April 9, 2024

VIA E-MAIL

Canadian Investment Regulatory Organization
Market_Regulation_Policy@ciro.ca

Dear Sirs and Mesdames,

Re: Proposed Guidance on UMIR Requirements Related to Short Selling and Failed Trades (the "Consultation Paper")

We at Select Vantage Canada Inc. thank CIRO for this opportunity to comment on the Consultation Paper.

Unnecessarily Restrictive Means of Establishing a "Reasonable Expectation to Settle"

The principle that all orders entered into the market (whether long, short, or sell) should have a "reasonable expectation to settle" is absolutely foundational to market integrity.

However, the amendments proposed in the Consultation Paper permit, in effect, only two means by which to demonstrate a "reasonable expectation to settle" a short sale: either by having an unconditional contract to purchase, or having issued irrevocable instructions to convert or exchange another security into, the security in question (section 2.1 of the Consultation Paper), or by obtaining an easy-to-borrow list of the security in question (section 4.4). The only solution proposed to securities that are "hard to borrow"[1] is "pre-borrowing a sufficient number of securities to settle the trade where appropriate", which loops back into section 4.4. Although the Consultation Paper reads as if the means specified in sections 2.1 and 4.4 are *non-exclusive* examples of how to establish a "reasonable expectation to settle" – and section 4.2 identifies past failed trades as a contra example of not having a "reasonable expectation to settle", which suggests there is some other legitimate scope of activity in between the Consultation Paper's examples of reasonable versus unreasonable expectations to settle - the logic of the Consultation Paper guidance is such that sections 2.1 and 4.4 are the *exclusive* means by which to establish this intention. (For the purposes of our comments below, we assume the substantial majority of securities sold short will be captured under the pre-borrow requirements of section 4.4.)

If our interpretation is correct, we believe the guidance as currently drafted is unnecessarily restrictive.

[1] Footnote 32 to the Consultation Paper guidance defines "hard to borrow" stocks as "difficult to borrow or unavailable for borrowing".

A number of proprietary trading firms, whether through algorithmic means or by adopting internal trading procedures, routinely cover their short positions on or before settlement date (usually same day) by going into the market to purchase corresponding long positions. Our firm in particular enforces such internal procedures, and on a review of our trading from January 2, 2023 to March 28, 2024, *absolutely all* (100%) of our short sales on Canadian marketplaces were netted to zero before settlement by offsetting share purchases (with a few exceptions of shares subject to intervening *force majeure* events such as trading halts or de-listings). Such trading performance is overwhelming evidence of our corporate intention to settle our short sales (or to be more accurate, our corporate intention to net our short positions to zero before settlement), but this is unfortunately not acknowledged by the Consultation Paper guidance.[2]

Costs and Implications of Implementing a Pre-Borrow Regime

We caution that mandating a pre-borrow regime, as opposed to contemplating it as one of several means of ensuring settlement, will likely impose material new trading costs on the industry.

Section 4.4 stipulates in part: "We expect that Participants and Access Persons would only rely on easy-to-borrow lists that they have compiled or from dealers with whom they have established a formal relationship regarding clearing or settlement, as such dealers usually provide assurances to their clients that securities included on these lists are readily available." We strongly believe this will result in the following: (a) legally binding pre-borrow contracts, and (b) pre-borrow fees of some form. Dealers can only provide such assurances if they have internally reserved a defined number of the shares in question, and since such reservation imposes an opportunity cost of not themselves being able to sell or otherwise loan such shares for the agreed time period, these dealers will likely charge a premium per share so reserved proportional to its overall liquidity.

In response to Regulation SHO, the U.S. securities industry has developed an extensive pre-borrow (or "short locate") market, with numerous clearing brokers quoting on pre-borrowed shares. Generally, "easy to borrow" stocks can be borrowed at a nominal or no fee, whereas "hard to borrow" stocks can attract significant pre-borrow fees. Based on a firm's trading profile, it may also qualify for a fixed pre-borrow fee per month. Unfortunately, this extensive shadow market is very opaque and most trading industry participants have no sense of the market cost of pre-borrows as there is no centralized marketplace for this service and no transparent reporting of pre-borrow costs by clearing brokers.

