

# Chapter 6

## Request for Comments

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### 6.1.1 CSA/IIROC Joint Notice 23-312 – Transparency of Short Selling and Failed Trades

**REQUEST FOR COMMENT**  
**CANADIAN SECURITIES ADMINISTRATORS / INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**  
**JOINT NOTICE 23-312**  
**TRANSPARENCY OF SHORT SELLING AND FAILED TRADES**

#### 1. Introduction

In recent years, there have been numerous international developments regarding the regulation of short sales and failed trades. A working group (the “Working Group”) comprised of staff from the Canadian Securities Administrators (“CSA”) and the Investment Industry Regulatory Organization of Canada (“IIROC”) has been monitoring these developments and reviewing regulatory approaches to issues arising from short selling and failed trades.

In light of this review, the Working Group is publishing this joint CSA-IIROC notice (“Joint Notice”) to solicit feedback on certain aspects of disclosure and transparency measures regarding short sales and failed trades in Canada.

#### 2. The Working Group’s approach

The Working Group is examining the issues in a phased approach. The first phase was the publication by IIROC (the “IIROC Notice”) of a request for public comment on proposed amendments (the “UMIR Amendments”) to the Universal Market Integrity Rules (“UMIR”) respecting short sales and failed trades.<sup>1</sup> With a number of minor revisions, the CSA recognizing regulators have approved the UMIR Amendments and IIROC is publishing notice of this approval, which includes a summary of the comments received by IIROC, in conjunction with this Joint Notice.<sup>2</sup> A summary of the UMIR Amendments is contained in Appendix C of this Joint Notice.

The IIROC Notice also described IIROC’s plans to enhance transparency of short selling activity and failed trades, which is the second phase. This Joint Notice is intended to complement the discussion and proposals in the IIROC Notice, but is not intended to revisit the UMIR Amendments.

The Working Group is considering other short-selling and failed-trades related issues which may be addressed in future notices. Although this Joint Notice seeks comment on introducing transparency of failed trades, the Working Group is examining issues of trade settlement more broadly and in a larger context. In particular, the Working Group is waiting until IIROC has had more experience with its requirement that Participants<sup>3</sup> report failed trades that have not been rectified by the tenth day following the settlement date (described in section 4 (iii) of this Joint Notice), which became effective on June 1, 2011.

#### 3. The structure of this notice

Section 4 of this Joint Notice sets forth the Working Group’s discussions and questions. The Working Group has considered the comments received in response to the specific questions in the IIROC Notice. The Working Group now seeks supplementary feedback from stakeholders on a range of additional approaches to enhance disclosure of short sales and to introduce some public disclosure of failed trades.

To assist stakeholders in considering the discussion and questions in Section 4, we have included in appendices to this Joint Notice summary background information on the following:

- Appendix A - Background on short sales and failed trades, including existing regulatory provisions in Canada governing these topics;

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<sup>1</sup> IIROC Notice 11-0075 – Rules Notice – Request for Comments – UMIR - *Provisions Respecting Regulation of Short Sales and Failed Trades* (February 25, 2011).

<sup>2</sup> The comments received by IIROC are available on IIROC’s Website at <http://docs.iiroc.ca/CommentsReceived.aspx?DocumentID=09B964F0FD814123AD04640B2F04A012&LinkID=766&Language=en>. A summary of the comments and the IIROC responses are contained in IIROC Notice 12-0078 – Rules Notice – Notice of Approval – UMIR – *Provisions Respecting Regulation of Short Sales and Failed Trades* (March 2, 2012).

<sup>3</sup> UMIR Rule 1.1 defines “Participant” as a dealer that is a member of an exchange, user of a quotation and trade reporting system or a subscriber of an alternative trading system (“ATS”), and “Access Person” as a person other than a Participant who is a subscriber or a user.

- Appendix B – Certain international developments regarding the regulation of short sales and failed trades, including an initiative in 2009 by the International Organization of Securities Commissions (“IOSCO”); and
- Appendix C – An overview of the UMIR Amendments and other measures described in the IIROC Notice.

#### 4. Specific areas for comment

The Working Group believes that Canada’s regulatory regime governing short sales is generally consistent with the IOSCO four principles for the effective regulation of short selling (see Appendix A for a summary of Canada’s regulatory regime and Appendix B for a summary of the IOSCO principles). However, the Working Group is of the view that it may be appropriate to consider whether additional measures are warranted to: (i) enhance the regulatory reporting and transparency of short sales; and (ii) introduce some transparency of failed trades in our markets.

While the UMIR Amendments promote improvements in these areas, the Working Group requests further stakeholder input on whether additional measures are desirable or needed. The Working Group also notes that IIROC’s regulatory jurisdiction is limited to trading by Participants and Access Persons on marketplaces and that CSA rulemaking may be necessary if any measures require a broader scope.

The events during the financial crisis in late 2008 provoked an inquiry into whether enhanced transparency of short selling would improve securities regulation. The Working Group believes that, for the Canadian setting, a careful balance between the potential benefits and costs of transparency of short selling activity must be struck, and is soliciting commenters’ views on how to best achieve such balance.

##### *(i) IIROC aggregate short sale trading data*

As indicated in the IIROC Notice, IIROC proposes the public release of semi-monthly short sale summaries, showing the aggregate proportion of short selling in the total trading activity of a particular security, based on trading data (number of trades, volume and value) aggregated across all marketplaces monitored by IIROC for trades marked “short sale”. This information will supplement the Consolidated Short Position Report (“CSPR”) and will correspond to the UMIR reporting cycle for the short position reporting requirement. While the CSPR is produced semi-monthly and shows the total short positions on dealers’ books on the first and fifteenth day of each month, the IIROC short sale summary will show the number, value and volume of short sales of each listed security based on all trading on all marketplaces during the semi-monthly period. The short sale summary will also express the number, value and volume of short sales for each security as a percentage of trading activity in that security during the period. IIROC expects to introduce the semi-monthly short sale summaries after the UMIR Amendments come into effect on September 1, 2012.

