March 8, 2023

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Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
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The Secretary, Ontario Securities Commission
20 Queen Street West 22nd Floor
Toronto, Ontario M5H 3S8

Dear Sirs/Mesdames:

RE: Joint CSA and IIROC Staff Notice 23-329 – Short Selling in Canada

About Alternative Investment Management Association (AIMA)

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit international educational and research body that represents practitioners in alternative investment funds, futures funds and currency fund management – whether managing money or providing a service such as prime brokerage, administration, legal or accounting.

AIMA's global membership comprises approximately 2,100 corporate members in more than 60 countries, including many leading investment managers, professional advisers and institutional investors and representing over $2.5 trillion in assets under management. AIMA Canada, established in 2003, has approximately 150 corporate members.

The objectives of AIMA are to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to provide leadership to the industry and be its pre-eminent voice; and to develop sound practices, enhance industry transparency and education, and to liaise with the wider financial community, institutional investors, the media,

regulators, governments and other policy makers.

The majority of AIMA Canada members are managers of alternative investment funds and fund of funds. Most are small businesses with fewer than 20 employees and $100 million or less in assets under management. The majority of assets under management are from high net worth investors and are typically invested in pooled funds managed by the member.

Investments in these pooled funds are sold under exemptions from the prospectus requirements, mainly the accredited investor and minimum amount investment exemptions. Manager members also have multiple registrations with the Canadian securities regulatory authorities: as Portfolio Managers, Investment Fund Managers, Commodity Trading Advisers and in many cases as Exempt Market Dealers. AIMA Canada's membership also includes accountancy and law firms with practices focused on the alternative investments sector.

For more information about AIMA Canada and AIMA, please visit our web sites at canada.aima.org and www.aima.org.

Comments

We are writing in response to **Staff Notice 23-329 – Short Selling in Canada** published jointly by the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC).[1]

Overall, AIMA Canada supports the objective of reviewing short selling regulation to ensure that it remains appropriate in light of ongoing developments in the Canadian securities market and globally. We were pleased to see that the Staff Notice highlights proactively the many benefits of short selling as a "legitimate trading practice that helps market participants manage risk, contributes to market liquidity and promotes price discovery." AIMA too has published research on the benefits of short selling and the important link between short selling and responsible investment.

We also endorse the following observations made in the Staff Notice:

- That short selling is already "subject to a well-developed framework comprising Canadian securities legislation and IIROC requirements".

- That "Canada's regulatory regime governing short sales is generally consistent with the four principles for the effective regulation of short selling published by the International Organization of Securities Commissions (IOSCO) in 2009".

- That potential issues related to activist short selling, as addressed in CSA Staff Notice 25-306, do not "justify a regulatory response".

In general, our view is that the existing framework relating to short selling in Canada is adequate, providing transparency to IIROC, encouraging settlement discipline and addressing manipulate/abusive behavior. We note that any change to the existing regime carries the risk of chilling short selling and curtailing the benefits that it provides to the Canadian securities markets and to end investors.

[1] Online at: https://www.osc.ca/sites/default/files/2022-12/csa-iiroc_20221208_23-329_short-selling.pdf.

We would also highlight our strong opposition to any move to introduce public transparency of individual short positions as exists in the EU and UK, noting that this has been demonstrated to reduce firms' willingness to enter into short sales given that public disclosure of their positions could lead to competitors replicating their strategies or to retaliation from issuers (notably limiting the scope for future dialogue with management). We address this further in our response to Question 5 in the Staff Notice.

Staff Notice Questions

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.**

   We believe that the existing regulatory regime underpinning orderly settlement of short positions is adequate and should not be changed.

   The Staff Notice rightly notes that IIROC's Universal Market Integrity Rules (UMIR) specify that entering an order to sell a security without having reasonable expectation of settling the resulting trade on settlement date is considered a false or misleading appearance of trading activity and thus a manipulative and deceptive activity.[2] This is further supported by IIROC's pre-borrow requirements, including the restriction on Participants or Access Persons from making further short sales where an Extended Failed Trade report that relates to a sale of a security failing to settle was filed with IIROC. Specifically, as emphasized in the Staff Notice, further short sales generally cannot be made by that Participant (acting as principal or as agent) or by an Access Person without prior arrangements to borrow the securities necessary for settlement.[3] Participants and Access Persons must also make prior arrangements to borrow any security designated by IIROC as a "Pre-Borrow Security" before entering an order to sell short on a marketplace.[4]

   We believe that this framework provides a sufficient basis for addressing potential deceptive practices and for encouraging settlement discipline, particularly considering the scope for market-led measures to ensure robust practice. We note that the UMIR provision addressing the "reasonable expectation of settling" is not substantially different from the limb of the US SEC's Regulation SHO, as referred to in the Staff Notice, that requires that a broker-dealer have "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due" before accepting a short sale. On this basis, we believe that the existing framework is adequate and appropriate.

2. **What would be the costs and benefits of implementing such requirements?**

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[2] Part 2 – False or Misleading Appearance of Trading Activity or Artificial Price of UMIR Policy 2.2 Manipulative and Deceptive Activities.

