Scotiabank®

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Via Email

Re: Proposed Amendments to Ontario Securities Commission Rule 48-501

We appreciate the opportunity to comment on the Ontario Securities Commission ("OSC") proposal to amend OSC rule 48-501 *Trading During Distributions, Formal Bids and Share Exchange Transactions* (the "Proposal", "Proposed Amendments" or "Proposed Rule"). We are writing on behalf of Scotiabank and providing comments from the perspectives of its Global Banking and Markets division as well as Scotia Global Asset Management.

Global Banking and Markets (GBM) conducts the Bank's wholesale banking and capital markets business with corporate, government and institutional investor clients. Scotia Global Asset Management (SGAM) offers a broad range of investment solutions to meet the diverse needs of clients across all levels of wealth in Canada and around the world. Our comments are presented below, and answers to the specific questions posed in the Proposal are attached as an Appendix.

We believe the Proposal in its current state does not strike a proper balance between perceived manipulation and fair and orderly markets, particularly in the absence of empirical data, and

considering modern non-manipulative trading and investment strategies. We believe the Proposal, if enacted, would reduce the potential universe of new issue buyers in Ontario leading to a decline in Ontario's competitiveness, and increased dilution and higher cost of capital for Ontario and Canadian equity issuers. We suggest, rather than proceeding with the Proposal, regulatory changes could enhance the enforcement of existing rules and prioritize detection and enforcement of insider trading, including by implementation of post-issuance reporting of allocations.

Fundamental Policy Direction Concerns

We strongly support the overarching policy goal of combatting manipulative and deceptive activities in equity markets. Preventing market abuse and manipulation is critical to the health of capital markets. However, we are concerned that the Proposal in its current state does not strike the appropriate balance between addressing perceived manipulation and supporting fair and orderly markets for all participants.

Short selling an equity security within five business days before purchasing the same security as part of a prospectus offering or private placement (the "Covered Activity") is not inherently manipulative. The Covered Activity is only manipulative when it is engaged in by an investor with advance knowledge of the financing. When investors without advance knowledge of a financing engage in the Covered Activity, this supports price discovery and fair, efficient and competitive capital markets.

In the absence of the short-seller's knowledge of an impending deal, short selling activity contributes to price discovery and to fair, efficient and competitive capital markets**.** Selling a security short involves significant risk and judgement and therefore further supports price discovery and liquidity for that security. Equity markets rely on both bullish and bearish views to function efficiently. Restricting bearish activities such as short selling can slow down the correction of inflated valuations resulting in artificially high prices. Therefore, the Covered Activity should only be prohibited where an investor has advance knowledge of the upcoming financing.

We appreciate that the Proposal is aimed at deterring investors with advance knowledge of an upcoming financing from engaging in the Covered Activity where such knowledge may not be "material information" under securities legislation or exchange policies. However, this could be accomplished by deeming knowledge of any pending prospectus offering or private placement a material fact, thereby prohibiting trading activity with knowledge of the pending financing

until it is publicly disclosed. Such an approach would similarly encompass long sales of securities for subsequent repurchase, which have the same impact on market confidence and price as the Covered Activity.

SGAM is one of the largest asset managers in Canada and our investment products often represent a lead order in equity transactions across many industry sectors. As we continue to launch more products employing alternative strategies for our clients, short-selling activity is likely to become more extensive. There are a variety of legitimate alternative strategies that we may employ to generate positive performance or hedge risks that would involve short-selling securities from an issuer then subsequently seeking to participate in a new issue. These alternative strategies are not utilized to manipulate securities prices, nor do they involve misuse of material non-public information.

Within SGAM there are nine distinct investment teams that operate independently of one another, and each employs an independent style and investment philosophy. Each investment team may have a different view of an issuer, which may result in one team shorting the security of that issuer while another is simultaneously looking to purchase it. One investment team may employ their investment philosophy and approach to different mandates with different investment objectives; for that same investment team, it may be appropriate to short a security in one mandate while purchasing the security in another mandate.