When the UMIR Amendments come into effect, a change will be made to the marking regime for short sales to help ensure the reported data does not contain unhelpful “noise”. The UMIR Amendments will require various accounts which, in the ordinary course, do not take a “directional” position when undertaking a short sale to mark orders as “short-marking exempt” rather than “short”.<sup>4</sup> Because these accounts do not know at the time of order entry whether they will be long or short at the time of execution, they mark all sell orders “short”. By using a different marker to identify these accounts, the record of orders marked “short” will show those orders that are taking a directional position (i.e. true shorts).

Orders which are designated as “short-marking exempt” will not be included in the semi-monthly short sale summaries. The “short-marking exempt” designation would be applied to all orders from such accounts, including purchases, sales from a long position and sales from a short position.

***Question 1: Do you believe that more frequent aggregate short sale summaries should be made publicly available? If so, what should be the frequency of such short sale summaries (e.g. weekly, daily)? What would be the costs and benefits to issuers, investors and Participants from making this information public? Please provide reasons for your answers.***

***Question 2: In addition to semi-monthly (or more frequent) aggregate short sale summaries, should there be public disclosure of individual short sale transaction data on an anonymous basis? If so, should the publication of this information be time deferred (e.g. one day, one month, etc.)? What would be the costs and benefits to market participants from making this information public? Please provide reasons for your answers.***

***Question 3: Should data on the usage of the “short-marking exempt” designation in relation to trading activity of a particular security be made publicly available? If so, what should be the frequency of the release of such data? Please provide reasons for your answers.***

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<sup>4</sup> See Appendix C to this Joint Notice. See also IIROC Notice 12-0079 – Rules Notice – Request for Comments – UMIR – Proposed Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations (March 2, 2012).

(ii) *Disclosure of short positions (to regulator and/or to public)*

As described in Appendix A to this Joint Notice, the aggregate short position in each listed security on the Toronto Stock Exchange (“TSX”) and TSX Venture Exchange (“TSXV”), which is contained in the CSPR, is provided twice monthly to IIROC and IIROC has access to the information submitted by each dealer. Currently, the TSX sells the CSPR as a data product and publishes a list of the 20 largest short positions and 20 largest changes in short positions on its website. A separate CSPR is produced by Canadian National Stock Exchange (“CNSX”) for securities listed on that exchange. As part of its application to be recognized as an exchange, Alpha Exchange (“Alpha”) has indicated an intention to produce a separate CSPR for securities that will be listed on that exchange.

The Working Group noted that, since the global financial crisis, many countries outside of North America have implemented permanent requirements to disclose significant individual short positions by the ultimate investor.<sup>5</sup> CSA Staff on the Working Group discussed whether such a rule should be considered for the Canadian capital markets. As noted in Appendix B to this Joint Notice, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“Dodd-Frank Act”) in the United States requires the Securities and Exchange Commission (“SEC”) to prescribe new rules governing the public disclosure of short sales, at least monthly, by institutional investment managers. However, the Working Group is not proposing any similar individual short sale or short position reporting requirement on buy-side investors at this time, as the Working Group is not convinced that the potential benefits of such reporting outweigh the costs, especially given recent and proposed initiatives described in this Joint Notice.<sup>6</sup> Nor does the Working Group propose at this time to require reporting of short positions under derivative contracts. However, the Working Group will reassess these issues again as regulatory developments in the short sale and short position transparency area continue to unfold in the U.S. and elsewhere.

Despite this, the Working Group recognizes that there are limitations to the current CSPR reporting. For example, only short positions in listed securities are reported. Also, only dealers who are “Participants” (generally dealers who are members of an exchange, users of a quotation and trade report system or subscribers to an ATS) are required to report positions, which means positions held by other dealers and custodians are not included. To the extent that a short position maintained by an Access Person (generally an institution other than a dealer that is a subscriber to an ATS) is held outside of an account with a Participant, the Access Person is required to file a short position report. If all dealers and custodians reported short positions, the CSPR could be more robust.<sup>7</sup>

**Question 4: Is the existing public disclosure of short positions adequate? If not, should the information be available for unlisted securities such as debt securities and foreign-listed securities traded on ATSs? Should there be one report covering all securities traded on marketplaces? Should custodians and dealers that are not Participants report their short positions? Please provide reasons for your answers.**

**Question 5: Is the information in the CSPR timely? Should this information be made available on a more frequent basis? Please provide reasons for your answers.**

(iii) *Transparency of Failed Trades*

The Working Group is soliciting commenters’ views on whether measures targeting specific settlement failures or participants that cause fails should be considered. When discussing failed trades in this Joint Notice, the Working Group did not focus specifically on failed trades caused by short sellers. In fact, a previous IIROC study found that long sales are more likely to fail than short sales and that the primary reasons for any trade failure are administrative and clerical errors in back office processing.<sup>8</sup> We believe that reducing failed trades in our markets, however caused, has multiple important policy objectives: it can help provide an effective control over some manipulative activities (including abusive short selling), and it is also an important means to mitigate broader systemic problems, particularly in the clearing and settlement system that underpins the efficiency and integrity of our capital markets.

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<sup>5</sup> See Appendix B to this Joint Notice. However, most of these countries do not also have marketplace short sale “flagging” mechanisms similar to the short sale marking regimes in North America. The obligations to make disclosure of significant individual short positions usually start when a minimum threshold is reached, such as a percentage of the total issued and outstanding number or value of the securities. Further disclosures are then required if and when the position reaches other thresholds. A final disclosure would be required if the position fell below the minimum threshold to show that a “disclosable” position was no longer being held. In addition, a two-tier model for disclosure of significant individual net short positions in securities would be used: reporting to regulators of positions would first be required when a certain minimum threshold is reached; and public disclosure would next be required when a higher minimum threshold is reached.

<sup>6</sup> Such investors are still subject to existing requirements under securities laws to declare a short sale to their dealer.

<sup>7</sup> Securities legislation currently requires that a person who places an order for the sale of a security with a registered dealer declare to the dealer at the time of placing the order whether they do not own the security. A custodian would not necessarily know that securities deposited with them are “owned” by the person on whose behalf the custodian is holding the securities. If custodians were required to report short positions, securities legislation would have to require a comparable declaration at the time the securities are deposited with the custodian.

