

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.1 SROs

13.1.1 Notice of Commission Approval – IIROC Rules Notice – UMIR – Provisions Respecting Short Sales and Failed Trades

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA (IIROC)

PROVISIONS RESPECTING SHORT SALES AND FAILED TRADES

NOTICE OF COMMISSION APPROVAL

The Ontario Securities Commission approved proposed amendments to the Universal Market Integrity Rules (UMIR). In addition, the British Columbia Securities Commission did not object to, and the Alberta Securities Commission, the Autorité des marchés financiers, the Saskatchewan Financial Services Commission, the Nova Scotia Securities Commission and the New Brunswick Securities Commission approved the proposed amendments. The objective of the amendments is to (i) remove the restrictions on the price at which a short sale may be made, (ii) require short-sellers to make prior arrangements to borrow securities to settle a short sale in certain circumstances, (iii) introduce a “short-marking exempt” marker and (iv) make minor administrative changes.

The proposed amendments were published for comment on February 25, 2011, at (2011) 34 OSCB 2435, and 16 comments was received. A summary of the comments and IIROC’s response and a copy of the approved amendments are included in Chapter 13 of this Bulletin.

**NOTICE OF COMMISSION APPROVAL – PROVISIONS RESPECTING
REGULATION OF SHORT SALES AND FAILED TRADES**

**12-0078
March 2, 2012**

Provisions Respecting Short Sales and Failed Trades

Executive Summary

On March 2, 2012, the applicable securities regulatory authorities approved amendments (“Amendments”) to UMIR respecting short sales and failed trades.¹ The Amendments, which are **effective September 1, 2012**:

- **repeal the tick test;**²
- impose pre-borrow requirements for short sales made in certain circumstances; and
- require a sell order from a short position to continue to be marked “short sale” but introduce a “short-marking exempt” designation to be used with an order for the ***purchase or sale*** of a security by certain accounts that adopt a “directionally neutral” strategy in the trading of securities.

When the Amendments become effective, Participants and Access Persons will:

- be relieved of the obligation to ensure short sales comply with the “tick test”;
- be required to have policies and procedures applicable to the circumstances when a security must be “pre-borrowed” prior to a short sale; and
- be required to have policies and procedures to properly identify on entry orders that should be designated as either “short sale” or “short-marking exempt”.

IIROC has initiated meetings with marketplaces and service providers to deal with the technological implications of the Amendments and, in particular, to co-ordinate the introduction of the “short-marking exempt” designation. IIROC expects to issue guidance on the use of the “short sale” and “short-marking exempt” designations prior to the Amendments coming into effect.

1. Development of a Strategy for the Canadian Market

Since a number of amendments to UMIR regarding short sales and failed trades were approved in October of 2008, IIROC has undertaken a process of evaluating additional steps which IIROC might take in Canada to deal with issues related to short sales and failed trades. In developing the proposals for the further regulation of short sales and failed trades, IIROC sought to ensure that any rules, guidance and monitoring regime is:

- supported by the empirical evidence regarding short sales and failed trades in the Canadian market;
- part of a comprehensive monitoring of market integrity risks (e.g. restricting short sales may not be the appropriate response to all “rapid” price declines);
- neutral, in that it treats “unusual” price movements of a security, whether up or down, as a reason for increased regulatory scrutiny;
- focused, in that the burden for compliance is placed on those that have failed to comply with the requirements;
- practical, in that marketplaces and dealers can comply with the requirements in a cost effective manner;

¹ Reference should be made to IIROC Notice 11-0075 – Rules Notice – Request for Comments – UMIR – *Provisions Respecting Short Sales and Failed Trades* (February 25, 2011) with which the proposed amendments were published for public comment (the “Proposed Amendments”). See Appendix B for the summary of comments received on the Proposed Amendments and the responses of IIROC. Column 1 of the table highlights the changes made to the Amendments as approved from the Proposed Amendments.

² The tick test is the requirement under Rule 3.1 of UMIR that a short sale not be made at a price which is less than the last sale price of the security.

- proportionate, in that the proposals do not invoke a regulatory response which results in a deterioration of market quality for all market participants; and
- effective, in that the proposals do not impede the proper uses of short selling and the liquidity that such proper activity provides to the market.

The overall strategy on the regulation of short sales and failed trades includes:

- repealing the tick test;
- increasing transparency of information regarding short sale activity and failed trades;
- monitoring of regulatory arbitrage opportunities related to short sales;
- enhancing investor education and confidence regarding the role of short selling in the operation of the market and the reasons for trade failures;
- disclosing the criteria for regulatory intervention for variation or cancellation of trades in the event of significant price volatility;
- enhancing monitoring of short sales and failed trades; and
- imposing pre-borrow requirements for short sales made in certain circumstances.

While the Amendments, including the repeal of the tick test, represent an important component of the strategy, Appendix “C” outlines the various initiatives which IIROC has undertaken since October of 2008 or plans to take to execute this strategy.

1.1 Repeal of Price Restrictions on Short Sales

Studies by IIROC support the premise that the tick test has no appreciable impact on pricing³ and, in light of that, IIROC believes that there are better mechanisms to detect and address abusive short selling. Under the Amendments, the tick test has been repealed but IIROC will continue to work with other Canadian regulators to enhance measures intended to identify and address incidents of “abusive” short selling.

1.2 Transparency

In an effort to enhance the transparency of short selling activity in the Canadian market, IIROC:

- will, following the implementation of the Amendments, 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 which should help establish a better appreciation for the “normal” levels of short selling for each security; and
- withdrew a proposal to repeal the requirements for the preparation of short position reports and, as a result, the Consolidated Short Position Report (“CSPR”)⁴ will continue to be produced on a semi-monthly basis.

In addition to the Amendments and other IIROC initiatives described in this IIROC Notice, the Canadian Securities Administrators (“CSA”) and IIROC have published a joint notice to solicit feedback on whether other proposals to enhance transparency of short sale and failed trade information are required or appropriate (“Joint Notice”).⁵ Based on responses to the Joint Notice, IIROC may propose additional rule changes or other initiatives.

1.3 Monitoring of Regulatory Arbitrage Opportunities

In the United States, the Securities and Exchange Commission (“SEC”) adopted Rule 201 which was implemented on February 28, 2011 and which provides that there is no price restriction or “tick test” for a short sale unless a circuit breaker has first been

³ In particular, reference should be made to IIROC Notice 11-0077 – Rules Notice – Technical – UMIR – *Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange* (February 25, 2011).

⁴ While Rule 10.10 of UMIR requires Participants and Access Persons to file short position reports, the CSPR is produced for securities listed on the TSX and TSXV by the TSX which makes certain of the information publicly available and provides the full CSPR on a subscription basis. A separate CSPR is produced by CNSX for securities listed on that exchange. See IIROC Notice 11-0075, *op. cit.*

⁵ IIROC Notice 12-0076 – Rules Notice – Request for Comments – UMIR – Canadian Securities Administrators / Investment Industry Regulatory Organization of Canada Joint Notice 23-312 – *Transparency of Short Selling and Failed Trades* (March 2, 2012).

triggered by a 10% price decline in a particular security, in which case a short sale must be entered at a price that is one increment above the best bid price for the balance of that trading day and the next trading day.⁶ Given the required price decline, coupled with the relatively short period of time during which price restrictions on short sales apply after imposition, the majority of U.S. market activity is not subject to a tick test.

Concurrent with the issuance of this Rules Notice, IIROC has published the results of a study of the effects of short sale circuit breakers in the U.S. on the trading of inter-listed securities in Canada ("Short Sale Circuit Breaker Study").⁷ The Short Sale Circuit Breaker Study analyzed the effect that the triggering of a short sale circuit breaker in the U.S. of a security inter-listed with the Toronto Stock Exchange ("TSX") or the TSXV Venture Exchange ("TSXV") had on trading activity in Canada, particularly short selling, during the period immediately before, during and immediately after the imposition of short sale price restrictions on the trading of the security on U.S. markets. The Short Sale Circuit Breaker Study suggests that, overall, there was minimal impact on short selling activity of inter-listed securities on marketplaces in Canada when price restrictions on short sales were in effect following the triggering of a short sale circuit breaker.

In the view of IIROC, Canada does not need to adopt the same short sale circuit breaker system and alternative uptick rules. In part, this view is due to the fact the empirical studies undertaken by IIROC did not find a relationship between rapid price declines and unusual short selling activity. In addition, IIROC believes that the Canadian market is able to demonstrate that its trade monitoring regime effectively addresses "abusive" short selling through other mechanisms, including real-time alerts based on trading activity across all Canadian marketplaces.