[2] Similarly, IIROC Guidance Note 16-0029 does not recognize our non-directional trading as qualifying for the "short marking exempt" (SME) marker because we do not employ "fully automated" order generation and entry, despite our trading being clearly "SME like" in its result.

In our experience of U.S. trading, we generally have three to four clearing brokers who offer us very competitive rates because of our track record of netting our short positions to zero on trade date (meaning the clearing broker almost never delivers any borrowed stock, but has the capacity to do so if required). Despite this cost advantage, in reviewing our trading on U.S. markets in January and February 2024, pre-borrow costs equalled 7.1% of our U.S. trade execution costs[3].

We cannot predict how Canadian firms will charge for pre-borrows, but we expect Canadian clearing brokers with affiliated U.S. clearing brokers will be the first to adopt the U.S. model for pre-borrow pricing, and then Canadian-based clearing broker businesses will follow suit. As a result, a significant new trading cost will be imposed on the Canadian securities trading industry – particularly in the sector of "hard to borrow" stocks. This cost deterrent on shares being sold short will result in some measurable decrease in overall traded liquidity and price discovery. This will be even more pronounced with "hard to borrow" shares that are, as CIRO defines them, "unavailable for borrowing". Trading in these already illiquid names, with restricted public floats, will be the most negatively impacted by this new guidance.

Our Proposal for a Third Alternative

We urge CIRO to consider adding to its guidance a third means by which to establish a "reasonable expectation to settle", and that is through something to the effect of the following:

(a) the Participant has adopted an internal policy expressing its corporate intention that proprietary short sales in a particular basket of stocks must be netted to zero by open market purchases on or before settlement, and for clients of a Participant, they must have each adopted such a policy as disclosed in writing to the Participant; and

(b) the Participant must have documented procedures whereby it monitors its traders for compliance with the policy, and has designated administrative staff who will execute the necessary covering open market purchases if it appears the trader in question is not doing so, and in the case of clients they must disclose in writing to their Participant dealer the foregoing procedures.[4]

Such an internal policy may cover all the firm's trading, or be limited to a sub-set of stocks (for example "hard to borrow" stocks, because the firm may otherwise rely on relatively cheap or free pre-borrows of "easy to borrow" stocks).

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[3] These were based on our U.S. brokerage fees, regulatory fees, clearing and settlement fees, and exchange fees. We excluded market data fees from this calculation because those do not exactly scale with the volume of trading conducted and are not comparable to Canada's generally higher level of market data cost per share traded.

[4] IIROC Guidance 16-0029 already allows an algorithmic trading firm that is directionally neutral to utilize the SME marker, which thereby establishes a "reasonable expectation to settle".

Reliance on such means would be conditional on the Participant or client not failing to settle on short sales above a *de minimis* threshold (for example, over any calendar month the lesser of (i) some absolute number and/or value of shares, and (ii) some small percentage of all of that Participant's or client's volume and/or value sold short under their particular internal policy), except for instances entirely outside its control such as stock halts or de-listings. If the Participant or client exceeds such threshold, it would afterward rely on sections 2.1 or 4.4 until it has demonstrated some reasonable period (say, three months) of being able to enforce its internal trading policy on netting-out short sales before settlement and related procedures.

We believe adoption of such a "safe harbour" alternative to sections 2.1 and 4.4 of the Consultation Paper will continue to protect the market integrity of all short sales, while avoiding the potentially costly and liquidity-reducing alternative of requiring the use of pre-borrows, particularly for "hard to borrow" stocks.

Sincerely,

Mario Josipovic
Chief Compliance Officer and General Counsel