<sup>8</sup> See Market Policy Notice 2007-003 – *General – Results of the Statistical Study of Failed Trades on Canadian Marketplace* (April 13, 2007).

Effective June 1, 2011, Rule 7.10 of UMIR requires Participants to report a trade (an “Extended Failed Trade”) that has failed to settle on the settlement date if the trade remains unresolved ten trading days following the settlement date (i.e., after T+13).<sup>9</sup> The report must give the reason for the settlement failure. The Participant is also required to update the report once the problem has been rectified. This information assists IIROC in detecting potential patterns of settlement failure, possibly indicating manipulative or deceptive trading activity.<sup>10</sup>

The Working Group considered whether some public disclosure of failed trades would assist in strengthening settlement discipline. The CSA could arrange for the public disclosure of information on failed trades in individual securities. The publicly-available information could be based on fails to deliver in depository eligible securities processed through the Continuous Net Settlement (“CNS”) facilities of CDS Clearing and Depository Services Inc. (“CDS”). This would include all equity securities and exchange-traded funds (“ETFs”) traded on all Canadian marketplaces. Fail-to-deliver (“FTD”) rates in the CNS facilities could be made publicly available twice a month. This could be supplemented by the public disclosure of aggregate CNS FTD rates in specific groups of securities, such as inter-listed securities, TSX-listed securities, TSXV-listed securities, CNSX-listed securities, ETFs, and so on.

Reporting FTD rates would provide a means of comparing information on short positions and short selling with trade failures during the same period, therefore allowing the reader to determine whether rates of trade failure may be correlated with rates of short selling of a particular security.

**Question 6: Currently, are measures for failed trades transparency warranted? If you agree:**

- **What types of information on failed trades would be most useful to participants (some options are described above) and what should be the frequency of such disclosure?**
- **In addition to equity and other securities processed through the CNS facilities at CDS, do other types of securities or products (e.g. fixed income securities) have FTD rates suggesting that similar failed trade transparency measures should apply to those securities? Please be specific in your answer.**
- **What would be the costs and benefits, if any, to market participants in implementing such measures? If you believe that measures for failed trades transparency are currently not required, why do you think this information would not be helpful to issuers, investors or Participants? Please provide reasons for your answers.**

## **5. Conclusion**

While the CSA and IIROC believe that the current regulatory framework governing short sales and failed trades in Canada is generally consistent with the four IOSCO principles, some of the proposed additional measures described in this Joint Notice may improve and strengthen our regulatory regime. The CSA and IIROC seek comment on all aspects of the various regulatory approaches discussed in this Joint Notice, and specifically solicit feedback on the questions set out in Section 4 above.

## **6. How to provide your comments**

You must submit your comments in writing by May 31, 2012. If you are not sending your comments by email, you should also send an electronic file containing the submissions (in Windows format, Microsoft Word).

Please address your comments to IIROC and all of the CSA member commissions, as follows:

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Financial Services Commission  
Manitoba Securities Commission

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<sup>9</sup> See the definition of “failed trade” in UMIR Rule 1.1. A “failed trade” includes a sale by an account which has failed to make available the securities for settlement or, in the case of a short sale, has failed to make arrangements with the Participant or Access Person to borrow the securities needed for settlement. Since the failure is determined at the account level, a trade may be considered a “failed trade” for the purposes of UMIR even if the Participant has in fact settled the trade in accordance with the requirements of the clearing agency. An Extended Failed Trade is a “failed trade” within the meaning of the UMIR that was not rectified within ten trading days following the date for settlement contemplated on the execution of that trade. See footnote 22 of Appendix A for information on reports of Extended Failed Trades in the period June 1, 2011 to September 30, 2011.

<sup>10</sup> National Instrument 24-101 *Institutional Trade Matching and Settlement* (NI 24-101) requires registered firms (dealers and advisers) to report to the CSA in certain circumstances information on trade matching (confirmation/affirmation) rates of their institutional equity and debt trades. In addition, clearing agencies and matching service providers are required to provide to the CSA aggregate trade-matching information in respect of their participants or users/subscribers under NI 24-101. However, NI 24-101 does not require the reporting of trade failures.

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Ontario Securities Commission  
Autorité des marchés financiers  
New Brunswick Securities Commission  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Superintendent of Securities, Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon Territory  
Superintendent of Securities, Nunavut

Please send your comments **only** to the addresses below. Your comments will be forwarded to the remaining CSA jurisdictions.

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**Please note that all comments received during the comment period will be made publicly available.** We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. We will post all comments received during the comment period to the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca) and to the AMF website at [www.lautorite.qc.ca](http://www.lautorite.qc.ca) to improve the transparency of the policy-making process.

### Questions

Please refer your questions to any of the following CSA and IIROC staff:

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Alberta Securities Commission  
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Direction de la supervision des OAR  
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## Appendix A

### Background on short sales and failed trades

#### **a) Introduction**

A short sale is generally considered to be the sale of a security that the seller does not own or will not be able to deliver on the settlement of any sale. It involves selling securities at the current market price in the expectation of being able to purchase later at a lower price or being able to cover the short position when securities owned by the seller become available. The selling of securities which are not owned can be risky. Unless the short sale is otherwise “covered” or “hedged”, a short seller can lose a potentially unlimited amount on the sale if the price of the particular share rises unexpectedly.

A failed trade occurs when the seller (whether short or long) fails to deliver securities to the buyer when delivery is due, generally three trading days after the trade (T+3). Settlement of a short sale must generally occur on T+3, which means that a short seller needs to purchase the security to cover the sale on the same trading day, unless the security can be “borrowed” from another source.

The terms “short sale” and “failed trade” are not defined in securities legislation, but are defined in UMIR.<sup>11</sup> Short selling is colloquially divided into “naked” and “covered”. There is no legal definition of “naked short selling” in Canada. The concept appears to have different meanings in different jurisdictions. In some jurisdictions, it refers to short selling without borrowing in time to make delivery on T+3. In others, a “naked” short sale is viewed as a sale where the seller does not own, and has not borrowed or made arrangements to borrow, securities at the time of the sale. A “covered” short sale is generally considered to be a sale of a security that has been “borrowed” by the seller at the time of the sale. Others have taken a wider interpretation and would include as a “covered” short sale any sale of a security where the seller has arranged or taken steps to borrow the security at the time of the short sale, but will only take delivery of the borrowed security after the sale has been executed.