IIROC has introduced an alert for its surveillance system that monitors for unusual levels of short selling activity, coupled with significant price movements. If unusual levels of short selling are detected which are disruptive to the market, IIROC also has the ability to intervene to vary or cancel the prices of any trade that is "unreasonable" or, in particularly egregious circumstances, to impose a halt on trading of a particular security across all marketplaces. In addition, IIROC has the ability to designate a security as a "Short Sale Ineligible Security" for a period of time.

1.4 Enhancement of Investor Confidence

In the view of IIROC, investor confidence is best bolstered by:

- educating investors and, to a lesser extent, the industry as to the role of short selling in ordinary trading activity (including releasing existing empirical studies undertaken by IIROC and supporting future academic research, particularly on the impact of the repeal of the tick test);
- greater disclosure of the monitoring undertaken by IIROC and the circumstances when IIROC would pursue "regulatory intervention" given rapid, significant and unexplained price declines in the price of particular securities;⁸ and
- adherence to the general principles of short sale regulation enunciated by the International Organization of Securities Commissions ("IOSCO") taking into consideration the unique characteristics and practices of the Canadian market.⁹

IIROC has published a number of studies on short sales and failed trades including:

- the Short Sale Circuit Breaker Study which suggests that, overall, there was minimal impact on short selling activity of inter-listed securities on marketplaces in Canada when price restrictions on short sales were in effect following the triggering of a short sale circuit breaker;¹⁰
- a study of the relationship between price movement and short selling activity for securities listed on the TSX Venture Exchange during the period May 1, 2007 to April 30, 2010, which found that prices and rates of short

⁶ See SEC Release 34-6159 – *Regulation SHO* (February 26, 2010) and SEC Release 34-63247 – *Regulation SHO* (November 4, 2010).

⁷ IIROC Notice 12-0077 – Rules Notice – Technical – UMIR – *Effects of Short Sale Circuit Breakers in the United States on the Trading of Inter-listed Securities in Canada* (March 2, 2012). The Short Sale Circuit Breaker Study considered the 112 instances between February 28, 2011 and April 29, 2011 when a short sale circuit breaker was triggered in the U.S. for an inter-listed security.

⁸ See IIROC Notice 12-0040 – Rules Notice – Guidance Note – UMIR – *Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012). See IIROC Notice 10-0331 – Rules Notice – Request for Comments – UMIR – *Proposed Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (December 15, 2010).

⁹ See Appendix "C" – *Reconciliation of UMIR and Proposed Amendments to the IOSCO Recommendations on Regulation of Short Sales* of IIROC Notice 11-0075, *op. cit.*

¹⁰ See IIROC Notice 12-0077, *op. cit.*

selling activity tended to move in tandem and that, in the periods of the most significant price decline, “shorts” were in the market purchasing securities to cover their positions thereby providing price support;¹¹

- a study of trends in trading activity, short sales and failed trades that covered the three-year period May 1, 2007 to April 30, 2010, which found that rates of short selling were relatively constant throughout the period and that rates of trade failure generally declined over the period (“Trends Study”);¹²
- a prior study of trends in trading activity, short sales and failed trades that covered the period May 1, 2007 to September 30, 2008 and generally identified trends consistent with those identified in the Trends Study;¹³
- an analysis of the impact of the prohibition on the short sale of certain financial sector issuers listed on the TSX that were also listed on a U.S. exchange that was in effect between September 22, 2008 and October 8, 2008 which found that the prohibition had a significant impact on market quality by reducing liquidity and increasing “spreads” while not having any effect on price volatility;¹⁴ and
- a study of failed trades undertaken by Market Regulation Services Inc. in 2006 that, among other findings, determined that a short sale had a lower probability of failing than trades generally and that the principal reason for trade failures was administrative error.¹⁵

Taken together, the results of the empirical studies indicate that the Canadian market has not had the problems with short sales, particularly naked short sales, and failed trades that may have been evident in other jurisdictions.

1.5 “Regulatory Intervention”

Currently, IIROC’s policies and procedures for undertaking a regulatory intervention to halt trading in a security or to vary or cancel trades are not publicly disclosed. In a separate initiative, IIROC has published for public comment draft guidance that would provide greater transparency of IIROC’s existing policies and procedures relating to the variation or cancellation of “unreasonable” trades and trades which are not in compliance with the requirements of UMIR.¹⁶ In addition, IIROC has published guidance respecting the implementation of “Single-Stock Circuit Breakers” that would halt trading in a particular security for a short period of time if that security experienced rapid, significant and unexplained price movement.¹⁷

1.6 Enhanced Monitoring

IIROC has taken steps to enhance its monitoring of short sales and failed trades. In particular:

- Effective June 1, 2011, IIROC has implemented a web-based system for the reporting of “Extended Failed Trades”, defined as trades which the client has failed to resolve within 10 business days following the regular settlement date, that helps to identify “problem” fails and allow IIROC to assess the reasons for the failure and monitor the steps being taken to resolve the problem.¹⁸
- IIROC has deployed a new surveillance alert which looks for declines in the price of a security associated with changes in the rate of short selling, based on a comparison to historical short selling patterns for the particular security.
- CDS Clearing and Depository Service Inc. (“CDS”) is providing to the Ontario Securities Commission data on daily trade failures for trades settling in the continuous net settlement facilities (“CNS”) of CDS. IIROC is in the

¹¹ Reference should be made to IIROC Notice 11-0077 – Rules Notice – Technical – *Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange* (February 25, 2011).

¹² Reference should be made to IIROC Notice 11-0078 – Rules Notice – Technical – *Trends in Trading Activity, Short Sales and Failed Trades* (February 25, 2011).

¹³ Reference should be made to IIROC Notice 09-0037 – Administrative Notice – General – *Recent Trends in Trading Activity, Short Sales and Failed Trades* (February 4, 2009).

¹⁴ Reference should be made to IIROC Notice 09-0038 – Administrative Notice – General – *Impact of the Prohibition on the Short Sale of Inter-listed Financial Sector Issuers* (February 9, 2009).

¹⁵ For a more detailed discussion of the Failed Trade Study and its results, see Market Policy Notice 2007-003 – General – *Results of the Statistical Study of Failed Trades on Canadian Marketplaces* (April 13, 2007).

¹⁶ See IIROC Notice 10-0331, *op. cit.* IIROC expects to publish the draft guidance in the near future for further public comment.

¹⁷ See IIROC Notice 12-0044, *op. cit.*

¹⁸ See IIROC Notice 11-0080 – Rules Notice – Guidance Note – UMIR – *Implementation Date for the Reporting of Extended Failed Trades* (February 25, 2011).

process of obtaining access to this database which would allow IIROC to determine, from time to time, variations in trade failures from historic patterns for particular securities and Participants.

- As part of the Amendments which become effective on September 1, 2012, purchase and sale orders from arbitrage accounts, accounts of persons with Marketplace Trading Obligations and certain accounts that adopt a “directionally neutral” strategy in the trading of securities would carry a “short-marking exempt order” designation. The use of this order designation will permit the data on “short sales” to better reflect the activities of persons who may have adopted a “directional” trading strategy.

1.7 Pre-Borrow Requirements

Rule 2.2 of UMIR deals with those activities which are considered to be “manipulative and deceptive” and, as such, prohibited. The entering of an order 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 constitutes a violation of the prohibition on manipulative and deceptive activities. As such, “naked short selling”, as that term is sometimes understood, is not permitted under UMIR.¹⁹ The provisions of Rule 2.2 of UMIR do not require the Participant or Access Person that is entering a short sale to have made a “positive affirmation” prior to the entry of the order that it can borrow or otherwise obtain the securities that would be required to settle a short sale. However, once a Participant or Access Person is aware of difficulties in obtaining particular securities to make settlement of any short sale, the Participant or Access Person would no longer have a “reasonable expectation” of being able to settle a resulting trade and therefore would not be able to enter further short sale orders. For trading in a particular security, certain Participants or Access Persons who do not have the ability to borrow that security may be precluded from entering short sales while other Participants or Access Persons with the ability to borrow that security may continue to undertake additional short sales.

