

# IIROC NOTICE

## **Rules Notice Request for Comments**

UMIR

*Please distribute internally to:*  
Legal and Compliance  
Trading

**Comments Due:** September 14, 2015

*Contact:*

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**15-0155**

**July 16, 2015**

## **Proposed Updated Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations**

### **Executive Summary**

IIROC requests comments on proposed guidance that would replace guidance, originally issued in October, 2012, on the application of “short sale” and “short-marking exempt” (SME) order designations<sup>1</sup> (“Proposed Guidance”), in order to reflect IIROC’s proposed amendment to UMIR to expand the definition of a SME order (“Proposed Amendment”).<sup>2</sup> The Proposed Amendment would capture orders related to all market making activity for Exempt Exchange-traded Funds<sup>3</sup> (ETFs), to ensure consistent application of the SME order designation to that trading activity. The Proposed Guidance would address the broader application of the SME order designation to all orders of ETF market makers under the Proposed Amendment and clarify existing short sale and SME order marking requirements.

<sup>1</sup> See IIROC Notice [12-0300](#) – Rules Notice – Guidance Note - UMIR – *Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations* (October 11, 2012). See UMIR for the definitions of “short sale” and “short-marking exempt order”.

<sup>2</sup> See IIROC Notice 15-0156 – *Proposed Amendment to the Short-marking Exempt Order Definition* (July 16, 2015).

<sup>3</sup> See UMIR definition.



## How to Submit Comments

Comments are requested on the Proposed Guidance, including any matter which it does not specifically address. Comments on the Proposed Guidance should be in writing and delivered by **September 14, 2015** to:

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***Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website ([www.iiroc.ca](http://www.iiroc.ca)) under the heading “Notices” and sub-heading [“Rules Notices – UMIR Request for Comments”](#).***

## Rules Notice - Table of Contents

1.	Background to the Proposed Guidance.....	3
1.1	Proposed Amendment to the SME Order Definition.....	3
1.2	Use of the SME Order Designation .....	3
1.3	Summary of Revisions from the Original Guidance.....	4
2.	Implementation Plan .....	5
3.	Policy Development Process .....	5
3.1	Regulatory Purpose .....	5
3.2	Regulatory Process.....	5



## **1. Background to the Proposed Guidance**

### **1.1 Proposed Amendment to the SME Order Definition**

Concurrent with the issuance of this Request for Comments on the Proposed Guidance, IIROC has published a Request for Comments respecting the Proposed Amendment to the SME order definition. The Proposed Guidance should be reviewed in conjunction with the Rules Notice respecting the Proposed Amendment. The Proposed Amendment is intended to ensure consistent application of the SME order designation to the trading activity of ETF market makers and to support the integrity of short selling statistics which IIROC uses and publishes<sup>4</sup> in order to enhance IIROC's ability to effectively monitor directional short selling activity. The Proposed Guidance is intended to address the broader application of the SME order designation to all orders of ETF market makers under the Proposed Amendment, and to clarify existing short sale and SME order marking requirements.

### **1.2 Use of the SME Order Designation**

The “short-marking exempt” designation is required to be applied to orders for qualifying accounts of arbitrageurs, market makers and “high frequency traders”<sup>5</sup> that typically generate a high volume and speed of orders on a fully automated basis, may have orders on both sides of the market on various marketplaces at the same time, and that adopt a “directionally neutral” strategy such that generally, the position in each security in the account is flat at the end of the trading day. The use of the SME order designation allows IIROC to separately monitor the trading activities of those accounts which are actively buying and selling the same security without taking a directional position in that security and which have a finite time horizon of a trading day or less to effectively balance purchases and sales of the particular security. Further, application of SME order marking to the applicable accounts permits IIROC to focus the monitoring of short sale activity on accounts that may have adopted a “directional” position with respect to particular securities.

The existing SME order definition identifies the accounts which qualify for the SME order designation, but there has been inconsistency in the application of the SME order marker for the accounts of ETF market makers, which in some cases did not conform to IIROC's guidance.<sup>6</sup> The Proposed Amendment intends to promote uniform SME order marking for ETF market making activity by expanding the SME order definition to capture all orders of ETF

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<sup>4</sup> See IIROC's [Short Sale Trading Statistics Summary](#).