Short selling is a legitimate trading practice which contributes to market liquidity, efficiency and price discovery. For example, it allows market makers to provide liquidity even when they do not hold a particular security, which helps to stabilise prices. Short selling can contribute to more efficient pricing of securities by moderating both price increases and declines. Short selling can also be an important part of an investor’s hedging and risk management strategy.

While fraud and manipulation are not concerns peculiar to short selling, short selling activity can be detrimental when short sellers engage in manipulative activity. Selling pressure spurred by fear and uncertainty may contribute to mispricing and destabilized markets. In extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets. In certain circumstances, short sellers may fail to honour their delivery obligations, usually by failing to borrow or make arrangements to borrow securities to settle the sale in a timely manner.

In addition to “naked” and “covered” short selling, trading strategies or derivative positions can create a synthetic short position, where the holder has the same economic exposure as a short seller. Synthetic short positions can be used to manage risk but also can be used as a means of market manipulation.

#### **b) Overview of Canadian short selling and settlement discipline regulation**

Existing regulatory controls over short sales and failed trades generally fall into one of the following three categories:

- direct constraints on short sales;
- reporting and transparency measures; and
- settlement discipline regime.

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<sup>11</sup> UMIR Rule 1.1 defines “short sale” as a sale of a security, other than a derivative instrument, which the seller does not own either directly or indirectly or through an agent or trustee. The provision further describes circumstances when a seller is considered to own and not own a security.

UMIR Rule 1.1 defines “failed trade” as a trade resulting from the execution of an order entered on a marketplace on behalf of an “account” and

(a) in the case of a sale, other than a short sale, the account failed to make available securities in such number and form;

(b) in the case of a short sale, the account failed to make:

(i) available securities in such number and form, or

(ii) arrangements with the Participant or Access Person to borrow securities in such number and form; and

(c) in the case of a purchase, the account failed to make available monies in such amount,

as to permit the settlement of the trade at the time on the date contemplated on the execution of the trade. The provision further provides that a trade shall be considered a “failed trade” irrespective of whether the trade has been settled in accordance with the rules or requirements of the clearing agency.

(i) *Direct constraints*

Most rules in Canada governing short selling are contained in UMIR. Until the UMIR Amendments become effective, UMIR prohibits a Participant or Access Person from making a short sale of a security unless the price is at or above the last sale price for that security (the "UMIR Tick Test").<sup>12</sup> The UMIR Amendments will repeal the UMIR Tick Test effective September 1, 2012.

Since October 2008, UMIR contains a provision that authorizes IIROC, with the approval of the CSA, to designate a security as a "Short Sale Ineligible Security". Such a designation prevents a Participant or Access Person from entering a short sale order on a marketplace in the particular security.<sup>13</sup> A key purpose of this provision is to provide IIROC with the flexibility to respond to evolving developments in the trading of a particular security or class of securities. The Working Group believes that the power to intervene in the markets on an emergency basis and ban short selling in particular securities is an important regulatory tool. Since the introduction of this provision, no circumstance has existed which has warranted the designation of a security as a Short Sale Ineligible Security.

(ii) *Short sale reporting and transparency measures*

UMIR requires that Participants and Access Persons identify those orders placed on a marketplace that, on execution, would constitute a short sale.<sup>14</sup> The UMIR Amendments will effect a change to the marking regime for short sales such that various accounts which, in the ordinary course, do not take a "directional" position when undertaking a short sale will be expected to mark the order as "short-marking exempt" rather than "short".

Also, Participants and Access Persons are required under UMIR to provide a report twice monthly of the aggregate short position of each individual account in respect of each listed and quoted security.<sup>15</sup> The TSX collects this information with respect to securities listed on the TSX and TSXV and produces the Consolidated Short Position Report ("CSPR") which is made available to IIROC.<sup>16</sup> The TSX also sells the CSPR as a data product and publishes a list of the 20 largest short positions and 20 largest changes in short positions on its website.<sup>17</sup>

(iii) *Settlement discipline regime*

There are a number of CSA, IIROC and other rules and industry standards that, together, comprise the *settlement discipline* regime in Canada. They include:

- Clause (h) of Part 2 of UMIR Policy 2.2, which interprets the anti-manipulative and deceptive trading provisions of Rule 2.2 of UMIR, provides that entering an order on a marketplace for the sale of a security without, at the time of entering the order, having the *reasonable expectation* of settling any trade that would result from the execution of the order would constitute a manipulative and deceptive trading activity. A similar policy exists for trades off-marketplace in the Companion Policy 23-101CP. A person who enters an order to either purchase or sell a security without having the *ability and intention* to settle the trade would be considered to be violating express anti-manipulation/anti-fraud rules in NI 23-101.<sup>18</sup>
- Rules of self-regulatory organizations ("SROs") and exchanges generally require trades to be settled within a T+3 settlement cycle.<sup>19</sup>

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<sup>12</sup> Inter-listed securities are exempt from the UMIR Tick Test pursuant to an IIROC decision, approved by the CSA in 2007. Inter-listed securities represent approximately 30% of traded volume and 60% of traded value of aggregate daily equity trading volume and value on Canadian marketplaces. ETFs, which account for another 10-15% of trading volume and value, are not subject to the UMIR Tick Test.

<sup>13</sup> See UMIR Rule 3.2(1)(b).

<sup>14</sup> See UMIR Rule 3.2(1)(a). This marking or "flagging" requirement is in addition to securities legislation requirements that require a person, who places an order for the sale of a security that it does not own at the time of placing the order, to declare to the dealer acting on their behalf, that it does not own the security. See, for example, section 48 of the *Securities Act* (Ontario) ("OSA").

<sup>15</sup> UMIR Rule 10.10.

<sup>16</sup> A separate CSPR is produced by CNSX for securities listed on that exchange. As part of its application to be recognized as an exchange, Alpha has indicated an intention to produce a separate CSPR for securities that will be listed on that exchange.

