements Related to Short Selling and Failed Trades* (the "**Proposed Guidance**", and together with the Proposed Amendments, the "**Notices**")

We are writing in response to the request for comments by CIRO with respect to the questions set out in the Notices published on January 11, 2024.[1]

Introduction

At the outset, we wish to commend CIRO for its continued re-evaluation of the Canadian short selling regime. The Proposed Amendments represent a significant step forward and we look forward to further engagement from CIRO on this important issue.

In this response letter, we begin with an assessment of the Proposed Amendments and a comparison to the relevant U.S. rules. We note that the Proposed Amendments more closely

[1] CIRO, *Notice 24-0003 – Proposed Amendments Respecting the Reasonable Expectation to Settle a Short Sale* (11 January 2024), online (pdf): *Canadian Investment Regulatory Organization* <https://www.ciro.ca/news-room/publications/proposed-amendments-respecting-reasonable-expectation-settle-short-sale>; CIRO, *Notice 24-0004 – Proposed Guidance on UMIR Requirements Related to Short Selling and Failed Trades* (11 January 2024), online (pdf): *Canadian Investment Regulatory Organization* <https://www.ciro.ca/news-room/publications/proposed-guidance-umir-requirements-related-short-selling-and-failed-trades> [*Notices*].

align with the U.S.' "reasonable grounds" standard under Regulation SHO[2]. We conclude that further clarification on certain aspects of the Proposed Amendments and the Proposed Guidance would be welcomed. We also reiterate the need for a review of whether mandatory buy-ins should be required and encourage CIRO to consider more transparent disclosure with respect to short selling.

Analysis of the Reasonable Expectation Standard in the Proposed Amendments

The Proposed Amendments represent a clear strengthening of the "reasonable expectation" requirement in Canada and a significant step forward in aligning the Canadian short selling regulatory regime with other similarly situated jurisdictions.

CIRO's predecessor had, in prior guidance, stated that to meet the reasonable expectation standard, Participants[3] and Access Persons[4] must have "reasonable certainty" that they can access sufficient securities to settle the trade by the settlement date. We have written that this appeared to be a higher standard than previously articulated by CIRO's predecessor.[5] While neither the Proposed Amendments nor the Proposed Guidance use the words "reasonable certainty", the Proposed Amendments and the associated Proposed Guidance continue to impose a higher standard than originally articulated by CIRO's predecessor, particularly by making it clear that (i) a reasonable expectation must be formed prior to order entry, (ii) Participants and Access Persons should take steps, including through the use of easy-to-borrow lists ("**ETB Lists**"), to demonstrate a reasonable expectation to settle, and (iii) documenting such steps would help Participants and Access Persons demonstrate compliance with proposed Universal Market Integrity Rule ("**UMIR**") 3.3.[6]

Comparison to other jurisdictions

We have previously written on the misalignment of Canada's own short selling regulatory regime with that of other well-established financial markets. The Proposed Amendments

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[2] *Short Sales: Proposed Rule*, SEC Release No. 34-48709 (28 October 2003) at § 242.203(b), online (pdf): *U.S. Securities and Exchange Commission* <https://www.sec.gov/rule-release/34-48709>, as adopted in Securities and Exchange Commission Release No. 34-50103 (2 August 2004) at Section V, online (pdf): *U.S. Securities and Exchange Commission* <https://www.sec.gov/rule-release/34-50103#V> [*SEC Release No. 34-48709*].

[3] "Participant" is defined in UMIR, and means generally, (i) a dealer registered in accordance with securities legislation of any jurisdiction and who is a member of an Exchange (as defined in UMIR), a user (as defined in National Instrument 21-101 – *Marketplace Operation* ("NI 21-101")) of a recognized quotation and trade reporting system, or a subscriber (as defined in NI 21-101) of an alternative trading system; or (ii) a person who has been granted trading access to a marketplace (as defined in NI 21-101) and who performs the functions of a derivatives market maker (as defined in UMIR).

[4] "Access Person" is defined in UMIR, and means a person, other than a Participant, who is a subscriber or a user.

