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Re: CIRO Request for Comments 24-0003 issued on January 11, 2024 - Proposed Amendments Respecting the Reasonable Expectation to Settle a Short Sale, and
CIRO Request for Comments 24-0004 issued on January 11, 2024 - Proposed Guidance on UMIR Requirements Related to Short Selling and Failed Trades

The **Canadian Independent Finance and Innovation Counsel** appreciates the opportunity to provide comments to CIRO regarding short selling.

The Canadian Independent Finance and Innovation Counsel represents national Investment Dealers and their industry's position on securities regulation, public policy, and industry issues. We represent notable CIRO-regulated Investment Dealers in the Canadian securities industry.

What is the regulatory intention of the Proposed Amendments and Guidance and the position of the industry?

CIRO, as it states, "is working on ways to support the current short selling framework, in part by reinforcing the obligation to have a reasonable expectation to settle a short sale on settlement date."

Many Investment Dealers agree with the regulators that sell orders, in most cases, must come with an expectation to settle.

However, one Investment Dealer did not believe the proposed changes to the short selling rules were required. They believe that CIRO's concern with settlement on the settlement date is misguided. Their rationale is that, in Canada, the cash buy-in mechanism is quite effective as a cure for failed settlements. This Dealer does not support CIRO's proposal to implement further requirements.

The proposed rules and guidance, specifically on how to demonstrate a Reasonable Expectation to Settle, revolve exclusively around the creation and maintenance of an "easy-to-borrow list." As the Guidance states that a Dealer cannot rely on another Dealer's list unless it settles/clears through that Dealer, one smaller self-clearing Investment Dealer is concerned it would be onerous to create its own list and would therefore request alternative options.

Nevertheless, all Investment Dealers we represent agree that a standard industry practice needs to be carved out of the regulatory proposal.

Specific industry practice needing a carve-out.

The firms we represent have identified a specific area of concern in the development of rules and regulations for short selling, which impacts a specific practice. Under the Proposed Amendments, **cashless stock option and warrant exercises** require a carve-out. More information on this is provided below.

Proposal blurring the line for cashless stock option and warrant exercises.

When exercising a warrant or stock option, a standard process in the industry is to sell the underlying security of such warrant or stock option in order to pay to exercise it prior to receiving the security in the account. This is known in the industry as a "cashless exercise."

Based on the Guidance, a cashless exercise may "look like" a short sale; however, the industry does not believe it to be one and believes cashless exercises should be carved out of the Proposed Amendments.

The operational process required when an option or warrant is exercised.

The process for exercising is not complicated but contains many steps. Below is the general process that takes place once a client executes the exercise and sells the security:

- In the case of warrants, the issuer may need to authorize the warrant exercise.
- In the case of an option exercise, the security is not sold until the issuer authorization is obtained.
- The transfer agent, when used, is notified to release the stock (from treasury).
- The transfer agent, when used, must release the stock to the Dealer.
- The Dealer must deposit the stock into the client account.
- The trade is then settled.

However, the process differs based on the issuer:

- Many publicly listed issuers on junior markets offer warrants as a component of offerings of their securities (as a "sweetener"). Warrants may be book-based or paper-based.
- Some issuers, under an agreement, pay the transfer agent to handle the entire process. These warrants are usually book-based. The process is therefore solely between the dealer and the transfer agent.
- To avoid the cost of the transfer agent, some issuers (generally junior) will issue paper-based warrants. The entire process becomes entirely manual between the dealer and the issuer. This creates process delays due to many factors such as: finding (and/or the availability of) the correct resource at the issuer; pulling the document from the vault; mailing the document; wiring or sending a certified cheque; waiting for the share certificate to be received by the dealer and finally deposited.

How long does this process usually take?

A book-based process usually occurs during the regular settlement period (T+2) as many issuers and transfer agents are able to meet the current timelines. Paper-based processes generally take longer than the regular settlement period (T+2).

Junior TSX Venture Exchange (TSXV) and Canadian Securities Exchange (CSE) issuers may experience difficulties meeting the T+2 deadline. This comes down to the size of the firm, the availability of person(s) authorized to exercise options and warrants, and the process used.