<sup>5</sup> The term “high frequency trader” is not defined in UMIR. However, IIROC would expect that a “high frequency trader” would have direct electronic access to more than one marketplace to execute fully-automated trading strategies that seek to benefit from liquidity imbalances or other short-term pricing inefficiencies and the trading strategy is generally directionally neutral or closed out by the end of each trading day.

<sup>6</sup> See IIROC Notice [12-0300](#), *op. cit.*



market makers, including “delta neutral” hedge<sup>7</sup> transactions in a single principal account, by an ETF market maker that has the ability to create and redeem ETF units to become flat at the end of the day. The Proposed Guidance would address the broader application of the SME order designation by ETF market makers, which is intended to ensure IIROC’s short sale statistics are meaningful and further enhance IIROC’s ability to monitor true directional short selling. The Proposed Guidance would also provide interpretation further clarifying the obligations to correctly designate orders as “short sale” or “short-marking exempt” on a marketplace as required by Rule 6.2 of UMIR.

### **1.3 Summary of Revisions from the Original Guidance**

The Proposed Guidance updates the original guidance issued in October, 2012 to align with the Proposed Amendment and to provide additional guidance on various questions relating to the correct use of the “short sale” and “short-marking exempt” designations. In particular, the Proposed Guidance:

- recognizes that ETF market making activity, which includes “minimal exposed risk” hedge transactions, should be marked consistently with the SME order designation to ensure the integrity IIROC’s short sale statistics and enhance IIROC’s ability to monitor true directional short selling;
- clarifies that to qualify for SME marking as an “arbitrage account”<sup>8</sup>, trading in the account must be “directionally neutral”, and that an account engaged in hedge transactions that involves an ETF security and the underlying securities is not an “arbitrage account” under the SME order definition;
- clarifies that to facilitate accurate order marking, an ETF market maker should preferably conduct trading eligible for SME marking in an account that is separate from other non-SME directional trading which may be undertaken by the ETF market maker; and
- makes editorial changes to questions relating to “short sale” and SME orders for clarity and completeness.

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<sup>7</sup> Hedge is defined in UMIR and means the purchase or sale of a security by a person to offset, in whole or in part, the risk assumed on a prior purchase or sale or to be assumed on a subsequent purchase or sale of that security or a related security. Delta hedging is the process of setting or keeping the delta of a portfolio as close to zero as possible to wholly offset risk.

<sup>8</sup> See definition in UMIR.



## **2. Implementation Plan**

**The Proposed Guidance would become effective concurrent with the Proposed Amendment, which would not be in effect earlier than 60 days after publication of the Notice of Approval for the Proposed Amendment.**

## **3. Policy Development Process**

### **3.1 Regulatory Purpose**

The Proposed Guidance would align with the expanded definition of a SME order under the Proposed Amendment and provide additional interpretation further clarifying the broader application of the SME order designation by ETF market makers. The Proposed Guidance would also provide guidance on various questions relating “short sale” and “short-marking exempt” designations to promote the correct use of these order markers necessary to maintain the integrity of the short selling statistics used and published by IIROC.

### **3.2 Regulatory Process**

The Proposed Guidance is being published for comment together with the Request for Comments on the Proposed Amendment. The Market Rules Advisory Committee of IIROC considered this matter as proposed in concept by IIROC.

After considering the comments on the Proposed Guidance received in response to this Request for Comments together with any comments on the Proposed Amendment, IIROC may recommend that revisions be made to the Proposed Guidance. If the revisions are not material, the Proposed Guidance as revised will be published together with the Proposed Amendment as approved. If the revisions are material, the Proposed Guidance as revised will be re-published for comment.