<sup>17</sup> To enhance transparency of short selling in Canada, IIROC is proposing to introduce short sale trade summaries on a semi-monthly basis that will supplement the CSPR and will correspond to the reporting cycle for short position reports. It is also proposing, as part of the UMIR Amendments, to modify the short sale marking requirements to reduce the "noise" in short selling statistics. See Appendix C to this Joint Notice.

<sup>18</sup> See Section 3.1(3)(f) of Companion Policy 23-101CP. Certain provinces have inserted similar general anti-fraud and market manipulation provisions into their securities laws (e.g., OSA s. 126.1), which generally override the anti-manipulation/anti-fraud rules in NI 23-101.

<sup>19</sup> See, for example, IIROC Dealer Member Rule 800.27 and TSX rule 5-103(1). These settlement cycle rules are designed to allow some degree of settlement failure. That is, sometimes legitimate reasons may exist for failures to deliver on time; e.g. improperly endorsed certificates received from a client, back-office glitches or human error. In essence, the SRO rules allow market participants to fix such problems if they do so reasonably quickly.

- The exchanges and CDS have “buy-in” rules to enforce settlement, which allow a purchaser, at its discretion, to require the purchase of securities in the market for delivery to the purchaser, with the seller obliged to pay for the costs of the purchase and thereby forcing the settlement obligation of the seller.<sup>20</sup>
- NI 24-101 requires registered firms trading for or with an institutional investor to have policies and procedures designed to match a “DAP/RAP trade” as soon as practical after the trade is executed, but no later than noon on T+1. Furthermore, NI 24-101 contains a principles-based settlement rule that requires registered dealers to establish, maintain and enforce policies and procedures designed to facilitate settlement of trades by no later than the standard settlement date.<sup>21</sup>
- UMIR Rule 7.10, discussed above, which requires Participants to report extended fails to settle.<sup>22</sup>

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<sup>20</sup> See, for example, CDS Rules 7.3.8(b) and 7.4.8(b) and TSX Rule 5-301 (Buy-ins). Generally, where a party to a trade fails to deliver within the usual settlement time, the counterparty may issue a buy-in notice to the defaulting party and request the marketplace to execute the buy-in.

<sup>21</sup> This settlement rule applies to all trades, not just DAP/RAP trades.

<sup>22</sup> The requirement to file an Extended Failed Trade report became effective on June 1, 2011 with respect to trades other than those using the “Trade-for-Trade” settlement facility of CDS. This requirement is at the account level and does not depend on whether the trade was “settled” in the continuous net settlement (CNS) system at CDS. The requirement to provide an Extended Failed Trade Report has not been implemented for a sufficient period of time to allow IIROC to determine if there are any systemic reasons for failures not being rectified within 10 days of the original settlement date. However, to date, all Extended Failed Trade Reports have indicated that the problems have resulted from administrative delays or errors. In the 2006 Failed Trades Study, approximately 4% of failures were not rectified within 10 days and, in the view of IIROC, these “failures” represent the greatest risk to market integrity and confidence in the market. The IIROC Failed Trades Study showed, among other things, that:

- failed trades accounted for 0.27% of the total number of trades executed;
- the predominant cause of failed trades was administrative delay or error, which accounted for almost 51% of fails;
- less than 6% of fails resulting from the sale of a security involved short sales; and
- fails involving short sales accounted for 0.07% of total short sales.

For more details, see the IIROC Notice.

## Appendix B

### International developments

#### a) *IOSCO*

In the wake of the 2008 global financial crisis, IOSCO established a task force to work to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions. Certain CSA staff on the Working Group participated on the IOSCO task force. The IOSCO task force also examined how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions that are critical to capital formation and to reducing market volatility. The task force published the report *Regulation of Short Selling* ("IOSCO Report") in June 2009, which contains four high-level principles for the effective regulation of short selling.<sup>23</sup> The four IOSCO principles are designed to assist regulators in their consideration of a regulatory regime for short selling. We briefly discuss the four principles below.<sup>24</sup>

***Principle 1: Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets.***

The IOSCO Report states that an effective discipline for settlement of short selling transactions is the first pillar for an effective short selling regulatory regime. It recommends that regulation of short selling *should as a minimum requirement impose a strict settlement (such as compulsory buy-in) of failed trades* (emphasis in IOSCO Report).

The IOSCO Report describes various regulatory tools used to control short selling activity, such as price restrictions (e.g. an uptick requirement), a pre-borrow or "locate" requirement or rules that allow short selling of shares only if they meet certain eligibility criteria. In many jurisdictions, there are settlement discipline requirements that impose a form of mandatory buy-in or close-out requirement if the shares in a transaction (whether a short sale or not) are not delivered within the standard settlement cycle, typically T+3.

The Working Group does not believe that a compulsory buy-in requirement is needed in Canada. As noted in this Joint Notice, there has not been a significant problem with failed trades and trade failures are primarily associated with administrative problems with long sales. We note that there are buy-in procedures available for buyers whose trades have failed, and that IIROC requires reporting of extended failed trades and can prohibit short sales in a particular security if warranted. The UMIR Amendments will give IIROC the power to require pre-borrowing for certain accounts or securities if warranted.

***Principle 2: Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.***

In order to achieve an appropriate level of transparency regarding short selling activity, the IOSCO Report encourages jurisdictions to consider some form of reporting of short selling information to the market or to market authorities. Broadly speaking, there are two models that are commonly in use for short selling reporting: (i) "flagging" of short sales (i.e. putting a marker on each short sale that a broker sends to a marketplace for execution); and (ii) short position reporting. The IOSCO Report notes that both models have their own merits and each could serve the above regulatory objectives.

In Canada, short sale orders are marked as such when entered on a marketplace. Short position reports are generated semi-monthly for listed securities. With the implementation of the UMIR Amendments, IIROC expects to produce a semi-monthly report on the proportion of short sales to total trading activity for each listed security.

***Principle 3: Short selling should be subject to an effective compliance and enforcement system.***

The IOSCO Report notes that because an effective compliance and enforcement system is essential for an effective short selling regulatory regime, regulators should, among other things, monitor and inspect settlement failures regularly and establish a mechanism to analyse the information obtained from the reporting of short positions and/or flagging of short sales to identify potential market abuses and systemic risk.