[3] UMIR, Part 6 – Order Entry and Exposure – Entry of Orders on Marketplace, Rules 6.1(4) and 6.1(6).

[4] "Pre-Borrow Security" means a security that has been designated by a Market Regulator to be a security in respect of which an order, that on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order. UMIR, Policy 1.1, Definition of Pre-Borrow Security, 1.1; See also Part 6 – Order Entry and Exposure – Entry of Orders on Marketplace, Rule 6.1(5).

Our concern is that potential changes to the existing pre-borrow framework could make it more costly to effect a short sale and could, in the extreme, make certain securities much harder to short, depending on the nature of the pre-borrow standard and any associated documentation requirements. This would be to the detriment of the price formation process and market functioning.

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

   The Staff Notice explains that a failed trade is generally understood to occur when a seller (whether short or long) fails to deliver securities or the buyer fails to pay the funds when delivery/payment is due, currently on the second business day after the trade date, unless a later settlement date is agreed to by all parties at the time of the trade. Failed trades may also occur when there are issues with instructions of the buyer and the seller regarding settlement (for example, when there are different instructions from the buyer and the seller, or one party of the trade has not provided instructions or provided them too late).

   We believe that this appropriately describes a failed trade.

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.**

   Consistent with our response to Question 1, we do not see a compelling case for changing the time period that is referenced by IIROC's Extended Failed Trades requirements.

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.**

   AIMA does not believe that additional public transparency requirements in respect of short selling activities or short positions should be considered.

   In particular, we would highlight our strong opposition of any move to introduce public transparency in respect of individual firm positions. The negative market impact of manager-level short-selling disclosure requirements has been quantified in several studies, drawing on both the European disclosure regimes and the temporary reporting requirements in the US during the Financial Crisis via Form SH (under temporary Exchange Act Rule 10a-3T).

   The European Securities and Markets Authority's (ESMA) December 2017 'Final Report: Technical Advice on the evaluation of certain elements of the Short Selling Regulation'[5] indicated that public short disclosure rules prompt a change in market participants' willingness to enter into short positions, creating the potential for pricing inefficiencies. Public transparency is also associated with increased herd behavior for two reasons. First, investors may assume that those who go public are likely to be better informed, and decide to replicate

[5] https://www.esma.europa.eu/sites/default/files/library/technical_advice_on_the_evaluation_of_certain_aspects_of_the_ssr.pdf

their competitors' strategies. Second, investors may be less concerned with keeping their strategy secret once another investor has gone public, and decide to take a larger position.[6]

The reduction in liquidity arising from disclosure of individual short positions can be substantial. One study in Europe conducted by Oliver Wyman found that public disclosure requirements decreased short sellers' participation in equity markets by approximately 20-25%, a figure confirmed using a short interest ratio as well as by proprietary data sourced from sell-side institutions. Similarly, short selling activity decreased measurably in the US for subject securities during the ten-month period in which US investment managers were required to file Form SH. Clearly, investment managers are less willing to trade short when public disclosure of short positions is required. Consequently, the capacity of stock loan markets to support normal levels of short selling activity also is impaired, with beneficial owners reducing the lendable equity supply.

As short-selling liquidity decreases, overall trading volumes also decrease, bid-ask spreads widen, price discovery becomes less efficient, and intraday volatility increases. It becomes more expensive and difficult for all investors to execute trades, whether long or short.

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.**

   We believe that current reporting requirements are adequate and effectively enable IIROC to oversee short selling in the Canadian securities market.

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.**

   Our overall preference is that there should be consistency across settlement provisions for different classes of securities rather than having differentiated provisions for junior securities that might be operationally complex to implement.

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.**
   AIMA strongly believes that buy-ins should be voluntary and not mandatory.

   A voluntary buy-in regime can grant investment managers greater flexibility in achieving their investment objectives while enhancing settlement rates and investor protection, as firms could allow sellers additional time for the delivery of securities, instead of settling for cash

[6] Ibid., p.125

compensation where not in the interest of clients. Buy-ins are rarely carried out, particularly by smaller firms, thus the imposition of a mandatory regime would not only create inefficiency in securities settlement, but it would act as a barrier to entry. A voluntary regime, however, would enable firms to initiate buy-ins at their own discretion, when appropriate and in line with their fiduciary duties, and support the entrance of new market participants.

Further to jeopardising investor protection, the imposition of mandatory buy-ins would have a negative impact on market liquidity. As market-makers reduce the number of shares that they cover and widen bid-offer spreads, brokers may be less likely to accept orders for shares where they believe they will not be available, causing liquidity in small- and mid-cap equity markets as well as the overall bond market to fall. Such would be exacerbated in corporate and high-yield bond markets which rely heavily on liquidity providers shorting bonds that they do not own, resulting in a lack of securities available for borrowing to cover short sales and settlements. Voluntary buy-ins, however, would reduce the risks of short selling and short sellers being bought-in, thereby providing market liquidity to buyers and sellers.

Yours truly,

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION CANADA

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