As mentioned above, once authorized by the issuer, the transfer agent (when used) must issue the security. Settlement issues are not due to negligence or false claims on the part of the Investment Dealer, but rather to such administrative processes as described, that may take more or less time.

Should Investment Dealers deny cashless exercises to certain issuers and transfer agents based on their efficiency or ability to meet the settlement deadline?

Dealers who operate in the TSXV and the CSE markets should not be restricted from allowing their clients to make a cashless exercise of their options and warrants based on timing of settlement. This would not be in the clients' best interests.

Senior issuers are of a size that allows them to process transactions in a timelier manner, while junior issuers have more limited resources. So, particularly in junior markets, being able to execute when prices are favourable is crucial.

Denying cashless exercises and transfers to issuers based on potential delays in settlement, would certainly be detrimental to junior markets.

We believe it is now important to give some historical background regarding short selling rules and regulations.

Regulatory development: from Ownership to Settlement.

The notion of short selling has historically been rooted in the notion of ownership. Owning a stock option or a warrant meant that, on exercise, a client would own the underlying securities.

Even ownership through an agent or trustee constituted "ownership."

The current definition of a short sale in UMIR states the following:

a seller shall be considered to own *[emphasis added]* ***a security if the seller, directly or through an agent or trustee*** *[emphasis added]****: [….]***

> ***(c) has an option to purchase the security and has exercised the option;***
>
> ***(d) has a right or warrant to subscribe for the security and has exercised the right or warrant;*** *[emphasis added]*

However, IIROC Guidance 22-0130, issued on August 17, 2022, moves away from the notion of ownership and towards the notion of "settlement." As stated in the Guidance's Executive Summary: "This Guidance Note (**Notice**) provides guidance on the obligation of a Participant to have reasonable expectations, prior to the entry of a short sale order, that sufficient securities will be available to allow the Participant **to settle any resulting trade on settlement date** [emphasis added]."

The current regulatory proposal also moves towards the notion of settlement, which creates issues, as previously stated, for **cashless stock option and warrant exercises**, a standard trading practice in the industry.

T+3 to T+2, to T+1.

The continuous move to a shortened settlement cycle undoubtably creates more failed transactions in general. It is expected that the move to T+1 will see an increased number of failed transactions at the beginning, which should decrease as industry participants become accustomed to the new shortened settlement timeframe.

The same is true for cashless stock option and warrant exercises. Due to the increased number of participants involved in the process to receive shares for settlement (Investment Dealer, agent, and/or trustee) and the administrative nature of the process, it becomes more difficult for Investment Dealers to assess whether a "Reasonable Expectation to Settle" the trade on settlement date exists.

Because agents and trustees will need to implement new processes to meet the requirements of T+1, which increases the risk of errors, we believe that a carve-out is needed for cashless stock options and warrant exercises.

Indeed, the majority of failed transactions that will occur following the move to T+1 are expected to be caused by errors in the administrative process, and not by "negligence or false claim" from the client. This should not have a negative impact on the reasonable expectation to settle in the future, as stated in the current Guidance and proposed Guidance under "**Client History – Presence of Prior Failed Trades**":

> o **A prior failed trade may negatively impact whether a Participant can demonstrate a reasonable expectation to settle future short sales for the same client in certain circumstances.** […] **Ascertaining the reason for the previously failed trade with the client can help the Participant determine if there is an impact on a reasonable expectation to settle future short sales from that client.**
>
> o **For example, if a Participant learns that the reason for the previous failed trade was due to an administrative error** [emphasis added]**, this may not have a negative impact on a reasonable expectation to settle future short sales from that client.**
>
> o **However, if a Participant relied on a client's attestation on having access to the necessary securities and that trade resulted in a failed trade under UMIR 1.1 due to the client's negligence or false claim** [emphasis added]**, it may not be reasonable to readily rely on such attestations from that client in relation to future potential short sales.** [emphasis added]

Administrative errors do occur and do not have a negative impact on a reasonable expectation to settle in the future. We fully agree with CIRO on this point.

Contradiction between the Guidance (above) and the current rules: what do the current rules say?

Does the moment an option or a warrant is exercised constitute ownership? Does the holder of that exercised option or warrant own the underlying security?