Even when the person entering an order has “reasonable expectations” of being able to settle any resulting trade, there may be circumstances in which the person should be required to have made arrangements to “pre-borrow” the securities which are the subject of a short sale. These types of circumstances may include when:

- the person making the short sale has previously executed trades which have failed to settle on the date scheduled for settlement and within a reasonable time after that date; and
- rates of settlement failure for a particular security have increased above historic levels and the increase is attributable to short selling activity.

2. Discussion of the Amendments

2.1 Repeal of Price Restrictions on Short Sales

The Amendments repeal all restrictions on the price at which a short sale may be made. The Amendments parallel action taken by the SEC to repeal price restrictions on short sales in the U.S. effective July 7, 2007 but the Amendments do not introduce a short sale circuit breaker as was done by Rule 201 in the U.S.

While the restrictions on the price at which a short sale may be executed are repealed under the Amendments, the requirement to mark an order as “short” continues.

2.2 Pre-Borrow Requirements

Under the Amendments, a Participant or Access Person would be given specific direction as to the need, subject to certain exceptions, to have made arrangements to borrow securities when entering an order that on execution would be a short sale of:

- any listed security on behalf of a client or non-client²⁰ that previously had an Extended Failed Trade in any listed security; or
- a particular security by the Participant or Access Person acting as principal if the Participant or Access Person had previously had an Extended Failed Trade in respect of a principal trade in that particular security.

¹⁹ There is no universally accepted definition of “naked short selling”. The most common usage is in connection with a short sale when the seller has not made arrangements to borrow any securities that may be required to settle the resulting trade. Some commentators use a more restrictive interpretation that describes any short sale when the seller has not pre-borrowed the securities necessary for settlement.

²⁰ 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.

An Extended Failed Trade is one in respect of which notice of the failed trade was required to be provided to IIROC in accordance with Rule 7.10 of UMIR as the reason for the failure had not been rectified within ten trading days following the date for settlement contemplated on the execution of the failed trade.

If an Extended Failed Trade report has been filed previously at any time by a Participant with IIROC with respect to an Extended Failed Trade in the account of a client or non-client, that client or non-client would not be able to enter an order that on execution would be a short sale without having made arrangements to borrow the securities necessary to settle any resulting trade unless the Participant through which the order is to be entered on a marketplace is satisfied, after reasonable inquiry, that the reason for any prior failed trade was not as a result of any intentional or negligent act of the client or non-client. IIROC confirms that “administrative error” or “delay” (such as delayed processing times by a transfer agent or custodian) would not be considered an intentional or negligent act of the client or non-client.

If a Participant or Access Person has filed previously at any time a report of an Extended Failed Trade in respect of a principal trade by that Participant or Access Person in a particular security, the Participant or Access Person would not be able to enter an order that on execution would be a short sale without having made arrangements to borrow the securities necessary to settle any resulting trade unless IIROC has consented to the entry of the principal order that is a short sale of that particular security. In providing the consent, IIROC will be able to review with the Participant or Access Person the circumstances surrounding the previous Extended Failed Trade and the reasons why the Participant or Access Person believes that future short sales of that particular security are unlikely to fail to settle.

Under the Amendments, a Participant or Access Person who enters an order that would, on execution, be a short sale of a security that IIROC has designated as a “Pre-Borrow Security” would be required to have made arrangements to borrow the securities necessary for settlement of any trade prior to the entry of the order on a marketplace.

As a result of the Amendments, each Participant and Access Person will have to ensure that they have adequate policies and procedures to regulate the entry of short sales in circumstances when the Participant or Access Person has previously executed an “Extended Failed Trade”²¹ or IIROC has designated a security as a “Pre-Borrow Security”.

2.3 Repeal of the “Short Exempt” Designation

Prior to the Amendments being implemented, the “short exempt” order designation will be used to identify an order for the short sale of a security which is not subject to the tick test. Upon the tick test being repealed on September 1, 2012, the use of the “short exempt” order designation will no longer be required and provisions for its use are also repealed.

2.4 Introduction of the “Short-Marking Exempt” Designation

Under the Amendments, a new order designation will be introduced to indicate that an order is being entered by an account that is exempt from marking an order as “short” (i.e. “short-marking exempt”). Under this provision, orders from particular accounts for the **purchase or sale** of a security would be designated as “short-marking exempt” upon entry on a marketplace. More specifically, orders would be marked as “short-marking exempt” if the order is from an account that is:

- an arbitrage account which makes a usual practice of buying and selling securities in different markets to take advantage of differences in prices;
- the account of a person with Marketplace Trading Obligations²² in respect of a security for which that person has obligations;
- a client, non-client or principal account:
 - for which order generation and entry is fully-automated, and
 - 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 a particular security; or
- 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

²¹ IIROC Notice 11-0080, *op. cit.* A report of an Extended Failed Trade is required on and after June 1, 2011 for trades settling through the CNS facilities of CDS. A report for failures of trades settling through the Trade-for-Trade settlement facility of CDS will become effective at a later date once IIROC has completed the development and testing of system that would permit IIROC to receive the information directly from CDS.

²² See IIROC Notice 11-0251 – Rules Notice – Notice of Approval – UMIR – *Provisions Respecting Market Maker, Odd Lot and Other Marketplace Trading Obligations* (August 26, 2011).

account does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security.

Concurrent with the issuance of this Rules Notice, IIROC has issued for public comment revised draft guidance on the use of the “short sale” and “short-marking exempt” order designations. IIROC would intend to issue the guidance in final form prior to the Amendments becoming effective.²³

2.5 Consequential Amendments

2.5.1 Definition of “Pre-Borrow Security”

The Amendments require a Participant or Access Person to have made arrangements to borrow securities prior to the entry of an order that would, on execution, be a short sale of a security that IIROC has designated as a “Pre-Borrow Security”. The Amendments add a definition of “Pre-Borrow Security” to Rule 1.1 and set out the considerations which IIROC would take into account in making such a designation in an addition to Policy 1.1. In determining whether to make such a designation, IIROC would have to consider whether:

- based on information known to IIROC, there has been an increase in the number, value or volume of failed trades in the particular security by more than one Participant or Access Person;
- the number or pattern of failed trades is related to short selling; and
- the designation helps to maintain a fair and orderly market.

2.5.2 Example of “Manipulative or Deceptive Method, Act or Practice”

With the repeal of the price restrictions on the price at which a short sale may be made, clause (d) of Part 1 of Policy 2.2 which precludes the practice of purchasing a security at a price below the last sale price with the intention of making a short sale at that new lower price has become spent and, as such, the Amendments repeal the provision.

3. Changes from the Proposed Amendments

The Amendments as approved vary from the Proposed Amendments in a number of areas including:

- changes to the definition of “short-marking exempt order” to permit any client, non-client or principal account (and not just an account of an institutional customer as set out in the Proposed Amendments) to qualify and to simplify the criteria to require that:
 - order generation and entry is fully-automated, and
 - in the ordinary course, trading activity is “non-directional”;
- extending the definition of “short-marking exempt order” to include certain principal “facilitation” accounts which are “non-directional”; and
- simplifying the ability of a Participant to relieve a client or non-client of the need to “pre-borrow” a security subject to a short sale if the Participant is satisfied that any previous failure was not as a result of any intentional or negligent act of the client or non-client (which simplification also eliminated the need for IIROC to have the ability to consent to such order entry).

4. Summary of the Impact of the Amendments

The following is a summary of the most significant impacts of the adoption of the Amendments:

- Participants and Access Persons are relieved of the obligation to ensure that short sales comply with the “tick test”;
- marketplaces, which have elected to system-enforce the “tick test” for Participants and Access Persons, are able to remove this functionality from their trading systems;

²³ See IIROC Notice 12-0079 – Rules Notice – Request for Comments – UMIR – *Proposed Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations* (March 2, 2012).

- each Participant and Access Person will have to ensure that they have policies and procedures that will adequately regulate the entry of short sales in circumstances where the security has been designated a “Pre-Borrow Security” or the Participant or Access Person has previously executed an Extended Failed Trade;
- Participants and Access Persons will need to have made arrangements to borrow securities when undertaking a short sale of:
 - a security that has been designated as a “Pre-Borrow Security”,
 - any listed security on behalf of a client or non-client that previously had an Extended Failed Trade in any listed security, or
 - a particular security by the Participant or Access Person acting as principal if the Participant or Access Person has had an Extended Failed Trade in respect of that particular security;
- each Participant will have to ensure that it has adequate policies and procedures to properly identify orders that should be designated as either “short sale” or “short-marking exempt”; and
- each marketplace will have to ensure that its trading systems correctly handle orders designated as “short sale” or “short-marking exempt”.