At all times, we honour existing securities laws and do not transact based on material non-public information. Limiting our ability to participate in a new issue as we employ these alternative strategies, including within an arbitrary five-day period of the new issue, could impair our ability as an asset manager to deliver on our investment objectives for clients. The Proposed Rule, as currently written, has the potential to disrupt the use of important investment strategies in an effort to prevent behaviour that is already illegal.

Finally, we appreciate that the Proposal seeks to avoid the obstacle to enforcement posed by the need to prove that an investor engaging in the Covered Activity did so with knowledge of an upcoming financing. However, since the Covered Activity is beneficial in the absence of such knowledge, and considering the negative consequences the Proposal may have for capital formation and Ontario's competitiveness, we believe that regulatory focus should shift to detection and enforcement.

The Proposal May Impede Capital Formation

The OSC's mandate includes the policy goal of fostering capital formation. We fully agree with the OSC's goal of instilling confidence in capital markets, promoting capital formation and creating an environment where investors can be confident in engaging with securities markets. We believe all policy proposals should be tested against whether they impact this laudable goal, including whether they have the potential to unduly restrict or cast a chill on capital formation activities in Ontario.

With respect to the Proposal, we believe these policy goals are not met. By introducing restrictions on the purchase of new issues which can only be lifted by relying on an exception, the Proposal would reduce the potential universe of new issue buyers in Ontario. Further, these restrictions impact the biggest and most complex organizations – which are also typically the anchor buyers of new issues in Ontario. Finally, the compliance burden and risk the Proposal would impose is significant. This could ultimately lead to increased dilution and higher cost of capital for Canadian equity issuers.

The buyer universe for Canadian equity transactions tends to be concentrated among large institutional purchasers, and most of these transactions are handled as bought deals. On common equity financings greater than $100mm in value executed since 2020, the top 5 institutional investors account for 46% of demand, and the top 10 institutional investors account for 62% of the total deal.

The Proposal limits the institutional buyer universe by specifically impacting participation from multi-strategy institutional investors. The added compliance burden of needing to identify whether the Proposal's definition of "short sale" is met accidentally, and whether a valid exception applies, is likely to result in some issuers simply avoiding new issue participation. We believe this currently occurs with certain U.S. participants whose concerns over Reg M Rule 105 compliance results in a blanket withdrawal from the Canadian new issue market when the issuer is cross-listed with the U.S.

As previously noted, SGAM is one of the largest asset managers in Canada and our investment products often represent a lead order in equity transactions across many industry sectors. As we continue to launch more products employing alternative strategies for our clients, short-selling activity is likely to become more extensive. There are a variety of legitimate alternative strategies that we may employ to generate positive performance or hedge risks that would involve short-selling securities from an issuer then subsequently seeking to participate in a new issue. Limiting our ability to participate in a new issue as we employ these alternative strategies,

including within an arbitrary five-day period of the new issue, could impair not only our ability as an asset manager to deliver on our investment objectives for clients, but also remove a prominent source of capital for new issues in Canada.

We are also concerned that the Proposed Rule is challenging to implement in a compliance monitoring program, which would lead compliant firms to avoid new issue participation rather than take a regulatory compliance risk.

The definition of "short sale" in the Proposal captures both (1) sales where the seller does not have title to the security and (2) sales that are settled or intended to be settled by the delivery of borrowed securities. Including sales that are settled or intended to be settled by the delivery of borrowed securities could lead to negative unintended consequences and should be removed. At the time of sale, investors typically do not know how the transaction will settle. A dealer may settle a long sale for an institutional investor using borrowed securities without the knowledge of the investor. For example, where a dealer has rehypothecated the securities the investor has sold so that they cannot be delivered on settlement, the dealer may borrow replacement securities to settle the transaction. Similarly, a clearing member may settle their net obligation to CDS using borrowed securities if their overall position is short from sales unrelated to a recent institutional sale.