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15-0\*\*\*  
\*\*\*\*, 2015

## Updated Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations

### Executive Summary

This Rules Notice provides updated guidance on the marking of orders pursuant to UMIR to include “short sale” and “short-marking exempt” (SME) order designations<sup>1</sup>. Any order to sell a security which the seller does not own either directly or through an agent or trustee must be marked “short” at the time of entry to a marketplace. An exception to this requirement is when the order is from an account for which purchase and sell orders are designated as “short-marking exempt”. ***If an account qualifies for the use of the “short-marking exempt” order designation, an order will only carry the “short-marking exempt” designation and should not also carry the “short sale” designation, even though the sale order may be from a short position. The use of the “short-marking exempt” designation is a requirement under Rule 6.2 of UMIR and its use on qualified orders is not optional.***

<sup>1</sup> This Rules Notice updates guidance originally issued as IIROC Notice [12-0300](#) – *Guidance on “Short Sale” and “Short-Marking Exempt” Orders* (October 11, 2012) effective on October 15, 2012, further to an amendment to the SME order definition pursuant to IIROC Notice [15-\\*\\*\\*\\*](#) – *Amendment to the Short-marking Exempt Order Definition (Date)*, which expanded the SME order definition to capture orders related to all ETF market making activity to ensure consistent application of the SME order designation to that trading activity.



## Rules Notice – Table of Contents

1.	General Order Marking Requirement.....	8
1.1	“Short Sale” Order Designation .....	8
1.2	“Short-Marking Exempt” Order Designation .....	9
1.2.1	Arbitrage Account.....	10
1.2.2	Accounts of Persons with Marketplace Trading Obligations.....	10
1.2.3	High Frequency Trading Accounts.....	11
1.2.4	Principal “Facilitation” Accounts.....	11
1.2.5	Policies and Procedures Respecting SME Order Accounts.....	11
2.	Questions and Answers .....	13
3.	Impact on Existing Guidance .....	19

### 1. General Order Marking Requirement

Correct order designations are essential to maintaining an accurate and complete audit trail.<sup>2</sup> A complete audit trail allows IIROC to effectively monitor trading activity on Canadian marketplaces and provides the supervisory personnel of each Participant with information that is necessary to enable them to carry out their supervisory obligations as required by Rule 7.1 of UMIR. Rule 6.2 of UMIR requires each order entered on a marketplace contain certain designations acceptable to IIROC, including the obligation of a Participant or Access Person to correctly designate whether an order is either:

- a “short sale” order; **OR**
- a “short-marking exempt” order.

If an account qualifies for the use of the “short-marking exempt” order designation, as described below, the entry of orders by the account will only carry the “short-marking exempt” designation and should not also carry the “short sale” designation, even though the sale order may be from a short position.

<sup>2</sup> IIROC has issued guidance on the procedures to be followed to correct the “markers” on executed trades. In particular, see IIROC Notice 08-0050 – Rules Notice- Guidance Note – UMIR – User Guide for the Regulatory Marker Correction Form (July 30, 2008).



### **1.1 “Short Sale” Order Designation**

UMIR defines a short sale as a sale of a security, other than a derivative instrument, which the seller does not own either directly or through an agent or trustee. A seller is considered to own a security if the seller:

- has purchased or has entered into an unconditional contract to purchase the security, but has not yet received delivery of the security;
- has tendered such other security for conversion or exchange or has issued irrevocable instructions to convert or exchange such other security;
- has an option to purchase the security and has exercised the option;
- has a right or warrant to subscribe for the security and has exercised the right or warrant; or
- has sold a security that trades on a “when issued” basis and the seller has entered into a contract to purchase such security, which is binding on both parties and subject only to the condition of issuance or distribution of the security.

A seller is considered **not** to own a security if:

- the seller has borrowed the security to be delivered on the settlement of the trade and the seller does not otherwise own the security (e.g. none of the five circumstances listed above apply to the seller);
- the security held by the seller is subject to any restriction on sale imposed by applicable securities legislation or by an Exchange or QTRS as a condition of the listing or quoting of the security; or
- the settlement date or issuance date pursuant to:
  - an unconditional contract to purchase,
  - a tender of a security for conversion or exchange,
  - an exercise or an option, or
  - an exercise of a right or warrant

would, in the ordinary course, be after the date for settlement of the sale.