5. Technological Implications and Implementation Plan

The technological implications of the Amendments on Participants, marketplaces or service providers are as follows:

- their systems have to be able to differentiate between an order designated as “short sale” and “short-marking exempt” (since, under the Amendments, the designations are mutually exclusive);
- their systems have to be able to accept the “short-marking exempt” designation on both purchase and sell orders; and
- their system enforcement of the tick test should be disabled for orders marked as a “short sale”.

The Amendments will become effective on **September 1, 2012**. IIROC has initiated meetings with marketplaces and service providers to deal with the technological implications of the Amendments and, in particular, to co-ordinate the introduction of the “short-marking exempt” designation.

Appendix A – Text of Provisions Respecting Regulation of Short Sales and Failed Trades

The Universal Market Integrity Rules are hereby amended as follows:

1. Rule 1.1 is amended by inserting the following definitions of “Pre-Borrow Security” and “short-marking exempt order”:

“Pre-Borrow Security” means a security that has been designated by a Market Regulator to be a security in respect of which an order, that on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order.

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

 - (a) an arbitrage account;
 - (b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;
 - (c) a client, non-client or principal account:
 - (i) for which order generation and entry is fully-automated, and
 - (ii) 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 a particular security; or
 - (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.
2. Rule 3.1 is deleted.
3. Rule 3.2 is amended by:
 - (a) deleting in clause (a) of subsection (1) the phrase “or subclause 6.2(1)(b)(ix)”;
 - (b) deleting subsection (2) and inserting:

Clause (a) of subsection (1) does not apply to an order that has been designated as a “short-marking exempt order” in accordance with subclause 6.2(1)(b)(ix).
4. Rule 6.1 is amended by adding the following subsections:
 - (3) A Participant acting as agent shall not enter a client order or a non-client order on a marketplace that would, if executed, be a short sale if the client or non-client has previously executed a sale of any listed security that became a failed trade in respect of which notice to the Market Regulator was required pursuant to Rule 7.10 unless:
 - (a) the Participant has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order; or
 - (b) the Participant is satisfied, after reasonable inquiry, that the reason for any prior failed trade was not as a result of any intentional or negligent act of the client or non-client.
 - (4) A Participant acting as principal or an Access Person shall not enter an order on a marketplace for a particular security that would, if executed, be a short sale if the Participant or Access Person has previously executed a sale in that security that became a failed trade in respect of which notice to the Market Regulator was required pursuant to Rule 7.10 unless:
 - (a) the Participant or Access Person has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order; or
 - (b) the Market Regulator has consented to the entry of such order or orders.

- (5) A Participant or an Access Person shall not enter an order on a marketplace for a Pre-Borrow Security that would, if executed, be a short sale unless the Participant or Access Person has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order.

5. Clause (b) of subsection (1) of Rule 6.2 is amended by:

- (a) deleting in subclause (viii) the phrase “which is subject to the price restriction under subsection (1) of Rule 3.1” and substituting the phrase “but not including an order which is designated as a “short-marking exempt order” in accordance with subclause 6.2(1)(b)(ix)”; and
- (b) deleting subclause (ix) and substituting the following:
- (ix) a short-marking exempt order.

The Policies to the Universal Market Integrity Rules are hereby amended as follows:

1. Policy 1.1 is amended by inserting the following as Part 2.1

Part 2.1 – Definition of “Pre-Borrow Security”

Under the definition of a “Pre-Borrow Security”, the Market Regulator may designate 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 entering the order has made arrangements to borrow the securities that would be required to settle the trade prior to the entry of the order. In determining whether to make such a designation, the Market Regulator shall consider whether:

- based on information known to the Market Regulator, there is an increase in the number, value or volume of failed trades in the particular security by more than one Participant or Access Person;
- the number or pattern of failed trades is related to short selling; and
- the designation would be in the interest of maintaining a fair and orderly market.

2. Part 1 of Policy 2.2 is amended by:

- (a) inserting at the end of clause (b) the word “and”;
- (b) deleting at the end of clause (c) the phrase “; and”;
- (c) deleting clause (d).

3. Policy 3.1 is repealed.

**Appendix B – Comments Received in Response to
Rules Notice 11-0075 – Request for Comments – UMIR –
Provisions Respecting Regulation of Short Sales and Failed Trades**

On February 25, 2011, the Investment Industry Regulatory Organization of Canada (“IIROC”) issued Rules Notice 11-0075 requesting comments on Provisions Respecting Regulation of Short Sales and Failed Trades (“Proposed Amendments”). IIROC received comments on the Proposed Amendments from:

The Canadian Depository for Securities Limited (“CDS”)
Canadian Security Traders Association, Inc. (“CSTA”)
Chi-X Canada (“Chix-X”)
CIBC World Markets Inc. (“CIBC”)
CNSX Markets Inc. (“CNSX”)
Desjardins Securities (“Desjardins”)
Brian M. Hearst (“Hearst”)
Investment Industry Association of Canada (“IIAC”)
Elaine and Robert MacDonald (“MacDonald”)
RBC Capital Markets (“RBC”)
Scotia Capital (“Scotia”)
Summerwood Capital Corp. (“Summerwood”)
TD Newcrest (“TD”)
William R. Thompson (“Thompson”)
TMX Group Inc. (“TMX”)
Wolverton Securities Ltd. (“Wolverton”)

A copy of the comment letter in response to the Proposed Amendments is publicly available on the website of IIROC (www.iiroc.ca under the heading “Policy” and sub-heading “Market Proposals/Comments”). The following table presents a summary of the comments received on the Proposed Amendments together with the responses of IIROC to those comments. Column 1 of the table highlights the revisions to the Proposed Amendments made on the approval of the Amendments.

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
<p>1.1 Definitions “Pre-Borrow Security” means a security that has been designated by a Market Regulator to be a security in respect of which an order, that on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order.</p>	<p>RBC – Believes that the proposal would impose disproportionate and substantial changes to Participants’ order entry and back office systems in order to maintain accurate and up-to-date lists of “pre-borrow” securities and “extended failed trades”.</p>	<p>IIROC believes that the approach (i.e. designating securities that will require “pre-borrowing” before undertaking a short sale) is preferable to general and comprehensive requirements such as in the United States. As set out in the notice, there have been historic instances of “problems” in the trading of specific securities but there have been none since the “manipulative” rules were amended in 2005. Presently, UMIR provides that IIROC may designate particular securities as being ineligible for short sale. The introduction of the “pre-borrow” requirement is seen as a less dramatic intervention with a similar impact on Participant’s systems.</p>
<p>1.1 Definitions “short-marking exempt order” means an order for the purchase or sale of a security from account that is: (a) an arbitrage account; (b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations; and (c) <u>a client, non-client or principal</u> the account of an institutional customer:</p>	<p>CSTA – Supports the proposal and suggests that the separate marking be extended to all trading activity from the “specialty participants”.</p>	<p>IIROC expanded the definition to permit orders from certain client, non-client and principal accounts to qualify as “short-marking exempt”. To qualify, the activity in the account would have to be “directionally” neutral and the generation and entry of orders would have to be fully-automated.</p>

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
<p>(i) for which order generation and entry is fully-automated, <u>and</u></p> <p>(ii) which, in the ordinary course, executes both purchases and sales of a particular security on one or more marketplaces on each trading day, and</p> <p>(iii) 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 <u>a the particular security; or</u></p> <p>(d) <u>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.</u></p>	<p>CIBC and IIAC– Supports the proposal but suggests that it be expanded to include proprietary accounts that use “directionally neutral strategies” such as “facilitation trades”.</p> <p>Scotia – Notes that there is no a generally accepted definition of “high frequency trading” but do not agree that HFT should have an “advantage” in marking trades that in effect were short at the time of entry simply because it is problematic. Suggests a “more principle based approach” in place of the specific criteria. Also suggests that principal accounts should be able to qualify.</p>	<p>See the response to CSTA above. In particular, the revisions permit orders from a principal account to be marked as a “short-marking exempt order” if the account is used essentially 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.</p> <p>IIROC would note that in some jurisdictions, HFTs have adopted the practice of marking all sell orders as “short”. Such a practice compromises the ability to properly monitor short sale activity. The Amendments seek to maintain the value of the order data by dividing the orders between those that make a general practice of being “directionally” neutral (e.g. any short sales during the day will be offset by purchases during the trading day such that securities will not have to be borrowed to effect settlement) from those that are entering short orders as a result of “negative” sentiment or who will have to borrow securities to effect settlement of any trade. IIROC would also note that the “rule” component is principle based but the guidance sets out “general guidelines”. Failure to meet the guidelines for short periods of time would not constitute “non-compliance”.</p>
<p>3.1 Restrictions on Short Selling – repealed</p>	<p>CSTA, Chi-X, CIBC, CNSX, Desjardins, IIAC, RBC, Scotia, Summerwood and TD- Supportive of the repeal of price restrictions at which a short sale may be made.</p> <p>Summerwood –Notes that some market participants confuse the principles of investor protection and market integrity with price stability.</p> <p>CNSX – Critical for IIROC to continue to work with other regulators to identify abusive practices, including abusive short selling.</p>	<p>IIROC acknowledges support for the repeal.</p> <p>In the view of IIROC, “unexplained” significant price movement, both to the upside and the downside, is a concern in maintaining a fair and orderly market.</p> <p>IIROC has introduced an alert to its surveillance system to detect price declines associated with increases in rates of short selling. The alert will allow regulatory attention to be directed to potentially abusive behaviour in “real-time”.</p>