IIROC currently monitors short selling activity in real time and has introduced a new alert designed to detect potential abusive short selling activity.

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<sup>23</sup> The IOSCO report is available on IOSCO's website ([www.iosco.org](http://www.iosco.org)). This IOSCO initiative was an important global response intended to help restore and maintain investor confidence, as the principles were formulated with a view to addressing the objectives of investor protection, helping to ensure that markets are fair, efficient and transparent, and reducing systemic risk.

<sup>24</sup> We note that the IIROC Notice also specifically dealt with the IOSCO initiative (including an appendix that contained an analysis of the application of each IOSCO principle to the situation in the Canadian markets, the impact of measures adopted by IIROC since 2008 and the intended effect of proposals described in the IIROC Notice). The IIROC Notice also contained an analysis of various measures taken or proposed in the United States and indicated why IIROC did not propose to adopt comparable measures for Canadian markets.

**Principle 4: Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.**

The IOSCO Report highlights the necessity for flexibility in short selling regulation in order to allow market transactions that are desirable for efficient market function and development, such as market making activity. Regulatory authorities are required, at a minimum, to clearly define the exempted activities and the manner in which these exemptions should be reported.

UMIR currently contains exemptions from the UMIR Tick Test for market maker and arbitrage activities and for certain types of securities, such as ETFs and securities inter-listed on U.S. stock exchanges. With the removal of the UMIR Tick Test on implementation of the UMIR Amendments, these exemptions will no longer be needed. The UMIR Amendments also contain an exemption from the short sale marking requirement for sell orders from non-directional accounts. Such accounts will be required to mark both purchase and sell orders as "short-marking exempt". See Appendix C for more details.

**b) United States**

*(i) The short sale circuit breaker price test*

After having repealed all short sale price restrictions (tick/uptick tests) in July 2007, the SEC in April 2009 introduced Rule 201 of Regulation SHO, which sets out a short sale "circuit breaker" triggered price restriction ("Rule 201"). Rule 201, which became effective on February 28, 2011,<sup>25</sup> prohibits short sales of National Market System ("NMS") securities at a price that is less than or equal to the current national best bid if the price of the security decreases intra-day by 10% or more from the prior day's closing price. This short sale price restriction remains in effect for the remainder of the day and the next trading day.

*(ii) SEC "locate" and "close-out" measures*

In 2005, the SEC introduced a number of measures, including the introduction of the "threshold" fails list and the locate and close-out requirements of Regulation SHO, designed to reduce overall settlement failure rates in the U.S. markets. In 2008, the SEC tightened their close-out rule by requiring participants of a registered clearing agency to close out fail-to-deliver positions in equity securities resulting from short sales by the morning of T+4, and fails to deliver positions resulting from long sales, or bona fide market making activity, by the morning of T+6. This rule (Rule 204 of Regulation SHO, which was first introduced in September 2008 as a temporary Rule 204T) has significantly decreased settlement failure rates in the U.S. The rule also prohibits any further short sales by the participant until a fail-to-deliver position is closed out or a "pre-borrow" is arranged prior to the sale.

*(iii) SEC naked short selling antifraud rule*

The SEC also adopted Rule 10b-21 under the 1934 Act, a "naked" short selling antifraud rule. Under that rule, a civil fraud violation occurs if a short seller misleads a broker-dealer about its intention or ability to deliver securities by settlement date and fails to deliver securities by settlement date.<sup>26</sup>

*(iv) Transparency developments*

With respect to transparency, the SEC coordinated with the SROs (which, in the U.S. includes the exchanges) to increase the public availability of short sale-related data. The following new measures were introduced in 2009 to increase transparency in the area of short selling:

1. U.S. SROs, such as the Financial Industry Regulatory Authority ("FINRA"), publish on their websites daily aggregate short sale volume data for that day in each individual security in the NMS.
2. SROs publish on their websites individual short sale transaction data on an anonymous and one-month delayed basis.

The above short sale information is in addition to the current twice-monthly SRO short position reporting requirement imposed on dealers,<sup>27</sup> which is similar to IIROC's short position reporting requirement in Canada. The SEC also introduced the twice-

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<sup>25</sup> The initial implementation date for this rule was November 10, 2010. However, on November 8, 2010, the SEC announced that it extended the date to February 28, 2011, to give certain exchanges additional time to modify their market opening, reopening, and closing procedures for individual securities covered by the rule, and in order to provide additional time to market participants for programming and testing of systems for implementation.

<sup>26</sup> In Canada, a person who misleads a dealer about its intention or ability to deliver securities by settlement date and fails to deliver securities by settlement date could be violating the anti-fraud and manipulation rules of securities laws (see NI 23-101 and section 3.1(3)(f) of Companion Policy 23-101CP and OSA s. 126.1). It is also possible that such person would be breaching securities law provisions that require the person, who places an order for the sale of a security that it does not own at the time of placing the order, to declare to the dealer acting for it in the sale that it does not own the security (see, e.g., OSA s.48).

monthly publication of fail-to-deliver data on its website for all equity securities processed through National Securities Clearing Corporation (“NSCC”)<sup>28</sup> in the U.S., regardless of the fails level.

(v) *Dodd-Frank Act*

The Dodd-Frank Act, which became law on July 21, 2010, requires the SEC to prescribe new rules governing the public disclosure of short sales, at least monthly, by institutional investment managers that are subject to section 13(f) of the 1934 Act (i.e., generally those with \$100 million and over in assets under management). It also mandates the SEC’s Division of Risk, Strategy, and Financial Innovation to conduct a study within a year of the feasibility, benefits, and costs of requiring reporting publicly, in real time, of short sale positions in publicly listed securities, or, in the alternative, reporting such short positions in real time only to the SEC and FINRA.<sup>29</sup> Moreover, within two years of the date of enactment, the SEC is required to conclude a study on the state of short selling after recent rule changes and the incidence of failures to deliver shares sold short on the fourth day following a short sale transaction (T+4). The SEC is also required to submit a report to Congress regarding the study, including recommendations for market improvements.