[5] McMillan LLP, *Comments with respect to the Joint Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada Staff Notice 23-329 – Short Selling in Canada* (22 February 2023), online (pdf): *Investment Industry Regulatory Organization of Canada* <https://www.iiroc.ca/sites/default/files/2023-02/McMillan%20LLP%20-%20February%2022%2C%202023.pdf> [*2023 Comment Letter*] at 15.

[6] *Supra* note 1.

appear to bring Canada closer to alignment, and in particular appear to adopt a slightly softer version of the Regulation SHO "locate" requirement as described below.[7]

In the U.S., the "locate" requirement of Regulation SHO requires that prior to effecting a short sale, broker-dealers must have either borrowed or entered into an arrangement to borrow the security, or have reasonable grounds to believe the security can be borrowed in time for delivery on the settlement date. This "locate" requirement must also be documented by the broker-dealer. The U.S. Securities & Exchange Commission ("**SEC**") noted that ETB Lists may provide "reasonable grounds" for a broker-dealer to believe that a security sold short is available for borrowing without directly contacting the source of the borrowed security.[8] For a broker-dealer to reasonably rely on such lists, the information used to generate the ETB List must be less than 24 hours old, and the securities on the list must be readily available such that it would be unlikely that a failure to deliver would occur.[9] Absent adequately documented mitigating circumstances, repeated failures to deliver securities on an ETB List would indicate that the broker-dealer's reliance on such a list does not meet the "reasonable grounds" standard.[10]

Additionally, in the U.S., where a broker-dealer seeks to rely on a client's assurances that it can make available the relevant securities for settlement in order to establish "reasonable grounds", the broker-dealer must investigate such client's trade history in order to determine whether the client has a history of failure-to-delivers.[11] If the client does have such a history, then the broker-dealer may not be able to rely on the client's assurances.

The Proposed Amendments and the Proposed Guidance appear to replicate, to an extent, the "reasonable grounds" requirement of Regulation SHO and in many ways mirror the associated commentary from the SEC. The Proposed Amendments require that participants have a reasonable expectation *prior* to order entry, much like the "reasonable grounds" standard. However, the Proposed Amendments and the Proposed Guidance do not appear to mandate documentation (beyond the general requirement contained in UMIR[12] to document compliance with such rules), but instead provide that "documenting how a reasonable expectation to settle prior to order entry was established would help Participants and Access Persons demonstrate compliance with [the Proposed Amendments]".[13]

The Proposed Guidance, like in the U.S., emphasizes that client history is an important factor affecting the "reasonable expectation" standard, noting that where a client has a history of failed trades, it would not be reasonable to rely on assurances from the client that they have access to the securities necessary to settle the trade. The Proposed Guidance, like the

[7] SEC Release No. 34-48709, *supra* note 2 at Section V.
[8] *Ibid.*
[9] *Ibid*.
[10] *Ibid*.
[11] *Ibid*.
[12] CIRO, *Universal Market Integrity Rules* (27 July 2023), online (pdf): *Canadian Investment Regulatory Organization* < https://www.ciro.ca/media/7526/download?inline>.
[13] Proposed Guidance at 4.1.

guidance from the SEC, indicates that it is important to understand the underlying reason for previous failed trades by a client in order to assess whether a "reasonable expectation" exists. However, it is not clear from the Proposed Guidance whether there is any requirement or expectation that the Participant or Access Person investigate a client's trading history in order to rely on a client's attestations, whereas the SEC has made clear that in order to rely on a client's assurances as a basis for "reasonable grounds", the broker-dealer must make reasonable efforts to obtain information on trading history from the client.