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
	<p>Hearst – Opposes the removal of the tick test and would support a ban on short selling as it makes it difficult for issuer to “keep their market stable”.</p>	<p>Studies by IIROC and others have demonstrated that short selling contributes to price stability and that volatility and spreads increase when short selling is prohibited. The purpose of markets is to provide price discovery and not to favour or support either “inflated” or “depressed” prices for securities. IIROC would note that the issuer does not have a responsibility for ensuring the price stability of their securities. The price discovery mechanism is premised on buyers and sellers with equal access to material information concerning the issuer coming together to establish the market price.</p>
	<p>MacDonald – Believes short selling enables large institutional holders/purchasers of stock to manipulate the market prices.</p>	<p>Short selling performs many functions not the least of which is lessening price volatility. Misuse of short selling for “manipulative” purposes is contrary to the rules in the same way as “pump and dump” from long positions is contrary from the rules.</p>
	<p>Thompson – Believes that the tick test “does slow down abusive short selling”. Allowing an excessive time frame to borrow stocks to cover short positions in no way protects the retail investor and leads to a lack of confidence in a fair and equitable marketplace.</p>	<p>“Abusive short selling” is manipulation and can be dealt with by existing rules dealing with manipulation. The tick test complicates the other “normal” short selling activity without providing a regulatory benefit. IIROC has introduced a real-time alert to assist in the detection of “abusive” short selling.</p>
	<p>TMX – Believes that removing the short sale tick test should not lead to any harm given the regulatory framework in Canada and IIROC’s ability to perform real-time surveillance.</p>	<p>IIROC is in agreement with the comment.</p>
	<p>Wolverton – Believes that the tick rule permits shorts when the market is “frothy” while shuts down short sales when a public company is weak and in need of protection. For junior companies market manipulation is a real concern both on the upside and the downside.</p>	<p>The empirical studies by IIROC demonstrate that rates of short selling and short positions increase in rising markets and fall during periods of price decline (indicating that “shorts” act as support in the periods of price decline and a not the cause of the decline). This pattern is particularly pronounced for “junior” securities. IIROC has moved to specifically introduce real-time alerts that monitor for “abusive” short selling (increases in rates of short selling during periods of price decline). The price</p>

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
		discovery mechanism is designed to provide a “true price” based on overall market sentiment and full disclosure of material information and should not be distorted to provide “protection” for the price of securities in certain circumstances.
<p>3.2 Prohibition on Entry of Orders</p> <p>(1) A Participant or Access Person shall not enter an order to sell a security on a marketplace that on execution would be a short sale:</p> <p>(a) unless the order is marked as a short sale in accordance with subclause 6.2(1)(b)(viii); or</p> <p>(b) if the security is a Short Sale Ineligible Security at the time of the entry of the order.</p> <p>(2) Clause (a) of subsection (1) does not apply to an order that has been designated as a “short-marking exempt order” in accordance with subclause 6.2(1)(b)(ix).</p> <p>...</p>		
<p>6.1 Entry of Orders to a Marketplace</p> <p>...</p> <p>(3) A Participant acting as agent shall not enter a client order or a non-client order on a marketplace that would, if executed, be a short sale if the client or non-client has previously executed a sale of any listed security that became a failed trade in respect of which notice to the Market Regulator was required pursuant to Rule 7.10 unless:</p> <p>(a) the Participant has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order; <u>or</u></p> <p>(b) the Participant is satisfied, after reasonable inquiry, that the reason for any prior failed trade was solely as a result of administrative error and not as a result of any intentional or negligent act of the client or non-client; or</p> <p>(c) the Market Regulator has consented to the entry of such order or orders.</p> <p>(4) A Participant acting as principal or an Access Person shall not enter an order on a marketplace for a particular security that would, if executed, be a short sale if the Participant or Access Person has previously executed a sale in that security that became a failed trade in respect of which notice to the Market</p>	<p>CSTA – Street will face significant costs to implement pre-borrow and regulators should weight the costs of implementation versus the actual benefits.</p>	<p>Unlike the regulatory framework in the United States, IIROC is not introducing a “general obligation” that is applicable to all short sales. Rather, IIROC has tried to focus the obligation only on those accounts that have demonstrated an inability to settle a trade within a reasonable time (10 days) following the original settlement date. IIROC originally proposed an exception from the requirement if the Participant is satisfied that the reason for the “extended failed trade” was due to administrative error. IIROC has revised the exception to clarify that the Participant may waive the requirement if the Participant is satisfied that the reason for the prior failure was not as a result of any intentional or negligent act. There would be no compliance costs if all trades are settled and the account has met all delivery requirements within the 10 days following the original settlement date.</p>
	<p>Chi-X – Supports IIROC’s determination not to introduce a mandatory pre-borrow requirement.</p>	<p>See response to CSTA comment above.</p>

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<p>Regulator was required pursuant to Rule 7.10 unless:</p> <ul style="list-style-type: none"> (a) the Participant or Access Person has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order; or (b) the Market Regulator has consented to the entry of such order or orders. <p>(5) A Participant or an Access Person shall not enter an order on a marketplace for a Pre-Borrow Security that would, if executed, be a short sale unless the Participant or Access Person has made arrangements for the borrowing of the securities necessary to settle any resulting trade prior to the entry of the order.</p>	<p>CIBC – Believes that existing UMIR requirements related to manipulative trading and other IIROC requirements make the proposal unnecessary. Believes that there will be significant costs to the investor in both time and resources.</p>	<p>IIROC agrees that a general “pre-borrow” requirement would be “unnecessary and burdensome” given the history in Canada of short selling and trade failures. For that reason, the proposed requirement is only applicable to those accounts that have previously executed an “extended failed trade”. In this way, the cost to investors will only be borne by those investors who have established a record for defaulting on settlement which has not been rectified within a “reasonable” time (e.g. 10 days after the original settlement date). The additional requirements become an “incentive” to investors and Participants to ensure rectification of delivery problems within the 10 days. IIROC acknowledges that these “failures” represent a very small percentage of failures but they have an inordinate impact on rates of cumulative trade failure. IIROC expects that these additional requirements will lead Participants to strengthen settlement discipline such that number of extended failed trades would fall from current levels and would focus on failures that may evidence non-compliance by the account holders with other regulatory requirements.</p>
	<p>Desjardins – Suggests that the requirement be revisited as the IIROC studies do “not indicate that a problem currently exists”.</p>	<p>IIROC acknowledges that the studies demonstrate that there is not a problem which would require a “general and comprehensive” solution. IIROC has attempted to focus the burden only on those accounts with a record of failing to settle within a reasonable time.</p>
	<p>IIAC –Believes that the pre-borrow requirement is an example of regulation without clear justification. If the requirement is to be retained, it should be based on a threshold where the number of shorts against a stock impairs the settlement process. Believes that there are significant systems issues to monitoring extended failed trades.</p>	<p>Under the Amendments, “pre-borrow” is not a requirement for all short sales. Pre-borrow would only apply if the account had previously experienced an extended failed trade that was not of an administrative nature or if IIROC designated a particular security due to settlement problems related to levels of short selling. Reference should be made to the proposed Part 2.1 of Policy 1.1 dealing with the definition of a “Pre-Borrow Security.” The definition of “Pre-Borrow Security” addresses the systemic problems arising from</p>