### **1.2 “Short-Marking Exempt” Order Designation**

UMIR defines a “short-marking exempt order” as an order for the **purchase or sale** of a security from an account that is:





- (a) an arbitrage account;<sup>3</sup>
- (b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;<sup>4</sup> or
- (c) a client, non-client or principal account:
  - o for which **order generation and entry is fully-automated**, and
  - o which, in the ordinary course, does not have, at the end of each trading day, more than a nominal position, whether short or long, in the **particular security**;
- (d) a principal account that has acquired during a trading day a position in a particular security in a transaction with a client that is unwound during the balance of the trading day such that, in the ordinary course, the account does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security; or
- (e) a principal account for a Participant that has:
  - (i) Marketplace Trading Obligations in respect of an Exempt Exchange-traded Fund<sup>5</sup> (ETF), or
  - (ii) entered into an agreement for the continuous distribution of an Exempt Exchange-traded Fund;if the order is for the Exempt Exchange-traded Fund or one of its underlying securities to hedge a pre-existing position in the Exempt Exchange-traded Fund security or one of its underlying securities and in the ordinary course, the account does not have, at the end of each trading day, more than a minimal exposed risk.

### 1.2.1 Arbitrage Account

Given the exemptions which currently exist under UMIR that are available to arbitrage accounts<sup>6</sup> IIROC would expect that Participants are able to readily identify such accounts and

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<sup>3</sup> Rule 1.1 of UMIR provides that an “arbitrage account” means an account in which the holder makes a usual practice of buying and selling:

- (a) securities in different markets to take advantage of differences in prices available in each market; or
- (b) securities which are or may become convertible or exchangeable by the terms of the securities or operation of law into other securities in order to take advantage of differences in prices between the securities.

<sup>4</sup> See Rule 1.1 of UMIR for the definition of “Marketplace Trading Obligations”.

<sup>5</sup> See UMIR definition of Exempt Exchange-traded Fund.

<sup>6</sup> Under UMIR 4.1(2)(f), an order entered for an arbitrage account does not contravene the prohibition against frontrunning. Also, under UMIR 7.7(4)(k), an exemption is provided for a dealer-restricted person to bid for a purchase of a restricted security for an arbitrage account if the dealer-restricted person knows or has reasonable grounds to believe that a bid enabling the dealer-restricted person to cover the purchase is then available and the dealer-restricted person intends to accept such bid immediately.



trading activity for the purpose of qualifying under paragraph (a) of the SME order definition as well. The activity in the arbitrage account must be “directionally neutral” and not result in more than a nominal position at the end of the day, such that the position held in each security is effectively flat.

An account used for hedge<sup>7</sup> transactions involving any convertible or exchangeable security, is not an arbitrage account, and does not meet paragraph (a) of the SME order definition. The hedging activity is not “directionally neutral” since short sales of the underlying security on that trading day have not been matched with purchases of the underlying security and a short position is maintained.

### *1.2.2 Accounts of Persons with Marketplace Trading Obligations*

Given the exemptions which currently exist under UMIR that are available to persons with Marketplace Trading Obligations for particular securities, IIROC would expect that Participants are able to readily identify such accounts and trading activity for the purposes of qualifying under paragraph (b) of the SME order definition as well. Paragraph (b) of the SME order definition can only be relied upon to qualify for SME order marking when trading a particular security pursuant to Marketplace Trading Obligations with respect to that security.

Orders for securities for which a person does not have Marketplace Trading Obligations do not qualify under paragraph (b) of the SME order definition and cannot be marked with the SME order designation. To the extent that a person with Marketplace Trading Obligations for a particular security also trades related, underlying or other securities for which the person does not have Marketplace Trading Obligations, and which do not qualify for SME order marking, the trading of SME orders and non-SME orders should preferably be conducted in separate accounts to facilitate accurate order marking.

Paragraph (e) of the SME order definition applies specifically when a Participant acts as an ETF market maker.<sup>8</sup> Whether or not the Participant has Marketplace Trading Obligations for an ETF security, provided that an agreement for continuous distribution of the ETF is engaged with the ETF issuer, a Participant is able to trade both the ETF security and the underlying securities in the same principal account and mark all the orders with the SME designation as long as the account does not have, at the end of each trading day, more than a minimal exposed risk. This

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<sup>7</sup> “Hedge” is defined in UMIR as the purchase or sale of a security by a person to offset, in whole or in part, the risk assumed on a prior purchase or sale or to be assumed on a subsequent purchase or sale of that security or a related security.