The industry believes that exercising an option or warrant does indeed give ownership of the underlying securities at the time of exercise. CIRO seems to agree with this view, as the current definition of a short sale in UMIR states the following:

"short sale" means a sale of a security, other than a derivative instrument, which the seller does not own either directly or through an agent or trustee and, for this purpose, a seller shall be considered to own *[emphasis added]* ***a security if the seller, directly or through an agent or trustee*** *[emphasis added]:*

> ***(c) has an option to purchase the security and has exercised the option;***

(d) has a right or warrant to subscribe for the security and has exercised the right or warrant; or *[…]*

but a seller shall be considered <u>not to own</u> *[emphasis added]* ***a security if:***

(h) the settlement date or issuance date pursuant to: […]

(iii) an exercise of an option, or

(iv) an exercise of a right or warrant

would, in the ordinary course, be after the date for settlement of the sale *[emphasis added]****.***

The current definition in UMIR versus the current interpretation in the Guidance from CIRO is where we believe the disconnect occurs.

<u>Interpretation of the IIROC Guidance from CIRO: what is the impact?</u>

If cashless stock option and warrant exercises are to be interpreted as short sales, all subsequent regulation and guidance with respect to short selling would apply to these transactions. This would mean additional processes for Investment Dealers, which, consequently, would have a negative impact on investors.

Firms, in order to comply with the Guidance, when they cannot guarantee a reasonable expectation to settle, are required to borrow the security; where no borrowing is available to meet the settlement date, the sale cannot be entered into.

In the case of cashless stock option and warrant exercises, the first scenario (borrowing the security) may mean that additional work is required, and additional costs are incurred by the Investment Dealer and their client for a transaction that may settle by the settlement date. Further, the ability to borrow, for many securities in the junior markets, is not often possible as there is limited to no availability. Where no borrowing is available, the second scenario applies, and the sale cannot be entered into: this is certainly not in the best interests of the client.

<u>What is the impact of considering cashless stock option and warrant exercises as short sales?</u>

Without a carve-out for cashless stock option and warrant exercises, additional work (i.e., borrowing the security) may have to be performed by the Dealer, and costs to both the Dealer and the client would be increased. Further, where no borrowing is available, a sale may not be made. This negatively impacts the client, the firm and the markets. It should be noted that there is no manipulation or deception occurring in these transactions. This is purely a

settlement timing issue resulting from administrative processes which are outside of the control of the Dealer and the client. An additional negative outcome of this is that some Investment Dealers could decide to avoid certain issuers or transfer agents, which would be harmful to the market and to the industry.

Would a carve-out of cashless stock option and warrant exercises be detrimental to investors or the market?

We do not believe a carve-out would be detrimental to investors or the market. Even having a cashless stock option or warrant exercise that creates a *failed* trade is not an issue in itself. Failed trades happen and will continue to happen, but we do not believe they create impactful or costly disruptions to the marketplace. We do not see any evidence that the process for exercising a cashless stock option or warrant is harmful to the integrity of the markets.

Industry recommendation based on a consideration of investors' best interests and market integrity.

Since the industry believes:

- that cashless stock option and warrant exercises benefit investors and should be maintained;
- that owning a stock option or warrant, on exercise, equates to ownership of the underlying securities;
- that Investment Dealers should not have to deny the practice for certain issuers on junior markets due to previous timing issues or delays with the issuer or transfer agent;
- that Investment Dealers should not avoid issuers or transfer agents due to past administrative errors;
- that a failed trade occurring from a cashless stock option or warrant exercise is due to an administrative process that is beyond the Investment Dealer's control; and
- that a failed trade occurring from a cashless stock option or warrant exercise is usually not due to negligence, false claim, or an intention to manipulate or deceive the market,

we recommend that this standard industry practice – cashless stock option and warrant exercises – be carved out from the short selling regulation.

We are available to discuss the content of this submission further, address any concerns you may have, or provide additional information as needed. Your feedback is invaluable to us, and we are committed to ensuring that we all achieve our objectives effectively and efficiently.

Please feel free to contact me at annie@cific.co with any questions, comments, or to schedule a call to discuss any aspects of the letter or explore potential next steps. We look forward to our continued collaboration on this matter.

Sincerely,

A. Sinigagliese

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