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GLOBAL BANKING AND MARKETS

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The Secretary
Ontario Securities Commission
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Via Email

Re: Joint CSA and IIROC Staff Notice 23-329 *Short Selling in Canada*

Scotiabank Global Banking and Markets appreciates the opportunity to provide comments on the Canadian Securities Administrators and the New SRO's consultation on the regulatory framework governing short selling in Canada.

General Remarks

We believe that short-selling is an activity integral to the healthy function of equity markets. Short-selling is critical to effective intermediation and therefore to market liquidity. Further, short-selling as an expression of a view on a security's value is crucial to effective price discovery.

We acknowledge that short-selling, and in particular naked short-selling, can present risks to the financial system by creating a greater possibility of unsettled trades (known as "fails"). Settlement fails by short-selling parties impose certain risks and costs on their clearing members and may also impact participants which did not (themselves) fail as a consequence of centralized and netted clearing and settlement. We therefore believe that regulatory concerns regarding short-selling are fundamentally concerns regarding settlement mechanics rather than the trading intent of the participants who sell short.

We believe that Canada's regulatory regime regarding short-selling is fundamentally sound, conforms with IOSCO principles in this area, and protects equity market investors. We believe the Canadian framework strikes an appropriate balance between risk management and efficiency. We do not believe that any major changes to the regime are required at this time. If changes are contemplated, we also believe it would be premature to introduce such changes before the industry has adapted to the effects of shortening the settlement cycle in equities (currently expected beginning in May, 2024).

Should additional measures be deemed necessary as a result of this consultation, we believe it would be most appropriate to introduce any measures in the form of policy & procedure requirements on dealers who provide securities lending services to short-sellers, and who manage the corresponding

collateral. Clearing firms and prime brokers are intrinsically motivated to manage the settlement risks and will generally introduce suitable policies in this area, over and above core prudential requirements. This approach aligns settlement risk management with the source of the potential risk – the activities of investors whose transactions may fail to settle on time.

Further, if a locate requirement (at the time of execution) is considered, we believe such a requirement should be applied exclusively where a trade is to be marked "short" rather than "short-marking exempt" ("SME"). The Canadian SME regime appropriately distinguishes between short sales for the purpose of relative-value positioning, and short sales which are strictly technical in nature, and expected to be short-lived. We believe that SME orders should be equally exempt from additional requirements on short-sale orders. This practice would align to exemptions available under Reg SHO, including market-making exemptions which recognize the fleeting nature of short sales established for intermediation purposes.

We caution that regulatory actions in this area be taken with care, as well-intentioned reforms may cause additional friction which in turn will be passed on to investors in the form of higher aggregate execution costs.

Answers to Specific Questions

Question #1: Should the existing regulatory regime around pre-borrowing in certain circumstances be strengthened? What requirements would be appropriate? Specifically, should there be "pre-borrow" requirements similar to those in the U.S., as described above? Please provide supporting rationale and data.

Question #2: What would be the costs and benefits of implementing such requirements?

> We do not believe the existing framework requires immediate changes, particularly around "pre-borrow." We believe the principles-based approach adopted in Canada accomplishes the overarching goals of minimizing the risk of widespread settlement fails while managing regulatory burden and costs.
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> We disagree with the introduction of a "pre-borrow" requirement. Notably, the U.S. requirements under Reg SHO do not require "pre-borrow." Rather, Reg SHO requires a "locate" at the time of order execution, which amounts to identifying the expected source of borrowed shares. The located shares on trade-date may not be available on settlement date, and the trade may fail for reasons unrelated to the locate. Therefore a "locate" requirement is not equivalent to the more stringent requirement to borrow in advance of execution.
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> We believe that a Canadian locate (or pre-borrow) requirement would not significantly reduce fail rates in Canada. New SRO's recent Failed Trade Study cites low aggregate fail rates, but does not draw a causative link to "naked" short-selling. Indeed, the most commonly cited reason for settlement failure (other than "other") is "counterparty short position" – which means that the party delivering the shares is unable to make delivery, not that the counterparty has a short position. This could occur in many circumstances involving long sales, particularly where the sold shares are lent out, posted to a third party as collateral, or where CNS has an overall short position for a clearing member.
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> A "pre-borrow" requirement (at the time of execution) would significantly increase execution costs for any participants in scope for the requirement, without producing an offsetting benefit. Such participants would pay the cost of borrowed securities for two days prior to settlement, and would be unable to return the security for two days after the trade day on

which they cover their short. If this requirement is extended to intermediaries, these costs would be passed on to investors and increase transaction friction for the market as a whole.

Finally, the introduction of any locate (or pre-borrow) requirement would add administrative burden to the investment community, including the cost of adapting systems to comply with new requirements. It is difficult to estimate the magnitude of these costs without specifics, but based on a high-level understanding we believe these costs would be comparable to those incurred by the Street in the implementation of IIROC's requirements to capture Legal Entity Identifiers, effective in 2021.

Question #3: Does the current definition of a "failed trade", as described in Part 1, above, appropriately describe a failed trade?

Yes.

Further, the definition may be amended to identify missing or mismatched instructions as a condition where a trade is deemed to have "failed."

Question #4: Should a timeline shorter than ten days following the expected settlement date be considered? What would be an appropriate timeline? Please provide rationale and supporting data.