<sup>8</sup> See IIROC Notice 15-\*\*\*\* *op. cit.*



allows the account to engage in “fully-hedged<sup>9</sup> transactions with the ETF and its underlying securities as an exception to the general requirement that trading in the account be “directionally neutral”. The administration of order marking for the ETF market making function has been simplified with this new requirement, to ensure the integrity of short selling data which IIROC uses and publishes and in recognition that the ETF market maker has the ability to create or redeem the ETF units in order to become flat at the end of the day.

### *1.2.3 High Frequency Trading Accounts*

Paragraph (c) of the SME order definition relates to the category of client, non-client or principal account that include accounts operating algorithms and would generally be known as “high-frequency traders”. There are two conditions for these client, non-client and principal accounts to qualify to use the “short-marking exempt” designation. The first condition is that order generation and entry is fully-automated. This means that the accounts must exclusively use “automated order systems”, as defined for the purposes of National Instrument 23-103 *Electronic Trading*, to generate orders. The second condition is that the trading activity conducted in the account be “directionally neutral” so that the account generally only has a nominal position, whether long or short, at the end of a trading day in any particular security.

### *1.2.4 Principal “Facilitation” Accounts*

Paragraph (d) of the SME order definition permits use of the SME order designation for orders from a principal account used for “facilitation” trades, such as entering into a short position to facilitate a client purchase which is then covered by purchases generally by the end of the same trading day. If a Participant undertaking a client “facilitation” trade carries a significant proportion of the position for more than one trading day, the trade should be conducted through an account which does not apply the “short-marking exempt” order designation.

### *1.2.5 Policies and Procedures Respecting SME Order Accounts*

In order for Participants to be able to properly identify accounts which would be required to designate orders as “short-marking exempt”, IIROC would expect the Participant to adopt compliance policies and procedures to regularly review the status of each account, and to use

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<sup>9</sup> An account which is “fully-hedged” by holding, for example, over a period of time a long position in a convertible security that is offset by a short position in the underlying security is not considered to be “directionally neutral” at the end of a trading day as short sales of the underlying security on that trading day have not been matched with purchases of the underlying security.



its best judgment in making such determinations. For client and non-client accounts, the Participant may rely:

- solely on the trading information in the accounts within the control of the Participant; or
- on trading information in the accounts together with representations by the client or non-client as to the trading strategy or strategies for the particular account.

For example, if an account is engaged in cross-border arbitrage activity, the trading information in the particular account may not by itself indicate that the trading is directionally neutral. The Participant may rely on representations by the client unless the contrary is indicated by the actual trading information. If the Participant bases its determination in part on client representations, IIROC would expect that the Participant would monitor the trading patterns in the account to ensure that they are consistent with the client representations and that the Participant would confirm the client representations on a periodic basis.

As a general guideline, IIROC would accept that an account with automated order generation and entry or a principal facilitation account would satisfy the requirements necessary to designate orders as “short-marking exempt” if the account is to be “directionally neutral” on the price of securities traded. IIROC would accept this to be the case if on approximately 90% of the trading days in the previous month, the aggregate net position of the account in respect of any security at the end of the trading day, whether short or long, did not exceed 5% of the volume of that security traded by the account on that trading day.

IIROC recognizes that trading in securities of limited liquidity may result in temporary positions in a particular security even when the overall strategy for the account is to be “directionally neutral”. IIROC would expect Participants to exercise their best judgment when evaluating whether the overall trading strategy of the account is to be directionally neutral.

Participants may wish to encourage clients who conduct high frequency trading or arbitrage trading and traditional “directional” investment, to do so in separate accounts. Generally speaking, if types of trading activity are co-mingled such that there is some activity which would qualify for the use of the short-marking exempt designation and other trading that would not, IIROC would expect that the SME marker would not be used on any order and that short sales would be properly designated. Trading activity in a principal account by a market maker or for the purpose of client facilitation, which qualifies for SME order designation, should also preferably be engaged in a separate account from any other directional trading that does not qualify for the SME order designation. (See Question 11 for a discussion of acceptable alternatives.)



## 2. Questions and Answers

The following is a list of questions regarding when an order must be designated as a “short sale” or “short-marking exempt” upon entry to a marketplace:

### **1. Must an order be marked as a “short sale” if it is a bundled order that is comprised of orders from accounts that are both “long” and “short” the security?**

Yes. While bundling is generally not encouraged, orders are sometimes bundled when a Participant is “working” several orders for the same security for different clients and any executions are allocated proportionately among the clients. If at least one of the clients has sold a security short, each bundled order must contain the short sale designation upon entry to a marketplace.