The Dodd-Frank Act amends the 1934 Act to prohibit any “manipulative short sale of any security”, and authorizes the SEC to issue rules to enforce this provision. It also requires brokers to notify customers that they may elect not to allow their securities to be used in connection with short sales, and brokers must disclose that they may receive compensation for lending their customers’ securities. The SEC is authorized to specify by rule the form, content, time and manner of delivery of such customer notifications. Moreover, the Dodd-Frank Act amends the 1934 Act to grant the SEC explicit authority to issue rules regarding securities lending. It also requires the SEC, within two years after enactment, to promulgate rules designed to increase the transparency of information available regarding securities lending.

c) *European Union*

In March 2010, the Committee of European Securities Regulators (“CESR”) (now the European Securities and Markets Authority or “ESMA”) released a report proposing a pan-European short position disclosure regime for European Union (“EU”) shares. CESR recommended that short positions should be disclosed to regulators at one threshold, and to the market at a higher threshold. The proposals largely follow the regime that the U.K. Financial Services Authority (“FSA”) had already imposed, which is based on a two-tier model for disclosure of significant individual net short positions in all shares that are admitted to trading on European marketplaces. Public disclosure would be required for a net short position of 0.5% of the issuer’s issued share capital (taking into account any economic exposure under derivative positions in addition to short positions in the cash markets). Subsequent disclosure would be required for any 0.1% increment change in short position. CESR also proposed a separate private disclosure to the regulators for any 0.2% net short position, and then again at every 0.1% increase or decrease.

Building on CESR’s proposals, the European Commission published a Consultation Paper in June 2010, where it sought views of market participants, regulators and other stakeholders about possible measures related to short selling and credit default swap issues that could be included in a legislative proposal. On September 15, 2010, the European Commission adopted a proposal for regulation of short sales and certain aspects of credit default swaps (the “September 15, 2010 Proposal”). On May 17, 2011, the Council of the EU agreed with the general approach of the proposal. On November 15, 2011, the European Parliament adopted the *Regulation of the European Parliament and Council on Short Selling and Certain Aspects of Credit Default Swaps* (the “*Regulation on Short Selling and Credit Default Swaps*”).<sup>30</sup> If the Council of the EU approves the regulation unaltered, it will come into force on November 1, 2012.

The main objectives of the *Regulation on Short Selling and Credit Default Swaps* are to ensure member states have clear powers to intervene in exceptional situations, create a harmonized framework for ESMA-coordinated action at the European level, increase transparency on short positions held by investors in EU securities, reduce settlement risks due to naked short selling and reduce risks to the stability of the sovereign debt markets. Highlights of the *Regulation on Short Selling and Credit Default Swaps* include the following:

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<sup>27</sup> Firms must report short interest positions in all securities (including NASDAQ, Amex, NYSE, Arca and OTC equity securities) through an SRO on a bi-monthly basis.

<sup>28</sup> Most marketable equity and corporate debt securities transactions in the U.S. are cleared and settled through the combination of two registered clearing agencies: NSCC is the entity that performs the clearing and central counterparty functions, while the Depository Trust Company (“DTC”) is the central securities depository.

<sup>29</sup> To assist in its study, the SEC’s Division of Risk, Strategy, and Financial Innovation published on May 3, 2011 a request for comment on a wide range of questions on both the existing uses of short selling in securities markets and the adequacy or inadequacy of currently available information regarding short sales, as well as comment on the likely effect of these possible future reporting regimes on the securities markets, including their feasibility, benefits, and costs. See SEC Release No. 34-64383; File No. 4-627 - *Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*.

<sup>30</sup> See *European Parliament legislative resolution of 15 November 2011 on the proposal for a regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps*, Strasbourg, 15.11.2011, COM (2010) 0482 (final) – 2010/0251 (COD), available at: <http://www.europarl.europa.eu/>.

1. Introducing a requirement that investors disclose significant net short positions in shares to regulators at 0.2% of the issued share capital, and to the public at 0.5%;
2. Introducing a requirement that investors notify regulators of significant net short positions in EU sovereign bonds, including notification of significant credit default swap positions relating to sovereign debt issuers;<sup>31</sup>
3. Giving ESMA the power to intervene in response to threats to financial markets, where the EU national regulator has either failed to act or to do so adequately, and adopt temporary measures with the effect of prohibiting or restricting short selling;
4. Giving the EU national regulators the power to require further transparency or restrict short selling and certain derivative transactions for a wide range of instruments in the case of adverse developments that constitute a serious threat to financial stability or market confidence in the European Union or a Member State;
5. Giving the EU national regulators the power to restrict short selling or limit transactions in a financial instrument<sup>32</sup> if the price of that financial instrument falls by a significant amount (10% from the previous day's close in the case of liquid shares). The restriction will last up to the end of the trading day following the day the price of the financial instrument fell, unless the price falls further;
6. Introducing a pre-borrow or "locate" type requirement where an investor, before entering a short sale for shares or for sovereign debt, would be required:
  - to have borrowed the instruments concerned,
  - to have entered into an agreement to borrow the instruments in order to deliver them by the settlement date, or
  - to have an arrangement with a third party to locate the instruments concerned and to have a "reasonable expectation" of being able to borrow them to affect settlement when it is due;
7. Requiring central counterparties in the EU to ensure that there are adequate arrangements in place for the buy-in of shares if there is a failure to settle a transaction, and requiring that daily fines be imposed for non-settlements;
8. Introducing a ban on holding an uncovered credit default swap position in EU sovereign debt; and
9. Providing an exemption from the regulation for market making and primary market operations, and for shares whose principal trading venue is outside the EU.

The preamble to the regulation<sup>33</sup> suggests that the European Commission consider requiring investment firms to provide information about short sales in transaction reports to EU national regulators.<sup>34</sup>

On January 13, 2011, the European Commission also sought public comment on establishing an effective EU securities settlement regime.<sup>35</sup> Among other things, the European Commission is proposing legislation and rules on settlement discipline that would focus on the following:

- early matching of settlement instructions and settlement in earlier settlement cycles on the settlement date - e.g., encouraging clearing houses to provide incentives for early settlement by participants through an appropriate tariff structure; requiring the use of pre-matching procedures and early matching by participants; and requiring the use of straight-through processing (STP) technology; and
- prevention of fails management and forced settlement of fails after the settlement date - e.g., high-level rules on a harmonized penalty regime for fails, and enforcement rules such as mandatory buy-ins and cash compensation for buyers if a buy-in is not possible.