The Proposed Guidance specifically mentions the use of ETB Lists as a method by which Participants can demonstrate a reasonable expectation to settle. The parameters of these ETB Lists are also similar to those of the U.S, with CIRO (like the SEC) indicating that failures of a security on an ETB List would make the list difficult to rely on.[14] While the SEC has the 24-hour recency requirement for reliance on ETB Lists as noted above, the Proposed Guidance indicates that the ETB List should be monitored and updated "on a regular basis", with no further clarification as to what constitutes updating on a "regular basis".[15] The Proposed Guidance also indicates that the expectation is that Participants only use and rely on ETB Lists that they have compiled or received from a dealer that they have a "formal relationship" with regarding clearing or settlement, which is similar to guidance provided by the SEC.[16]

The SEC has also specifically noted that simply because securities are not on a "hard-to-borrow" list does not mean that such securities are easy-to-borrow and accordingly does not mean that the broker-dealer has "reasonable grounds" simply because securities are not on a hard-to-borrow list.[17] The Proposed Guidance also specifically notes this requirement.[18]

In summary, while we are pleased that the Proposed Amendments and the Proposed Guidance establish a similar "locate" requirement as that imposed in the U.S., we would encourage CIRO to (i) mandate specific documentation reflecting compliance, (ii) provide more clarity as to how often ETB Lists should be updated, and (iii) require that Participants and Access Persons investigate a client's trading history where a client provides assurances with respect to settlement.

Mandatory Buy-Ins Should Still Be Considered

We have previously written about the need for mandatory close-out/buy-in procedures. As we have described in our 2023 Comment Letter[19], mandatory close-out procedures exist in some form in the U.S. and are awaiting implementation in the EU, and to this end, the Canadian short selling regime again stands in contrast to other jurisdictions in not providing for a buy-in mechanism. We are therefore pleased that Canadian Securities Administrators

[14] *Ibid* at 4.4.
[15] *Ibid*.
[16] *Ibid*.
[17] SEC Release No. 34-48709, *supra* note 2 at Section V.
[18] Proposed Guidance at 4.4.
[19] 2023 Comment Letter at 29.

("**CSA**") staff is exploring mandatory close-out requirements. We would encourage the CSA and CIRO to put forward mandatory close-out/buy-in procedures that would foster public confidence in capital markets by helping ensure the timely delivery of securities by settlement date in connection with short sales.

Disclosure

While not the focus of the Proposed Amendments, we strongly encourage CIRO to review and consider the need for better transparency with respect to short selling. We believe this is especially important given that other jurisdictions are trending towards increased transparency. For example, in the U.S., "institutional investment managers" that meet or exceed certain thresholds[20] will soon be required to file monthly reports on "Form SHO" for a broad spectrum of "equity securities". These reports will include detailed short sale position data and information regarding short sales and acquisitions of the relevant security for each settlement date during the calendar month. This data will be aggregated and publicly disseminated by the SEC, and will include the gross short position at the end of the month and daily net activity for each settlement date during the calendar month for an issuer. These developments mark a significant effort towards public transparency.[21] For a detailed discussion of our views on disclosure and the need for transparency, please see our 2019 Short Selling Paper[22], our 2021 Comment Letter[23], and our 2023 Comment Letter.[24]

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.

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[20] For securities of SEC reporting companies, the thresholds are either a monthly average gross short position with a U.S. dollar value of $10 million or more at the close of regular trading hours during the calendar month or a monthly average gross short position equal to 2.5% or more of the shares outstanding of that reporting issuer.
[21] U.S. Securities and Exchange Commission, *Release No. 34-98738* (13 October 2023), online (pdf): *Securities and Exchange Commission* < https://www.sec.gov/files/rules/final/2023/34-98738.pdf>.
[22] McMillan LLP, *An Analysis of the Short Selling Landscape in Canada: A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risks* (October 2019), online (pdf): *McMillan LLP* <https://mcmillan.ca/wp-content/uploads/2020/07/An-Analysis-of-the-Short-Selling-Landscape-of-Canada-Digital.pdf> [*2019 Short Selling Paper*].
[23] McMillan LLP, *CSA Consultation Paper 25-403 – Activist Short Selling* (3 March 2021), online (pdf): *Ontario Securities Commission* <https://www.osc.ca/sites/default/files/2021-03/com_20210303_25-403_mcmillan.pdf> [*2021 Comment Letter*].
[24] 2023 Comment Letter at 24-28.

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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