A shortened timeline for extended failed trade ("EFT") reporting should be considered only in conjunction with reforms to the EFT reporting regime in its entirety. Currently, the consequence for an extended failed trade report includes an open-ended requirement on the failing Participant or Access Person to pre-borrow all securities in all short sales, with no clarity on what remediation steps the Participant or Access Person may take to ease the pre-borrow requirement. This requirement is very onerous and prompts dealers to take steps to close out positions well before an Extended Failed Trade Report is filed.

Shortening the EFT reporting deadline should be considered in the context of an analysis of the full impact of this change on dealer practices, and the potential for unintended side-effects. There is no specific bright-line test which makes an appropriate timeline easily defined.

We recommend that this analysis be conducted only after the upcoming change to the settlement cycle (to T+1) takes effect.

Question #5: Should additional public transparency requirements of short selling activities or short positions be considered? Please indicate what such requirements should be and the frequency of any disclosure. Please also provide a rationale and empirical data to support your suggestions or to support why changes are not needed.

Additional transparency measures for short positions or short activity should only be introduced if there is a clear need for disclosure over and above the normal transparency requirements for long investors.

Long position disclosure, for example requirements for filing share holdings beyond certain thresholds, are rooted in the ability of share owners to vote their shares and hence exert control over an enterprise. These considerations do not apply to short sellers, because short sellers do not vote. Instead, short sellers take on the additional risk of share recall, buy-in, and short squeeze. We therefore believe transparency measures have the potential to unfairly punish those contributing to price discovery.

Concerns in this area are often focused on "short and distort" activities, with the implication that such activities are misleading. We believe these concerns should be equally applied to long investors who may also engage in "distortive" campaigns, and should be regulated similarly. In other words, the regulatory regime related to distortion, manipulation, the spread of misleading information or any other malfeasance should be applied to investors regardless of whether their position is long or short.

Question #6: Should additional reporting requirements regarding short selling activities be considered by the securities regulatory authorities? Please indicate what such requirements should be and the frequency of any disclosure. Please also provide a rationale and empirical data to support your suggestions or to support why changes are not needed.

With the introduction of LEI reporting requirements on all trades in Canada, we believe regulators have significant visibility into investor activity – both long and short. LEI reporting allows market regulatory authorities to tie activities to specific clients, including for the purpose of investigating short selling activities. Additional reporting requirements should only be contemplated if market surveillance authorities lack the tools to adequately enforce existing regulations.

Question #7: As noted above, IIROC's study of failed trades showed that correlations between short sales and settlement issues in junior securities were more significant, and that junior securities experience more settlement issues compared to other securities. Should specific reporting, transparency or other requirements be considered for junior issuers? Please provide additional relevant details to support your response.

We believe that rules related to short-selling should be equally applied to all securities. Distinctions based on the types of listing would in turn require investors to be able to clearly distinguish between junior and senior equities, ETFs, closed-end funds, etc. for the purpose of short-selling treatment. In all other respects, trading mechanics may be identical – and therefore the differentiated treatment is likely to cause investor confusion and unnecessary friction.

Any regulation on "junior" securities would require a clear distinction of what constitutes a "junior" issuer, as well as clear rationale justifying special treatment for "junior" issuers' securities. No precise definition of each term exists. Commonly accepted definitions of "junior" vs. "senior" equity issuers rely on distinctions in listing requirements for companies in various stages of growth, rather than being connected to settlement mechanics and risks. It would be inappropriate to use existing colloquial definitions for a regulatory purpose.

Question #8: Would mandatory close-out or buy-in requirements similar to those in the U.S. and the European Union be beneficial for the Canadian capital markets? Please provide rationale and data substantiating the costs and benefits of such requirements on market participants.

From a Canadian perspective, we do not believe that mandatory close-out or buy-in requirements would be effective at addressing any perceived problems with the Canadian short-selling regime, or meaningfully reduce the incidence of fails. The biggest hurdle to such a regime is ensuring that a mandatory close-out settles. We believe that a purchase resulting from a mandatory buy-in to cover a short would be likely to fail. Such buy-ins would likely face intermediaries seeking to earn an arbitrage profit by selling at a premium to prevailing market

prices and would be selling short – in an environment where settlement is difficult and borrow may be hard to access.

We believe that if any close-out requirement is introduced, it should take the form of policies & procedures requirements for carrying dealers to reasonably avoid extended failed trades among their clients.

Conclusion

We believe that Canada's short-selling regulatory framework on short-selling is fundamentally sound and protects the integrity of Canada's equity market. We commend the CSA and the New SRO (and its predecessor organizations) for the long history of principles-based regulation in this area. We believe that any changes to the regime should be taken cautiously and in a targeted manner, with an emphasis on addressing potential areas of concern at their source – rather than imposing blanket requirements on legitimate and beneficial activity.

Changes to Canada's short-selling regime at this time would conflict with extensive industry efforts to shorten the settlement cycle to T+1, which we expect would increase settlement challenges. Introducing both changes concurrently will make it difficult to separate the effect of each change from the other, and make it difficult to understand the appropriate regulatory approach to short-selling in a T+1 environment. We recommend that if any changes are contemplated, the analysis supporting these changes (and their implementation) be done only after industry settlement has moved to T+1.

We appreciate the opportunity to comment on this important topic.

Respectfully,

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