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		<p>short sales while the extended failed trade threshold addresses “potential abusive short selling” which may be occurring at the account level (such as when the account holder has engaged in “naked” short selling without an intention of effecting settlement on the settlement date.) The number of extended failed trades will be extremely low (and IIROC further expects that Participants will “tighten” settlement procedures to avoid triggering the extended failed trade provisions except in circumstances that would justify regulatory review of the trade to ensure that the failure is not part of a manipulative pattern of trading.</p>
	<p>RBC – Believes that the restriction on clients to pre-borrow should only be for the specific security which was the subject of an extended failed trade. Failed trades resulting from administrative delay should not be treated in the same manner as fails resulting from improper shorts.</p>	<p>If a client has previously had an “extended failed trade”, the pre-borrow requirement would apply to all securities unless the Participant was satisfied that the earlier failure was not as a result of an intentional or negligent act by the client. If the client intentionally defaulted on its obligations to settle a sale of stock “A”, IIROC is of the view that the client should not be permitted to make a short sale of stock “B” (since the Participant could not know in advance whether the client intended to default on its settlement obligations). IIROC confirms that “administrative error” or “delay” (such as delayed processing times by a transfer agent or custodian) would not be considered an intentional or negligent act of the client or non-client.</p>
	<p>RBC – The proposed requirements would likely have a negative impact on the number of short sales executed and may unduly reduce or restrict trading in certain securities that are not readily available for pre-borrow, such as “junior securities”. Particular complexities may arise with the sale of securities subject to Rule 144A restrictions which, due to delays in the removal of the legend, are prone to extended fails.</p>	<p>IIROC believes that the “pre-borrow” requirements will have no impact on short selling activity unless there is an abnormal situation in the market or the person entering the order has previously had an extended failed trade. IIROC has previously issued guidance (Market Integrity Notice 2006-006 – Sale of Securities Subject to Certain United States Securities Laws) that confirms that the sale of securities subject to Rule 144A or Regulation D other than as a Special Term Order with</p>

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		<p>“delayed delivery” to allow for the removal of the restrictive legend would be achieved by the Participant marking the order as “short exempt” and “the Participant would need to borrow free-trading securities to complete settlement while arranging for the removal of any restrictive legend”. To do otherwise would be the entry of an order without having “the reasonable expectation of settling” any resulting trade contrary to Policy 2.2 of UMIR.</p>
	<p>Scotia – Does not believe that the “pre-borrowing” requirement will benefit the overall settlement process. It also will not deter manipulative behaviours of individuals that wish to naked short.</p>	<p>The studies by IIROC demonstrated that there was no demonstrable relationship between short selling and failed trades. In fact, the IIROC studies indicated that a short sale was less likely to fail than a regular trade. However, IIROC is of the view that those persons who have failed to settle and have not rectified the situation within a reasonable period of time should be subject to additional restrictions and that this approach is preferable to options pursued in other jurisdictions such as locate requirements for any short sale or the imposition of “mandatory close-outs” when the majority of trade failures are due to administrative error or delay.</p>
	<p>Wolverton – Problem with restraining shorts with borrowing is that most small companies are purchased in cash accounts and fully-paid for by clients resulting in almost no stock available for borrowing thereby “eliminating” short sales.</p>	<p>The Amendments do not introduce a general borrowing requirement for short sales. Rather the requirement is limited to securities which are experiencing highly unusual settlement problems or when the person making the short sale has previously executed an “extended failed trade” that is attributable to an intentional or negligent act of the client or non-client. The pre-borrowing requirement would not arise if the prior failure was due to administrative error or delay. Existing UMIR provisions require a Participant that is entering an order on a marketplace to have a “reasonable expectation of settling any trade that would result from the execution of the order”. A Participant is not able to enter an order if the Participant knows the Participant will not be in a position</p>

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		to settle the trade on the settlement date.
<p>6.2 Designations and Identifiers</p> <p>(1) Each order entered on a marketplace shall contain:</p> <p>...</p> <p>(b) a designation acceptable to the Market Regulator for the marketplace on which the order is entered, if the order is:</p> <ul style="list-style-type: none"> (i) a Call Market Order, (ii) an Opening Order, (iii) a Market-on-Close Order, (iv) a Special Terms Order, (v) a Volume-Weighted Average Price Order, (v.1) a Basis Order, (v.2) a Closing Price Order, (v.3) a bypass order, (v.4) a directed action order as defined in the Trading Rules, (vi) part of a Program Trade, (vii) part of an intentional cross or internal cross, (viii) a short sale but not including an order which is designated as a “short-marking exempt order” in accordance with subclause 6.2(1)(b)(ix), (ix) a short-marking exempt order, (x) a non-client order, (xi) a principal order, (xii) a jitney order, (xiii) for the account of a derivatives market maker, (xiv) for the account of a person who is an insider of the issuer of the security which is the subject of the order, (xv) for the account of a person who is a significant shareholder of the issuer of the security which is the subject of the order, or (xvi) of a type for which the Market Regulator may from time to time require a specific or particular designation. 		
<p>Policy 1.1 - Definitions</p> <p>Part 2.1 – Definition of “Pre-Borrow Security”</p> <p>Under the definition of a “Pre-Borrow Security”, the Market Regulator may designate 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 entering the order has made arrangements to borrow the securities that would be required to settle the trade prior to the entry of the order. In determining whether to make such a designation, the Market Regulator</p>		

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
<p>shall consider whether:</p> <ul style="list-style-type: none"> based on information known to the Market Regulator, there is an increase in the number, value or volume of failed trades in the particular security by more than one Participant or Access Person; the number or pattern of failed trades is related to short selling; and the designation would be in the interest of maintaining a fair and orderly market. 		
<p>Policy 2.2. – Manipulative and Deceptive Activities Part 1 – Manipulative or Deceptive Method, Act or Practice There are a number of activities which, by their very nature, will be considered to be a manipulative or deceptive method, act or practice. For the purpose of subsection (1) of Rule 2.2 and without limiting the generality that subsection, the following activities when undertaken on a marketplace constitute a manipulative or deceptive method, act or practice: (a) making a fictitious trade; (b) effecting a trade in a security which involves no change in the beneficial or economic ownership; and (c) effecting trades by a single interest or group with the intent of limiting the supply of a security for settlement of trades made by other persons except at prices and on terms arbitrarily dictated by such interest or group. If persons know or ought reasonably to know that they are engaging or participating in these or similar types of activities those persons will be in breach of subsection (1) of Rule 2.2 irrespective of whether such method, act or practice results in a false or misleading appearance of trading activity or interest in the purchase or sale of a security or an artificial ask price, bid price or sale price for a security or a related security.</p>		
<p>Policy 3.1 Restrictions on Short Selling Part 1 – Entry of Short Sales Prior to the Opening <i>- repealed</i></p>		
<p>Policy 3.1 Restrictions on Short Selling Part 2 – Short Sale Price When Trading Ex-Distribution <i>- repealed</i></p>		
<p>Questions: 1. Are there any policy reasons, other than those identified in this Request for Comments, that IIROC should consider in pursuing the proposed repeal of the existing “tick test” (short sales must be made at a price not less than the last sale price)? If you disagree with the proposal to repeal the tick test, please indicate why it should be retained.</p>	<p>Scotia – Agrees with the repeal but suggests other safeguards such as circuit breakers.</p>	<p>IIROC does not support restrictions on short sales when a circuit breaker is triggered. The analysis by IIROC indicates that sharp price declines are rarely associated with short selling activity (though IIROC monitors for this type of activity and has introduced an alert based on increased short selling activity and price declines).</p>