These complexities mean that investors could be unknowingly ineligible to participate in a subsequent financing – and find themselves offside the rule should they participate. Organizations may find themselves caught in the technical requirements of the definition without any intent to short sell a security, making compliance challenging or impossible in practice. This could have a chilling effect on investor appetite to participate in financings. It would also impose an administrative burden on dealers who will be required to enhance existing process to track shares used for hypothecation against new issues.

Further, investment funds represent a significant segment of institutional investors. The portfolio manager firms and advising representative individuals that make investment decisions for an investment fund have a fiduciary duty to act in the best interest of the fund. Portfolio managers and advising representatives must make investment decisions that align with each fund's investment mandate. Portfolio managers and advising representatives advise multiple funds with different investment mandates and different portfolio characteristics at any given time. It is possible for an opposite investment decision to be appropriate for two funds with the same portfolio manager or advising representative – i.e. it may be appropriate for one fund to short-sell a security and the other fund to purchase the same security.

Clarification that such activity would fall under the separate account exception is called for. If the same individual advising representative made simultaneous but opposite investment decisions for two investment funds, such decisions should be considered made "separately and without coordination". Any regulatory or compliance risk around this point could have a chilling effect on the ability and/or willingness of investment funds to participate in prospectus offerings or private placements – even if it is in the best interest of their funds to do so.

These challenges are magnified by the fact that the Proposal's requirement applies only to Ontario reporting issuers. Compliance regimes would therefore need to be tailored to the jurisdiction of the issuer, leading to confusion and erosion of confidence in Canada's capital markets.

For underwriters acting in a gatekeeping role, the obligations are even less clear. A dealer making allocations on a financing would have no knowledge of whether a client is compliant with the Proposed 48-501 requirements. This hampers underwriters' ability to discharge their typical duties of gatekeepers of market integrity, while simultaneously increasing their overall risk on bought deals. To comply with the Proposed Rule, dealers would have to integrate their new issue booking system with their centralized order and trade repository. This level of integration is a complex and costly endeavour which would also undermine a dealer's information barrier policy.

High level estimates of the work effort involved in a comprehensive compliance solution for the Proposed Rule indicate one-time costs in the range of $4.6mm-$6.6mm for the underwriting function, with a further $0.5mm-$1mm for enhancements to SGAM's order management functionality to ensure ongoing compliance. These estimates do not include additional recurring maintenance and support costs.

This combination of factors may compel large institutional purchasers of new issues to avoid participation due to compliance costs and risks. We are concerned that if even a small portion of institutional purchasers were unable or unwilling to participate in new issues, the effect would be to widen pricing discounts on new issues (by dealers) to account for added distribution risk. This results in additional dilution and higher cost of capital for Canadian equity issuers.

We estimate that the additional discount, which will vary according to the specific circumstances of an offering, would be in the range of 2% to 4%. Based on Scotiabank's tracking of new issue activity, over the past five years Canadian corporations have raised approximately $124bn in new capital from investors. An additional pricing discount of 2-4%

would result in incremental costs to corporate issuers of $2.5bn-$5.0bn over the past five years, or a range of $500mm-$1bn per year, consistent with long term average financing rates in Canada.

The Proposal May Diminish Ontario's Competitiveness

The Proposal would create a rule only in Ontario, impacting Ontario reporting issuers, and not fully extend to other Canadian jurisdictions. This would include many small-cap issuers listed on the TSX Venture Exchange and based outside of Ontario. If the practice of arbitrage between short sales and new issues is truly an issue, then we believe it would be an issue across all Canadian jurisdictions, and not just Ontario reporting issuers. We observe that many of the issuers concerned with short selling as an issue are listed on the TSX Venture Exchange, and may not benefit from the Proposed Amendments.

In the absence of a Canada-wide rule, a restriction that limits issue purchases in Ontario relative to other provinces would create an unlevel playing field, with Ontario reporting issuers generally having a higher cost of capital than issuers in other provinces, all else being equal. This would incent corporations to shift their reporting obligations and domicile to other provinces with the goal of reducing their cost of capital.

