

CIRO PROPOSES AMENDMENTS TO STRENGTHEN SHORT SELLING REGULATIONS

Posted on January 17, 2024

Categories: [Insights](#), [Publications](#)

On January 11, 2024, the Canadian Investment Regulatory Organization (“**CIRO**”) published for comment, in Notice 24-0003 – *Proposed Amendments Respecting the Reasonable Expectation to Settle a Short Sale* (the “**CIRO Notice**”), proposed amendments to the short selling framework under the Universal Market Integrity Rules (“**UMIR**”).^[1] CIRO is proposing to “support and clarify the short selling framework under UMIR” by:

1. adding a new positive requirement under UMIR 3.3 to have, prior to order entry, a reasonable expectation to settle on settlement date any order that upon execution would be a short sale;
2. adding in supervisory and gatekeeping requirements relating to the proposed UMIR 3.3; and
3. generally consolidating current UMIR provisions relating to short selling into one location within UMIR with corresponding housekeeping changes to UMIR generally (the “**Proposed Amendments**”).

Simultaneously, CIRO also published proposed guidance (the “**Proposed Guidance**”) aimed at clarifying the various current and proposed requirements related to short sales and failed trades.^[2]

CIRO also noted that, together with staff of the Canadian Securities Administrators, they will continue to explore other areas of short sale regulations where additional regulatory measures may be appropriate, including but not limited to mandatory close-out requirements.

The Proposed Amendments and the Proposed Guidance are open for comment until April 12, 2024.

Proposed UMIR 3.3

Currently, UMIR 2.2(2) prohibits Participants^[3] and Access Persons^[4] from entering an order to execute a trade that would create, or could reasonably be expected to create, either (i) a false or misleading appearance of trading activity in or interest in the purchase or sale of the security or (ii) an artificial ask price, bid price or sale price for the security or a related security. Paragraph 2(h) of UMIR Policy 2.2 provides that one of the activities which constitutes a violation of UMIR 2.2(2) is the entering of an order for a sale of a security (both long and short) on a marketplace without having, at the time of order entry, a reasonable expectation of settling any resulting trade.

The proposed UMIR 3.3 would impose a new positive requirement that Participants and Access Persons have a reasonable expectation to settle any resulting trade before entering an order that would result in a short sale. The CISO Notice additionally clarified that the reasonable expectation requirement applies to Participants with respect to any self-directed orders from clients to a marketplace which upon execution would result in a short sale. CISO noted that documenting how a reasonable expectation to settle was established would help Participants and Access Persons demonstrate compliance with UMIR 3.3, but has stopped short of requiring such documentation.

CISO also reiterated that trades which do not settle on the date contemplated on the execution of the trade (currently, T+2, with a move to T+1 expected on May 27, 2024) will be considered failed trades, regardless of whether or not the trade has been settled in accordance with the rules or requirements of the clearing agency.

Importantly, the Proposed Guidance provides that merely because a trade did not ultimately fail is not in itself sufficient evidence to show that the seller had a reasonable expectation to settle prior to order entry.

Factors that Affect the Ability to Demonstrate a Reasonable Expectation to Settle

The Proposed Guidance outlines factors that would affect the ability of Participants and Access Persons to show a reasonable expectation to settle a short sale under the Proposed Amendments, including the presence of prior failed trades from a client, regardless of whether such failed trades did not persist beyond the ten-day window to trigger an extended failed trade report to CISO. The Proposed Guidance provides that the reasons for the failed trade by the client should be ascertained to help determine whether there is an impact on a reasonable expectation to settle future short sales from that client.^[5]

Additionally, where a security has been determined to be hard-to-borrow, the Proposed Guidance provides that Participants and Access Persons may need to take additional steps to establish a reasonable expectation to settle the resulting trade on settlement date, which may include pre-borrowing a sufficient number of securities to settle the trade, where appropriate.

How to Demonstrate a Reasonable Expectation to Settle

Under the Proposed Guidance, Participants and Access Persons can demonstrate a reasonable expectation to settle as required by the Proposed Amendments by relying on easy-to-borrow lists, provided that such lists only include securities that are readily available.

CISO's expectation is that Participants and Access Persons would only rely on easy-to-borrow lists that they have compiled, or from dealers which they have established a formal relationship with regarding clearing or settlement.

In establishing easy-to-borrow lists, Participants and Access Persons might consider the following when determining which securities to include on such lists: (i) liquidity parameters, (ii) avoiding securities with a known history of delivery failures, (iii) price thresholds determined by the Participant's or Access Person's prime broker or custodian and (iv) the lack of any other conditions limiting availability. Importantly, a security cannot automatically be considered easy-to-borrow simply because a security is not hard-to-borrow. Additionally, the easy-to-borrow lists should be reviewed and updated on a regular basis.

Supervision and Gatekeeper Requirements

In order to demonstrate compliance with the proposed UMIR 3.3, Participants and Access Persons would need to update (i) their policies, procedures and trading processes, (ii) supervision systems to ensure there are regular compliance reviews with respect to the requirements for a reasonable expectation to settle and (iii) gatekeeper reporting processes to ensure that potential violations of UMIR 3.3 are reported to CIRO in a timely fashion. As noted by CIRO, Participants and Access Persons would generally already have in place policies, systems and reporting processes to prevent trading without a reasonable expectation to settle pursuant to UMIR Policy 2.2.