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
		IIROC has been monitoring the instances in which an inter-listed security has been subject to a short sale circuit breaker in the U.S. In more than 80% of the cases, the price decline was attributable to the release of material negative news or sector specific events. Patterns of short selling in the period leading up to the triggering of the circuit breaker were not significantly different from that in the period after the circuit breaker had expired (nor the pattern during the period when the circuit breaker was in effect in the U.S.). IIROC continues to believe that a short sale circuit breaker regime is not warranted.
2. If restrictions on the price of a short sale are to be retained, should UMIR adopt a “bid test” at the time of order entry (e.g. a short order may only be entered on a marketplace at a price above the best bid price)?	Scotia – Does not support the use of any type of tick test unless it is coupled with a circuit breaker approach and evidence exists that short sales were driving down the market.	See comment on Scotia response to Question 1.
	TD – Does not believe any restriction on the price of a short sale should be retained.	IIROC agrees with the comment.
3. If restrictions on the price of a short sale are to be retained, whether in the short-term or on a long-term basis, should there be an exemption provided to securities inter-listed on an exchange in the United States?	CIBC, Desjardins, IIAC, Scotia and TD – If the tick test is retained, inter-listed securities should be exempt to prevent regulatory arbitrage detrimental to Canadian markets.	IIROC agrees with the comment.
4. If restrictions on the price of a short sale are repealed, what regulatory arbitrage opportunities may exist in the case of an inter-listed security, where a circuit breaker has been triggered in the United States giving rise to short sale price restrictions? What measures could be taken, if any, to limit this potential regulatory arbitrage?	Chi-X –Where possible, differences in regulatory regimes should be reconciled, nonetheless the policy rationale for repeal of the “tick test” outweighs the impact of creating an opportunity for regulatory arbitrage.	IIROC has been monitoring the trading of inter-listed securities which have triggered short sale circuit breakers in the United States. IIROC has found no evidence of “short sale” migration. In addition, IIROC has found no evidence that increases in the rate of short selling was the cause of price declines.
	CIBC – Proposed “general” circuit breaker should be sufficient.	IIROC agrees with the comment. Guidance for the triggering of “Single-Stock Circuit Breakers” has been published in IIROC Notice 12-0040. Revised proposed guidance on regulatory intervention for the cancellation or variation of trades has been published for comment.
	Desjardins and Scotia – Believes that no measures will be necessary.	

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	<p>IIAC – If no regulatory risk in repealing the tick test, there is no reason why the arbitrage opportunity should not be permitted to exist.</p>	
	<p>TD – Believes that opportunities for regulatory arbitrage will be “extremely limited”. Notes that historically Canadian rules on short sale price restrictions have varied from those in the U.S.</p>	
	<p>TMX – Not aware of any regulatory arbitrage to date and believes existing UMIR provisions are adequate to protect the Canadian market.</p>	
<p>5. The Proposed Amendments would “reuse” the existing “short exempt” designation to indicate accounts that qualify for the “short-marking exempt” designation. Are there any specific operational considerations for marketplaces or Participants from this change in use? Would there be any benefits to introducing a separate, new designation if marketplaces, service providers and Participants still have to modify their system to remove functionality and provision for the existing “short exempt” designation?</p>	<p>Chi-X , CIBC, CNSX and Scotia – While the “re-use” of the existing marker may save costs, commenters suggest that investor confusion/variations from the FIX protocol used in the U.S. may make the introduction of a new tag preferable.</p>	<p>IIROC agrees with the suggestion.</p>
	<p>IIAC – Suggest marketplaces be required to provide a new tag/marker that would be uniform across all venues.</p>	<p>IIROC agrees with the suggestion.</p>
	<p>RBC – Implementation costs will be significant and, if the change is for purely statistical reasons, suggests that IIROC reconsider the proposal.</p>	<p>The key element in the Amendments is the removal of the tick test on short sales. To address concerns that this removal may open the door to “abusive” short selling, IIROC needs to be in a position to better monitor short selling activity. The provisions differentiate short sales being made by investors with a “directional” focus on the merits of a security from short sales by “persons” who are directionally neutral but simply taking advantage of “trading opportunities” principally created by an increase in the number of markets and marketplaces trading the same securities</p> <p>While there will be costs to the implementation of the new marker, the changes will, in the longer term, simplify the oversight by Participants of the fact that orders have been properly marked. The change will also have the effect of removing the requirement for</p>

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
		accounts that qualify as “short-marking exempt” to change the status of a previously entered order to “short” when subsequent to the entry of the sell order the account has moved from a “long” position. Such changes to an order may affect the order’s priority on certain marketplaces.
	TD – Supports the “re-use” of the marker.	
	TMX – Prefers the introduction of a new order marker.	IIROC agrees with the suggestion.
6. Are there any other operational considerations for marketplaces or Participants that would arise as a result of the adoption of the Proposed Amendments, beyond those identified in this Request for Comments?	Chi-X – The repeal of the “tick test” will simplify routing decisions for smart order routers that will no longer have to take into account differences in the mechanisms used by each marketplace to system enforce the price restrictions.	IIROC agrees. IIROC has solicited comment on changes to the requirements surrounding the calculation of “last sale price” as part of proposed amendments to UMIR regarding “Dark Liquidity”. See IIROC Notice 11-0225 issued on July 29, 2011.
	CIBC and IIAC – Believes that the time and resources required to scope and develop system to automate and monitor compliance with the requirements may be disproportionate to the regulatory benefits obtained.	The number of failed trades is small and the extended failed trades are less than 4% of that. IIROC would expect that Participants will review their policies and procedures with a view to minimizing the number of extended failed trades even further. Given the limited number of instances, IIROC does not expect that Participants would specifically “automate” compliance with either EFTR or pre-borrow. Each Participant presently monitors “credit” activity of accounts and has the ability to “manually” place restrictions on trading activity.
7. If the Proposed Amendments are approved, IIROC is proposing to delay the implementation for a period of one hundred and eighty (180) days in order to provide Participants, marketplaces and service providers the time to make necessary changes to their systems, policies and procedures. Should the implementation period be longer and, if so, why?	CIBC and IIAC – Suggests one year implementation period.	See response to CIBC comment on question 6.
	Desjardins – Difficult to estimate the time.	IIROC can be flexible in extending the implementation if issues arise.
	Scotia – Suggests an implementation period of not less than one year given system changes together with education, training and testing.	Given the limited nature of the Amendments (i.e. to impose additional restrictions on particular accounts that have defaulted in delivery on settlement or the trading of particular securities in extraordinary circumstances), IIROC believes that the existing policies, procedures or mechanisms which Participants have to constrain trading activities in particular securities or accounts

Text of Provision Following Adoption of the Amendments (Revisions to the Proposed Amendments Highlighted)	Commentator and Summary of Comment	IIROC Response to Commentator and Additional IIROC Commentary
		will be adequate (and should not require major modification).
	TD – Supports suggested 180 day implementation period.	
	TMX – 180 days should be sufficient for marketplaces (if a new “short marking exempt” marker is introduced rather than “re-used”).	
8. The requirement to mark a sell order as a “short sale” is determined based on the aggregate holdings of the “seller” (across multiple accounts which may in fact be held at multiple Participants or dealers) while the requirement of a Participant to file a short position report is based on the position of each individual account. If the tick test is repealed, should the basis for determining the marking orders and filing short position reports be harmonized? Would it be preferable for the marking of orders to be determined based on the holdings in the account entering the sell order at the time the order is entered?	CIBC and IIAC – Marking for client accounts should be on an “aggregate” basis but suggests that proprietary accounts be given the option of either methodology.	With the repeal of the tick test, any benefit from aggregating positions across accounts will be removed (i.e. the ability to make a sale below the last sale price even when the account actually making the sale will be in a short position.). If there is in fact “settlement” risk when the security is not held in the account making the sale, there may be merit to having such sale marked “short”.
	Desjardins – Supports use of “aggregate” level.	
	Scotia – Suggests that “net position” for both firm and client would provide a more reliable benchmark for marking purposes and short position reporting purposes. Questions whether accounts exempt from marking orders as short would be exempt from short position reporting.	Accounts exempt from “short” marking are not exempt from short position reporting.
	TD – Practicable approach is to make the determination based on the position of each individual account. For “delivery against payment” accounts dealers currently have to rely on client disclosure.	
General Comments	CDS – Strongly supports all initiatives to reduce failed trades. If IIROC or CDS participants determine that additional or enhanced reports would facilitate IIROC’s objectives, CDS will engage in discussions to determine how best to develop these reports and the timing for such development work.	IIROC and the CSA are issuing a joint notice requesting comments on various aspects of transparency of short sales and failed trades.
	CSTA – Notes problems with U.S. short sale circuit breakers including the fact that securities subject to a	IIROC did not support a short sale circuit breaker as its analysis did not find a relationship between significant price declines and short