Ontario's competitiveness is of paramount political importance, with stated government objectives (at all levels) of reducing inter-provincial barriers to commerce. We believe that a provincial requirement which would hurt the ability of Ontario reporting issuers to raise capital in the province is out of step with government priorities today.

Some may argue that a higher cost of capital in Ontario may be offset by greater investor confidence because of this Proposed Rule being in place. We do not believe this is a likely outcome. To date, we have seen no evidence that the Covered Activity is prevalent, or that it is hurting investor confidence in markets. In the absence of clear evidence, we believe that the inter-provincial opportunity for regulatory arbitrage being introduced by the 48-501 Proposal hurts Ontario's competitiveness within Canada.

We believe this concern also extends beyond Canada's borders. Global competitiveness for Canada as a whole, and Ontario in particular, relies on appropriately balancing access to capital with investor protection. A reduction in Canadian (in particular Ontario) issuers' access to capital in the domestic market may incent some businesses to seek financing elsewhere.

Focus On Enforcement

Most follow-on financings in Canada occur through a bought deal structure. In the case of bought deals, the pricing of the transaction occurs at the time of announcement. Any investor that has knowledge of the financing ahead of pricing, and acted on this knowledge, would therefore likely be in violation of insider trading prohibitions. Similarly, if a purchaser of a private placement was selling short the stock ahead of the issue, they are likely to have been acting on material non-public information, which should be addressed through enforcement rather than rulemaking. Any gray area could be clarified by deeming knowledge of an upcoming prospectus offering or private placement a "material fact."

For these reasons, we recommend that at minimum the Proposal be narrowed in scope to focus on marketed offerings, wherein the market at large is aware of the coming transaction, but not its price. This would align the rule to the market context under which Reg M Rule 105 was introduced, and allow the effective and efficient Canadian bought deal regime to continue unimpeded.

We suggest that rather than proceeding with the Proposal, focus should be given to detection and enforcement of insider trading, by implementing a new post-issuance reporting requirement of allocations that can be matched with CIRO's trade execution data. No single regulatory body is currently optimally placed to surveil and enforce insider trading in connection with the Covered Activity:

- CIRO's data on trading activity, including short markers and LEI disclosure, is not combined with new issue allocations. CIRO also lacks jurisdiction to enforce the 48-501 requirements.
- The OSC, absent CIRO involvement, does not collect secondary market short sale data, but has the necessary jurisdiction.

We recommend that a separate rulemaking effort take place to empower CIRO to detect market abuse in connection with the Covered Activity, which could require dealers to report post-deal allocation data for prospectus offerings and private placements (i.e. purchaser LEIs). This would permit CIRO incorporate primary issue information into its market surveillance programme to detect suspicious behaviour and engage enforcement teams as appropriate.

Additionally, if the OSC moves forward with implementing a prohibition on the Covered Activity, it is essential to adopt CIRO's definition of a short sale and to clearly articulate and broaden the scope of exceptions – specifically to include syndicate participation and highly liquid issuers exemptions.

Ultimately, we believe the Proposal, as drafted, does not effectively address the core issue – manipulative intent and manipulative activities undertaken with advance knowledge of an upcoming financing – while introducing additional regulatory burden, risk and cost. The regulatory focus should be on enhancing the enforcement of existing rules. Any additional rulemaking should be focused on reducing existing barriers to enforcement, including by providing CIRO with new issue purchase information. Enhancing enforcement powers to detect and breaches of existing insider trading and market manipulation rules could accomplish the benefits the Proposal aims for, without causing the unintended negative consequences to capital formation and competitiveness of Ontario's capital markets discussed in this letter.

Conclusion

We believe that the Proposal introduces significant risks and additional compliance costs to capital formation in Ontario and presents irreconcilable technical challenges to implementation. We believe an alternative path, leaning on a strengthened enforcement regime, is the best path forward to addressing the concerns which gave rise to the Proposal.