The Participant must submit a Regulatory Marker Correction Form<sup>10</sup> to IIROC to “unbundle” the long portion of any quantity executed which was allocated to any account. The Regulatory Marker Correction Form should be filed as soon as practicable after the execution of the trade, and in any case, by the later of 5:00 p.m. and 15 minutes following the close of trading on the marketplace on which the trade was executed.

### **2. Can a “short-marking exempt” order be bundled with other orders including a “short sale” order?**

Yes. However, given the role of the “short-marking exempt” designation in IIROC’s monitoring of trading activity, the “bundling” of a “short-marking exempt” order with other orders is generally discouraged (and, for practical reasons, may be limited to orders from accounts with Marketplace Trading Obligations or arbitrage accounts or for principal facilitation since other accounts qualified to use the short-marking exempt designation must have fully-automated order generation and entry). If bundling is necessary, upon entry to a marketplace, the entire order should be designated as:

- “short” if the bundle contains a short sale; or
- “short-marking exempt” if the bundle does not contain a short sale.

The Participant must submit a Regulatory Marker Correction Form<sup>10</sup> to IIROC to “unbundle” the non-“short-marking exempt” portion of any quantity executed, which was allocated to any account which was not eligible to use the “short-marking exempt”

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<sup>10</sup> For details on the use of the Regulatory Marker Correction Form, see IIROC Notice [08-0050](#) – Rules Notice- Guidance Note – UMIR – User Guide for the Regulatory Marker Correction Form (July 30, 2008).



designation. The Regulatory Marker Correction Form should be filed as soon as practicable after the execution of the trade, and in any case, by the later of 5:00 p.m. and 15 minutes following the close of trading on the marketplace on which the trade was executed.

**3. If an account operates an inter-listed arbitrage strategy, should sell orders entered when the account is in a short position be designated as “short sales”?**

No. The short-marking exempt order definition includes an “arbitrage account” in which the holder makes a usual practice of buying and selling securities in different markets to take advantage of differences in prices available in each market. This arbitrage activity is “directionally neutral” since as a result of the purchase and sale transactions, the account is effectively flat. The purchase and sale orders in the arbitrage account must be accordingly be designated as “short-marking exempt” upon entry to a marketplace.

**4. If a Participant has agreed to buy a block of stock from a client and is “moving the market” down to the agreed print price, should an order entered for the purpose of displacing the market be designated as a “short sale”?**

No. These orders are not required to be designated as short sales. In this situation, the Participant is considered to be “long” as the Participant committed to purchase the position from the client prior to displacing the market.

**5. Is a client who accesses a marketplace through direct electronic access (DEA) subject to the order designation requirements?**

Yes. All orders entered on a marketplace must be properly designated, including those of a DEA client. The Participant is responsible to review order designation for DEA clients as part of the Participant’s supervisory procedures required by Rule 7.1 of UMIR. In this regard, IIROC expects a Participant to undertake periodic monitoring, no less frequently than monthly, of the trading pattern of an institutional customer in order to ensure it is consistent with any client representations and that the purchase and sale orders for particular securities in the account are being appropriately designated as “short-marking exempt”. Similarly, if an institutional customer does not have DEA but maintains an account with a Participant for which order entry is fully-automated, the Participant should periodically review, no less frequently than monthly, whether the purchase and sale orders for particular securities in the account are being appropriately designated as “short-marking exempt”.





**6. Should all orders entered by a person with Marketplace Trading Obligations be designated as “short-marking exempt”?**

No. A person with Marketplace Trading Obligations should only designate purchase and sale orders for securities for which that person has responsibility as “short-marking exempt”. Orders for other securities should not be designated as “short-marking exempt”. An order for the short sale of a security for which the person does not have Marketplace Trading Obligations should be designated as a “short sale”.

To the extent that a person with Marketplace Trading Obligations for a particular security also trades related or other securities for which the person does not have Marketplace Trading Obligations, and which must not be marked SME, the trading of SME orders and non-SME orders should preferably be conducted in separate accounts to facilitate accurate order marking.