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<sup>31</sup> No requirement was proposed that investors disclose significant positions of sovereign bonds or credit default swaps to the public, due to the potential negative consequences on the sovereign bond market.

<sup>32</sup> These powers extend to a wide range of instruments.

<sup>33</sup> See *Regulation on Short Selling and Credit Default Swaps*, Preamble (13). See note 29.

<sup>34</sup> As part of its revision of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 ("MiFID").

<sup>35</sup> See *Public consultation on Central Securities Depositories (CSDs) and on the harmonisation of certain aspects of securities settlement in the European Union*, Brussels, 13 January 2011, DG Markt G2 D(201) 8641, available at: [http://ec.europa.eu/internal\\_market/consultations/2011/csd\\_en.htm](http://ec.europa.eu/internal_market/consultations/2011/csd_en.htm)

More recently, on August 11, 2011, some authorities in the EU imposed or extended existing short-selling bans or restrictions in their respective countries due to recent volatility in the European financial markets.<sup>36</sup> ESMA stated, "While short-selling can be a valid trading strategy, when used in combination with spreading false market rumours this is clearly abusive." On the same day, the regulatory authorities in several jurisdictions (France, Italy, Spain and Belgium) announced new bans on short-selling or on the holding of short positions. By banning, restricting and requiring the disclosure of short sales, such countries' regulators are seeking to maintain confidence in their own markets and complement the measures taken by other EU regulators.

**d) Hong Kong**

The Securities and Futures Commission of Hong Kong (the "SFC-HK") has adopted a rule that, among other things, will:

1. introduce a requirement for weekly reporting of short positions in specified shares that exceed on a net basis either: 0.2% of the issued share capital or HK\$30 million. This requirement would apply to both covered and uncovered short positions;
2. only apply to positions taken through the Hong Kong Stock Exchange or an authorized automated trading system specified by the SFC-HK;
3. only apply to shares that are constituents of the Hang Seng Index or the Hang Seng Enterprises Index, and to designated financial stocks and any other security designated by the SFC-HK; and
4. allow the SFC-HK to require daily reporting of short positions when needed, if the financial stability of Hong Kong is threatened.

The rule comes into force on June 18, 2012.

**e) Other jurisdictions**

The IIROC Notice describes a number of regulatory initiatives undertaken in other countries not mentioned above, including Australia and Asian jurisdictions.

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<sup>36</sup> ESMA's public statement is available at: <http://www.esma.europa.eu/popup2.php?id=7699>. On August 8, 2011, the Greek regulator, the Hellenic Capital Market Commission announced a temporary ban on the short selling of shares or units in exchange-traded funds listed on the Athens Exchange irrespective of the venue where the transaction is executed; intraday positions are also included within the prohibition.

## Appendix C

### Summary of UMIR Amendments

The UMIR Amendments are effective September 1, 2012. The UMIR Amendments repeal pricing restrictions on short sales; however IIROC does not propose to adopt a circuit breaker rule similar to Rule 201 because IIROC does not believe such a rule is necessary in the Canadian capital markets (as explained in more detail in the IIROC Notice).<sup>37</sup>

The UMIR Amendments also change the marking regime for short sales such that various accounts which, in the ordinary course, do not take a “directional” position when undertaking a short sale (i.e. the short sale is being undertaken for arbitrage, market making or other trading strategy which generally results in the account being “flat” at the end of each trading day) are not required to mark sale orders as “short” but rather as “short-marking exempt”. Under the UMIR Amendments, the order designation “short-marking exempt” is used in connection with orders for the *purchase* or *sale* of a security by any exempt account. IIROC suggests that, with this new order designation, it will be able to remove much of the “noise” in the short sale data flowing from trades by persons who are not taking a directional position. This, in turn, will permit IIROC’s new surveillance and monitoring “alert” system (described below) to operate more effectively. This “short-marking exempt” designation will not be displayed to the public.

The UMIR Amendments also include a limited pre-borrow rule that requires, subject to certain exceptions, a Participant or Access Person to have made arrangements to borrow securities that would be necessary to settle any short sale prior to the entry of the order on a marketplace if:

- the security has been designated by IIROC to be a “Pre-Borrow Security”,<sup>38</sup>
- the client or “non-client”<sup>39</sup> account on whose behalf the short sale order is being entered has previously had an Extended Failed Trade; or
- the Participant had executed, as principal, an Extended Failed Trade in that particular security.

In addition, the IIROC Notice describes the introduction of a new IIROC surveillance and monitoring “alert” that is designed to detect abusive short selling activity on a timely basis and enable IIROC to take appropriate remedial or investigative actions, including designating the security as being ineligible for further short selling activity.

With the approval and forthcoming implementation of the UMIR Amendments, IIROC also expects to be in a position to produce, and to disseminate publicly, a semi-monthly report on the proportion of short sales in the total trading activity of each security across all marketplaces. It believes this should help establish a better appreciation for the “normal” levels of short selling for each security. IIROC withdrew its 2007 proposal to repeal the UMIR short position reporting requirement, with the result that the CSPR will continue to be available.

IIROC suggests that, while no one data source can provide a “complete” picture of short sale activity or positions, the semi-monthly aggregate trading summaries will provide timely information in a cost efficient manner and will supplement the information available through the semi-monthly CSPR.

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<sup>37</sup> See also IIROC Notice 12-0077 — Rules Notice — Technical — Effects of Short Sale Circuit Breakers in the United States on the Trading of Inter-listed Securities in Canada (March 2, 2012).

<sup>38</sup> The UMIR Amendments would define a “Pre-Borrow Security” in Rule 1.1 as a security that has been designated by IIROC 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.

<sup>39</sup> A “non-client” is a person who is a partner, director, officer or employee of a Participant or a related entity of a Participant that holds an approval from an exchange or self-regulatory entity.