CIRO's View of the Impact of the Amendments

The CIRO Notice contains an impact assessment relating to the Proposed Amendments. Overall, CIRO believes that the Proposed Amendments will have neutral to positive impacts on market participants, particularly because a prohibition on entering into short sales without a reasonable expectation to settle currently exists under UMIR Policy 2.2.

With respect to issuers specifically, CIRO expects that the Proposed Amendments will have neutral to minor positive impacts on issuers, as the Proposed Amendments "would address the concerns of certain issuers regarding short selling by imposing a positive obligation to have a reasonable expectation to settle on settlement date prior to the entry of a short sale order on a marketplace".

CIRO also expects that the Proposed Amendments would have a greater impact in areas where there are a higher number of (i) issuers whose securities may be deemed hard-to-borrow or (ii) Participants and Access Persons that lack access to available securities to establish a reasonable expectation to settle.

Implementation

CIRO is proposing a 90-day implementation period following the publication of the notice of approval, with an effective date that would not be prior to the move to the T+1 settlement cycle.

Clarifications Regarding Certain Requirements Related to Extended Failed Trades

Where a Participant acts as agent for a client and executes a trade that becomes an extended failed trade, the Participant must, among other things, be satisfied after making “reasonable inquiry” that the reason for the prior failed trade was not the result of any intentional or negligent act of the client or non-client. The Proposed Guidance states that a reasonable inquiry would include contacting the client or non-client to obtain sufficient information to determine whether the prior failed trade was due to an intentional or negligent act. The Proposed Guidance provides that Participants and Access Persons are expected to document this inquiry, including their assessment.

What is an “intentional act”?

The Proposed Guidance indicates that intentional acts are those that are performed knowingly, with malicious intent not being required. The Proposed Guidance provides as an example of an “intentional act” a situation where a client seeks to short a security knowing that the security is hard-to-borrow and provides attestations to the executing Participant that the client has the ability to access available securities. Notwithstanding this, the client does not make any arrangements to ensure securities are available to settle the resulting trade and the resulting trade becomes an extended failed trade.

What is a “negligent act”?

The Proposed Guidance states that a negligent act includes actions that may not have resulted from the intention of the client, but rather, from the failure to take the steps that a reasonable person would take to ensure settlement. According to the Proposed Guidance, a negligent act is one that could have been avoided with reasonable diligence. The Proposed Guidance provides as an example of a “negligent act” a scenario where a client wishes to short a security and provides representations to the executing Participant that they have access to such security, but the client’s representations were based on an outdated easy-to-borrow list and the client does not pay attention to the changed status of the security at the time of entering the order, with the resulting trade becoming an extended failed trade.

Observations

Distinctions between paragraph 2(h) of Policy 2.2 and proposed UMIR 3.3(1)

There are two important distinctions between the existing requirement in paragraph 2(h) of UMIR Policy 2.2 and proposed UMIR 3.3(1). First, the proposed UMIR 3.3(1) is focused solely on short sales and makes clear that no consideration of manipulative or deceptive trading is required, which CIRO believes will help Participants and Access Persons in complying with the Proposed Amendments. Second, the proposed UMIR 3.3(1) imposes an affirmative obligation to establish a reasonable expectation *prior* to order entry, whereas paragraph 2(h) of UMIR Policy 2.2 merely prohibited the sale of a security, long or short, without the reasonable expectation, at

the time of order entry, of being able to settle the trade.

Meaning of “Reasonable Expectation”

CIRO had, in prior guidance, stated that to meet the reasonable expectation standard Participants and Access Persons 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 that previously articulated by CIRO’s predecessor.^[6] While the CIRO Notice does not 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, to demonstrate a reasonable expectation to settle and (iii) documenting such steps would help Participants and Access Persons demonstrate compliance with proposed UMIR 3.3.

McMillan LLP intends to use our considerable expertise in short selling to provide a response to the CIRO Notice with input from our clients and other market participants. If you have any comments related to the current Canadian short selling regulatory framework, the Proposed Amendments, or the Proposed Guidance, please contact any of the authors of this bulletin.

[1] *Proposed Amendments Respecting the Reasonable Expectation to Settle a Short Sale*, Notice 24-0003, online: [Canadian Investment Regulatory Organization](#).

[2] *Proposed Guidance on UMIR Requirements Related to Short Selling and Failed Trades*, Notice 24-0004, online: [Canadian Investment Regulatory Organization](#).

[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] CIRO provided, as an example, trades by a client which failed for administrative reasons versus trades by a client which failed as a result of negligence or false claims. The former may not impact a reasonable expectation to settle, while the latter would.

[6] See our bulletin on the prior guidance [here](#). As we have noted in the bulletin, CIRO’s predecessor had, prior to CIRO Notice 22-0130, stated that the “reasonable expectation” standard “merely requires that the vendor not make a sale *knowing* that the securities cannot be borrowed and that the vendor take ‘reasonable steps’ to

attempt to borrow the securities to make delivery on closing”.

by [Charlotte Conlin](#), [Paul Davis](#), [Troy Hilson](#), [Shahen Mirakian](#), [Leila Rafi](#), and [Sandra Zhao](#)

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2024