The SME order definition however specifically permits a Participant that has Marketplace Trading Obligations for an ETF security or that has an agreement for continuous distribution of the ETF with the ETF issuer, to more broadly apply the SME order designation to all orders:

- for the ETF security for which the Participant has Marketplace Trading Obligations; or
- for the ETF security for which the Participant has an agreement for continuous distribution with the ETF issuer; and
- for the underlying securities of the same ETF security

as long as the account of the ETF market maker does not have, at the end of each trading day, more than a minimal exposed risk<sup>11</sup>.

**7. A person holds an option and intends to pay the exercise price of the option from the proceeds of the sale of the securities that will be issued on the exercise of the option. Must the sell order be designated as a “short sale”?**

Yes. The definition of “short sale” in Rule 1.1 of UMIR states that a seller shall be considered to own a security if the seller “has an option to purchase the security and has exercised the option”. Since the holder of the option has not done everything required to exercise the option (including the payment of the exercise price) at the time of the proposed sale, any sell order for the underlying securities must be designated as “short” upon entry to a marketplace.

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<sup>11</sup> An account with “minimal exposed risk” is “fully-hedged” to attempt to wholly offset risk.



**8. Is there any difference in the order designation requirements if the order is entered on a marketplace prior to the marketplace opening for execution of trades?**

No. A short sale order entered on a marketplace in the “pre-opening” is required to be designated as a “short sale”. Orders entered on a marketplace during the “pre-opening” by an account that meets the definition of “short-marking exempt order”, whether a buy order or a sell order, must be designated as “short-marking exempt”.

**9. Must an order to sell a security that is subject to a regulatory hold period that has not yet expired be designated as a “short sale”?**

Yes, assuming that the seller does not also hold a long position in the security which is not restricted. For the purposes of the UMIR definition of a “short sale”, a person will not be considered to own a security if the security is subject to a restriction on the sale imposed by applicable securities legislation or by a marketplace as a condition of listing or quoting the security. As such, a holder of a security which is subject to such a sale restriction who enters an order on a marketplace for the sale of a security before the expiration of the sale restriction must designate the sale order as a “short sale”. This obligation to mark the order as “short sale” applies even if the regulatory hold period will expire prior to the settlement of the trade.

**10. Must a sell order be marked “short” if the security is trading on a marketplace on a “when issued” basis?**

No, if the sale is made on a “when issued” basis<sup>12</sup> on a marketplace which has posted a “when issued” market for that security. A person that has entered into a contract to purchase a security that trades on a “when issued” basis (either by subscription to the offering or purchase on a “when issued” basis over-the-counter or on a marketplace) or would become the holder of such security as a result of an arrangement, amalgamation or take-over, that sells such securities on a marketplace which has posted a “when issued” market for that security, will not be considered to enter into a short sale since the settlement of the sale will be subject to the condition that the securities be issued or distributed.

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<sup>12</sup> For more details concerning securities trading on a “when issued” basis, reference should be made to Market Integrity Notice [2006-002](#) – Guidance - “When Issued” Trading (January 30, 2006).





However, if a marketplace has a “regular” market in that security which are issued and outstanding, any sell order entered in the “regular” market by that person for the sale of their “when-issued” security will be considered a “short sale” and must be marked as such in accordance with Rule 6.2 of UMIR. The sale is considered “short” in this circumstance because the issuance or distribution of the security is subject to a condition which may not be met and the trade will have to be settled with borrowed securities.

If a person does not have an entitlement to receive a security when that security is issued, any sale of that security in either the “when issued” or the “regular” market will be considered to be a “short sale”.

**11. Must an order to sell a security subject to a U.S. resale restriction be marked “short” when the order is entered on a marketplace in Canada?**

Yes. A Participant that facilitates the sale into Canada of a security that is subject to resale restrictions in the United States<sup>13</sup>, for example, by virtue of having been acquired under Rule 144A or Regulation D under the Securities Act of 1933, will be considered to have entered a “short sale” as defined in UMIR if the Participant effects the trade for “regular delivery” and the Participant would need to borrow free-trading securities to complete settlement while arranging for the removal of any restrictive legend.