Despite our concerns, we commend the OSC for its long history of principles-based regulation in the area of short selling. We believe Canada's regulatory regime regarding short selling is fundamentally sound, strikes an appropriate balance between risk management and efficiency, and does not need fundamental change.

Thank you for the opportunity to comment on this important Proposal. We would welcome the opportunity to discuss these issues directly with OSC staff.

Respectfully,

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Appendix: Answers to the Proposal's Specific Questions

Question 1 *Will the Proposed Amendments address concerns with short selling making pricing and completion of offerings more difficult?*

No. On the contrary, we believe the Proposed Amendments will exacerbate the difficulty of making pricing and completion of offerings. We discuss our rationale for this view above.

Question 2 *Will the Proposed Amendments have any unintended consequences, such as (i) making it more difficult for certain reporting issuers to raise capital or (ii) requiring a greater price discount on offerings?*

Yes. We believe the Proposed Amendments will increase the difficulty for reporting issuers to raise capital, including through greater price discounts on offerings. The compliance uncertainty created by the Proposed Amendments would decrease the propensity of institutional purchasers to participate in new issues. This reduction in demand will lead to greater underwriting risk on bought deals, wider price discounts, and higher cost of capital for issuers, especially for Ontario reporting issuers.

Question 3 *Is the definition of "short sale" in the Proposed Amendments adequate for achieving the purposes of the Proposed Amendments?*

No. We do not believe the proposed definition of "short sale" is appropriate. In particular, the reliance of the definition on whether a security is settled using borrowed shares makes it impossible to verify whether a sale was considered short until after settlement has occurred – which may also be after pricing date.

In some situations, a long seller of a security may find that their sale settled using borrowed shares for a variety of settlement issues, including the presence of unrelated short positions within the same clearing member or technical factors to cross-border settlement. This may inadvertently

expand the scope of the Proposed Amendments' prohibition on new issue purchase to parties which had no intent to be short. Further, the mechanisms to adequately surveil and monitor the link between trade execution and ultimate settlement do not currently exist and are difficult to implement. For further discussion of the challenges in linking execution to settlement we refer you to our response to CIRO Notice 25-0001 *Proposed Amendments Respecting Mandatory Close-Out Requirements.*[1]

Question 4 *Should the Proposed Amendments apply to distributions of securities of a broader or narrower group of issuers? If so, what criteria should be used to define this population?*

We believe consideration should be given to an alternative path, as described in our remarks above and in our response to Question 5 below.

Question 5 *Are the securities covered by the Proposed Amendments correctly scoped?*

The Proposed Amendments, including the Taskforce Report, do not cite specific evidence which would lead to a significant policy response beyond a generalized concern of potential harm. This is at odds with the principles of evidence-based and data-driven policymaking.

We believe the Proposed Amendments should be applied to a targeted subset of securities where a demonstrated harm has been observed. In the absence of a defined problem statement, it is difficult for us to suggest specific criteria to define the population. In all cases, we do not believe it is appropriate to apply the Proposed Amendments to bought deals or private placements.

We believe the sole reason to prohibit purchase of the offering by recent short sellers would be if those parties had advance knowledge of the transaction. In this case, the matter is one of insider trading and should be enforced as such. On the other hand, speculative activity without knowledge should be rewarded and encouraged as a valuable source of price discovery and market efficiency.

We acknowledge that concerns may arise from short selling related to marketed offerings wherein the market at large is informed of an offering prior to the pricing date. Short selling in this window

[1] https://www.ciro.ca/media/12681/download?inline

of time simultaneously helps market prices stabilize at a clearing price, and increases demand for the offering, as short sellers would be looking to cover. This may increase the issuer's access to capital and ultimately improve market efficiency.

Importantly, none of these issues are specific to short selling. The economic effect of existing holders selling shares with the aim of repurchasing on a new issue is identical to the effect of short selling for this purpose. We therefore disagree with the scope of the Proposed Amendments.