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	<p>“corporate action” have not been exempted.</p>	<p>selling activity.</p>
	<p>IIAC – Suggests the proposals be re-examined to ensure that they are addressing a demonstrated Canadian problem that would justify the increased regulatory burden.</p>	<p>Given the limited nature of the IIROC proposals to impose additional restrictions on particular accounts that have defaulted in delivery on settlement or the trading of particular securities in extraordinary circumstances, IIROC that the existing policies, procedures or mechanisms which Participants have to constrain trading activities in particular securities or accounts will be adequate (and should not require major modification).</p>
	<p>Wolverton – Significant differences in settlement and margin rules between Canada and the United States mean Canada has not had the short sale or failure problems experienced in the United States. Shorting does not need fixing, “respectfully, please resist the urge to fix things that aren’t broken.”</p>	<p>IIROC has not proposed to adopt the general and comprehensive “solutions” suggested or adopted in the United States. Rather the Amendments focus any additional requirements only in situations in which there have been “problems” and to remove restrictions which are not warranted by trading experience.</p>

Appendix C – IIROC Initiatives on Short Sales and Failed Trades

The following table outlines the initiatives taken or proposed by IIROC in connection with short sales and failed trades since October of 2008. The initiatives are grouped under the following elements of the overall strategy of IIROC regarding the regulation of short sales and failed trades:

- repeal the price restrictions on short sales;
- enhance investor education and confidence regarding the role of short selling in the operation of the market and the reasons for trade failures;
- increase transparency of information regarding short sale activity and failed trades;
- monitoring regulatory arbitrage opportunities related to short sales;
- disclose the criteria for regulatory intervention for variation or cancellation of trades in the event of significant price volatility;
- enhance monitoring of short sales and failed trades; and
- impose pre-borrow requirements for short sales made in certain circumstances.

Specific Initiative	Summary Description	Status of Initiative	Implementation Dates	
			Approved Initiatives	Proposed/On-going Initiatives
Repeal of Price Restrictions on Short Sales				
Repeal of Price Restrictions on Short Sales	Repeal of the requirement that a short sale may not be made at a price less than the last sale price of the security ("tick test").	Approved		September 1, 2012
Elimination of "Short Exempt" Order Marking Requirements	Eliminate the ability to mark a "short sale" as being "exempt" from the tick test.	Approved		September 1, 2012
Enhancement of Investor Confidence				
Educating Investors on the Role of Short Selling	Provide disclosure in the IIROC on-line investor education tool ("Guide to Equity Markets: Learning the Mechanics and Rules of Trading") regarding the role of short selling. Address "short selling" at the "Investor Forum" that would be accompany the launch of the investor education tool.	Completed	May 2011	
Release of Empirical Studies	Publication of <i>Trends in Trading Activity, Short Sales and Failed Trades (for the period May 1, 2007 to April 30, 2010)</i> and <i>Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange (for the period May 1, 2007 to April 30, 2010)</i> .	Completed	February 25, 2011 (Studies published as IIROC Notices 11-0077 and 11-0078)	
Update of Empirical Studies	Undertake and publish updates of the empirical studies to determine the effect, if any, of the Amendments and other initiatives on trends in trading activity, short sales and failed trades.	Planning Stage		Approximately one year after implementation of Amendments
Release Study on Short Sale Circuit Breakers	Publication of <i>Effects of Short Sale Circuit Breakers in the United States on the Trading of Inter-listed Securities in Canada</i> .	Completed	March 2, 2012 (Published as IIROC Notice 12-0077)	

Specific Initiative	Summary Description	Status of Initiative	Implementation Dates	
			Approved Initiatives	Proposed/On-going Initiatives
Transparency				
Marketplace Dissemination of Daily Summaries of Short Sale Activity	Encourage marketplaces to co-operatively prepare and disseminate daily summaries of short sale activity.	Meetings with marketplaces		While certain marketplaces have explored this option, there are no firm plans to provide this information
IIROC Dissemination of Semi-Monthly Short Sale Trading Summaries	IIROC to prepare and publish on a semi-monthly basis (that corresponds to the timetable for the Consolidated Short Position Reports) information on short selling activity in each security consolidated from trading on each marketplace.	Planning Stage		Following introduction of the "Short-Marking Exempt" designation
Continuation of Semi-Monthly Short Position Report	Withdrawal of the proposal to repeal the requirement for each Participant to prepare a short position report.	Withdrawn	February 25, 2011	
Additional Transparency of Short Sale and Failed Trade Information	In conjunction with the Canadian Securities Administrators, solicit public input of possible additional transparency of short sales and failed trades.	Issuance of Request for Comments on March 2, 2012 (IIROC Notice 12-0076)		Publication of comments received and specific proposals
Monitoring of Regulatory Arbitrage Opportunities				
Short Sale Ineligible Security	Provide that IIROC, with the concurrence of applicable securities regulatory authorities, may designate a security as being ineligible to be sold short for a period of time.	Approved (October 15, 2008)	October 15, 2008	
Monitoring of Short Selling of Inter-listed Securities Subject to Price Restriction in the United States	The Securities and Exchange Commission has adopted a rule effective February 28, 2011 which provides that if a the price of a security declines 10% from the previous closing on the listing market that any short sales for the balance of that trading day and the next trading day must be entered at a price at least one trading increment above the national best bid at the time of entry. IIROC Surveillance will monitor the triggering of short sale circuit breakers for inter-listed securities and impact on short selling activities on Canadian marketplaces.	On-going	Since February 28, 2011	

Specific Initiative	Summary Description	Status of Initiative	Implementation Dates	
			Approved Initiatives	Proposed/On-going Initiatives
Disclosure of Criteria for Regulatory Intervention				
Guidance on Implementation of Single Stock Circuit Breakers	IIROC has issued guidance respecting the use of IIROC's power to impose a regulatory halt in the event of a significant (of at least 10%) and unexplained price movement over a 5-minute period in a security included in the S&P/TSX Composite Index or an exchange-traded fund comprised principally of listed securities.	Completed (Guidance issued as IIROC Notice 12-0040)	February 2, 2012	
Proposed Guidance on Regulatory Intervention for Trade Variation or Cancellation	IIROC has issued proposed guidance respecting the use of IIROC's power to vary or cancel "unreasonable" trades or certain other trades which were not in compliance with UMIR.	Republication of Request for Comments		Following review of public comments
Enhanced Monitoring				
Report of an "Extended Failed Trade"	Requirement to provide an on-line report to IIROC if a "failed trade" persists for a period of 10 days or more.	Approved (October 15, 2008)	June 1, 2011 (for trades other than those utilizing the Trade-for-Trade facility of CDS)	
Report of a Trade Variation or Cancellation	Requirement to provide a report to IIROC if a trade is varied or cancelled (with respect to price, volume or settlement date) after execution outside of procedures of the marketplace on which the trade was executed or the clearing agency.	Approved (October 15, 2008)	June 1, 2011	
Clarify Requirements to be Considered "Owner" of Securities	Clarify that a person will only be considered to own securities as a result of a conversion, exchange or exercise if full payment has been made and all forms, notices and, if applicable, certificates have been submitted.	Approved (October 15, 2008)	October 15, 2008	
Introduce Short Sale/Price Movement Trade Alert	Introduce a new alert in the surveillance system that looks specifically at changes in the pattern of short selling in connection with price declines.	Completed	Fully operational First Quarter of 2011	
Daily Failed Trade Database	Co-operate with the OSC and CDS in the development of a database of daily trade failures.	Planning Stage		Following review of public comments
Introduce "Short-Marking Exempt" Designation	Provide that certain accounts (arbitrage, market makers and automated institutional accounts that do not take a "directional" position on particular securities) are exempt from marking sales as "short sales".	Approved		September 1, 2012
Pre-Borrow Requirements in Certain Circumstances				
Client or Non-Client Having an "Extended Failed Trade"	Require a client or "non-client" to have pre-borrowed securities that are the subject of a short sale if the client or non-client has previously executed an "extended failed	Approved		September 1, 2012

SROs, Marketplaces and Clearing Agencies

Specific Initiative	Summary Description	Status of Initiative	Implementation Dates	
			Approved Initiatives	Proposed/On-going Initiatives
	trade" in any security (and the Participant is not satisfied that the extended failed trade was not solely the result of an administrative error).			
Participant Having an "Extended Failed Trade"	Require a Participant to have pre-borrowed securities that are the subject of a short sale if the Participant has previously executed an "extended failed trade" in the particular security (if IIROC has not consented to the entry of the order).	Approved		September 1, 2012
Designation of a "Pre-Borrow Security"	Provide that a person will have to have made arrangements to pre-borrow any security that is the subject of a short sale if IIROC has designated the particular security as a "Pre-Borrow Security" based on rates of short selling and trade failure in that security.	Approved		September 1, 2012