However, if the trade is completed as a Special Terms Order with “delayed delivery” to allow time before settlement for the removal of any restrictive legend, the sale will be considered to have been made from a “long” position and will not be marked “short”.

**12. I am long warrants and wish to hedge my exposure by selling the underlying securities. Is the order required to be designated as a “short sale”?**

Yes. The order to sell the underlying securities must be designated as a “short sale” upon entry to a marketplace. For the purposes of the UMIR definition of “short sale”, a long position in a warrant does not constitute a deemed long position of the underlying security unless irrevocable instructions to exercise the warrants have been submitted **and** the shares received through the exercise of the warrants would, in the ordinary course, settle prior to or on the settlement date of any sale affected through a marketplace.

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<sup>13</sup> For a more detailed discussion of issues related to sales of securities subject to a U.S. resale restriction, reference should be made to Market Integrity Notice [2006-006](#) – Guidance - Sale of Securities Subject To Certain United States Securities Laws (February 17, 2006).



Similar marking requirements would apply to a person holding rights or convertible securities. Any sale of the underlying securities would have to be marked as a “short sale” unless the rights have been exercised or instructions to convert or exchange the convertible securities have been submitted and the person would, in the ordinary course, expect to receive the securities prior to or on the settlement date of the sale.

In addition, hedge transactions that result in holding over a period of time a long position in a security that is offset by a short position in a related security, are not “directionally neutral” at the end of a trading day, and do not qualify for SME order marking, since short sales of the underlying security on that trading day have not been matched with purchases of the related security.

There is however a limited exception under the SME order definition that allows a Participant that is an ETF market maker pursuant to Marketplace Trading Obligations or under an agreement for continuous distribution of an ETF with an ETF issuer, to maintain an account with a “minimal exposed risk” by holding the ETF security and selling the underlying securities, and to apply the SME order designation to the orders in the account for the ETF security and the sales of the underlying securities.<sup>14</sup>

**13. Does an account that operates a hedging strategy with convertible or exchangeable securities and their underlying securities qualify as an “arbitrage account”?**

No. The hedging strategy is designed to reduce the risk of adverse price movements for the convertible or exchangeable security and involves making an offsetting purchase or sale of the underlying securities. Holding over a period of time a long position in the convertible or exchangeable security that is offset by a short position in the underlying securities is not considered to be “directionally neutral” at the end of a trading day as short sales of the underlying security on that trading day have not been matched with purchases of the underlying security.

Trading in an arbitrage account must be directionally neutral so that the account does not have more than a nominal position at the end of the day or is effectively flat. This requires buying and selling securities which are or may become convertible or exchangeable by the terms of the securities or operation of law into other securities in order to take advantage of differences in prices between the securities. Instructions to convert or exchange the securities must have been submitted and in the ordinary course, the underlying securities would be received prior to or on the settlement date of the sale of those securities.

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<sup>14</sup> See IROC Notice 15-\*\*\*\* *op. cit.*



**14. What should a Participant do if an account that is directionally neutral in its trading and qualifies for the use of the “short marking exempt” designation wants to take a position in one or more particular securities?**

Participants may wish to encourage clients who conduct both algorithmic or “high frequency trading” and traditional “directional” investment, to do so in a separate account. Generally speaking, if types of trading activity are co-mingled such that there is some activity which would qualify for the use of the short-marking exempt designation and other trading that would not, IIROC would expect that the short-marking exempt marker would not be used on any order and that short sales would be properly designated.

IIROC would accept co-mingling of trading activity in an account which otherwise qualifies for the use of the “short-marking exempt” designation if the client or the Participant knows that a particular order or series of orders will not be directionally neutral and:

- the client or Participant overrides any default setting to apply the “short-marking exempt” designation and instead applies the “short” designation on orders that are intended to create a short position in the particular security; or
- the Participant uses the Regulatory Marker Correction System on the date of the trade to remove the “short-marking exempt” designation from any trades that created a long or short position in the particular security and to add the “short” designation on trades that created a short position in the particular security.

**3. Impact on Existing Guidance**

***This Rules Notice repeals and replaces, effective as of, [date], 2015 the guidance set out in IIROC Notice 12-0300 – Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations (October 11, 2012).***