Question 6 *Is the prohibition on buying and selling short a security "of the same class" too narrow?*

No.

Question 7 *Is the exemption under section 4.1.2(b) of the Proposed Amendments appropriate?*

Notwithstanding our overall concerns, we believe the conceptual exceptions offered in section 4.1.2 are generally appropriate for the Proposed Amendments as written. However, we wish to highlight certain shortcomings.

First, the "separate account" exemption under section 4.1.2(4) carries a significant implementation burden to ensure compliance, including clarifying ambiguity to the concept of "coordination." Sophisticated institutional investors routinely aggregate trading activities across funds for efficiency and cost management purposes. It may be difficult to demonstrate the absence of "coordination of trading" or "cooperation among or between the accounts" in circumstances involving complex organizations with cross-functional investment teams.

We also believe that this exception may be unnecessarily restrictive in circumstances involving portfolio managers whose decision making needs to adhere to fund investment objectives. For instance, a portfolio manager managing multiple funds may find that it is equally appropriate for one fund to be short a security while another fund would benefit from purchasing an offering. This circumstance may run afoul of the 4.1.2(4) exception because the same portfolio manager oversees both cases, and it is difficult to argue that the decisions are made "separately".

Second, the repurchase exception under section 4.1.2(3) arbitrarily restricts repurchases to the business day prior to pricing. We believe any repurchase in advance of pricing, including on the

same day, should be included in the exception. However, we note that in practice reliance on this exception is challenging for dealers to adequately monitor for gatekeeping purposes, as dealers do not have knowledge of an institutional investor's total activity.

Further, we suggest that additional exceptions are appropriate:

- Activities of syndicate members where those activities are unrelated to and without knowledge of a pending transaction.
- Sales made in facilitation inventories by a dealer that is a member of a syndicate.
- All short-marking exempt accounts, as defined in UMIR.
- Any purchase where the new issue purchaser can demonstrate that their short position will be covered using shares other than those from the new issue.
- Short sales executed in anticipation of options exercise or corporate action events.

The exceptions offered must be comprehensive enough to permit the capital formation process in Ontario to proceed with as little disruption as feasible while achieving appropriate policy goals. We are concerned that current exceptions remain ambiguous, restrictive, and may hamper capital raising activities in the province of Ontario.

Question 8 *Are there other types of distributions or securities that should exempted from the Proposed Amendments?*

Notwithstanding our overall concern with the Proposed Amendments, we believe that only marketed offerings should be in scope.

Question 9 *The 5-day period is based on Rule 105 and is intended to ensure that, in a marketed offering, a short seller intending to participate in the offering would not have an opportunity to adversely affect the market price of the offering through short sales immediately before pricing of the offering, as any activity from before that period should no longer be reflected in the market price of the offered securities. Is this assumption correct?*

Today's modern and dynamic equity markets feature faster information dissemination and price adjustment than at the time of the introduction of Rule 105. We believe the 5-day period in Rule 105 is too long for the current trading environment.

Question 10 *Should the restricted period be extended for a period of time following pricing?*

No.

Question 11 *Does your answer to Question 9 depend on whether the issuer made a press release announcing the offering and when the press release was issued?*

No.

Question 12 *Is the assumption that the separate account exemption will be sufficient for underwriters and market makers correct? If not, please provide specific examples of how the Proposed Amendments would adversely affect their activities.*

Consistent with our answers to Question 7 above and other commentary, we believe that the separate account exception does not provide adequately clear and unambiguous safe harbour for underwriters and market makers, as it is unclear how these exceptions could be implemented in a compliance monitoring program.

This issue is significantly exacerbated by the definition of "short sale" in the Proposed Amendments, which includes in scope any transaction that settled with borrowed shares, an outcome that is unknown at the time of execution and out of the control of the party making the sale.

Question 13 *Are there any additional foreseeable costs if the Proposed Amendments are adopted? Can these costs be mitigated?*

Please see the discussion above, including concerns regarding overall impact on capital formation in the Ontario capital markets.