

# IIROC NOTICE

## **Rules Notice Request for Comments**

UMIR

*Please distribute internally to:*

Institutional  
Legal and Compliance  
Senior Management  
Trading Desk

**Comments Due By: September 14, 2015**

*Contact:*

Kevin McCoy

Acting Vice-President, Market Regulation Policy

Telephone: 416.943.4659

fax: 416.646.7265

e-mail: [kmccoy@iiroc.ca](mailto:kmccoy@iiroc.ca)

**15-0156**

**July 16, 2015**

## **Proposed Amendment to the Short-marking Exempt Order Definition**

### **Executive Summary**

IIROC proposes to amend UMIR (the “Proposed Amendment”) to broaden the definition of a short-marking exempt order<sup>1</sup> (“SME order”) to include an order for an Exempt Exchange-traded Fund<sup>1</sup> (ETF) or one of its underlying securities for the principal account of a Participant that:

- has Marketplace Trading Obligations<sup>1</sup> for the ETF security; or
- has entered into an agreement with the ETF issuer to maintain a continuous distribution of the ETF,

and the account for this purpose at the end of each trading day has no more than a “minimal exposed risk”.

The expansion of the SME order definition is intended to:

- simplify and promote uniform SME marking standards for ETF market makers engaging in similar activities;

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<sup>1</sup> See UMIR for definition.



- assist in preserving the integrity of short selling data used and published by IIROC; and
- avoid unnecessary administrative burden to the ETF market making function.

The text of the Proposed Amendment is set out in Appendix “A” and a black-line of the change is set out in Appendix “B”. If approved, the Proposed Amendment would be effective no earlier than 60 days after publication of the Notice of Approval.

### **How to Submit Comments**

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

Kevin McCoy,  
Acting Vice-President, Market Regulation Policy,  
Investment Industry Regulatory Organization of Canada,  
Suite 2000  
121 King Street West,  
Toronto, Ontario M5H 3T9  
Fax: 416.646.7265  
e-mail: [kmccoy@iiroc.ca](mailto:kmccoy@iiroc.ca)

A copy should also be provided to IIROC’s Recognizing Regulators<sup>2</sup> by forwarding a copy to:

Susan Greenglass  
Director, Market Regulation  
Ontario Securities Commission  
Suite 1903, Box 55,  
20 Queen Street West  
Toronto, Ontario. M5H 3S8

Fax: (416) 595-8940  
e-mail: [marketregulation@osc.gov.on.ca](mailto:marketregulation@osc.gov.on.ca)

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

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<sup>2</sup> IIROC’s Recognizing Regulators are each of the Canadian provincial securities regulatory authorities.



## Rules Notice - Table of Contents

|     |  |    |
|-----|--|----|
| 1.  | Discussion of the Proposed Amendment .....                               | 3  |
| 1.1 | Summary of Proposed Amendment.....                                       | 3  |
| 1.2 | SME Marking Practices of Participants Engaged in ETF Market Making ..... | 4  |
| 1.3 | Rationale for the Proposed Amendment .....                               | 4  |
| 1.4 | Scope of Proposed Amendment.....   | 5  |
| 2.  | Analysis .....   | 5  |
| 2.1 | Current SME Order Definition.....  | 5  |
| 2.2 | Basis for Directionally Neutral Condition on SME Marking .....           | 6  |
| 2.3 | ETF Market Making.....   | 7  |
| 3.  | Impacts of the Proposed Amendment .....                                  | 8  |
| 3.1 | Participant Impacts .....  | 8  |
| 3.2 | Marketplace Impacts .....  | 8  |
| 3.3 | Impact on IIROC’s Short Sale Statistics .....                            | 8  |
| 4.  | Implementation Plan .....  | 9  |
| 5.  | Policy Development Process.....  | 9  |
| 5.1 | Regulatory Purpose .....   | 9  |
| 5.2 | Regulatory Process.....  | 9  |
|     | Appendix A – Proposed Amendment.....                                     | 10 |
|     | Appendix B – Text of UMIR to Reflect Proposed Amendment .....            | 11 |

## 1. Discussion of the Proposed Amendment

### 1.1 Summary of Proposed Amendment

The Proposed Amendment is designed to permit the expansion of SME marking to orders in the underlying securities of the ETF for the account of a person with Marketplace Trading Obligations. In addition, for consistency, the Proposed Amendment would permit the same ETF market making activity under a Participant’s agreement with an ETF issuer for continuous distribution of an ETF to be marked SME, although this activity is not pursuant to Marketplace Trading Obligations. The ETF market maker’s account for this purpose at the end of each trading day would be required to have no more than a “minimal exposed risk”<sup>3</sup>.

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<sup>3</sup> An account with a “minimal exposed risk” is “fully-hedged” by holding, for example, over a period of time, a position in a security to attempt to fully offset risk assumed on a prior purchase or sale or to be assumed on a subsequent purchase or sale of that security or a related security. See also the definition of “hedge” in UMIR.



## **1.2 SME Marking Practices of Participants Engaged in ETF Market Making**

Since the SME order designation was implemented, certain Participants with Marketplace Trading Obligations and certain Participants which act as ETF “market makers” by having entered into a Continuous Distribution Dealer Agreement (“agreement”) with an ETF issuer have generally not been applying the SME designation for transactions in ETFs and their underlying securities in a manner that conforms to IIROC’s guidance<sup>4</sup>. Participants have either been “over-marking” or “under-marking” orders related to ETF market making transactions depending on their interpretation of the SME order definition. ETF market makers have generally not separately marked non-SME orders for underlying securities of an ETF from orders for the ETF security for which they have Marketplace Trading Obligations which qualify for SME marking. Also, orders related to ETF market making under an agreement for continuous distribution of the ETF with the ETF issuer have not generally been entered in a separate non-SME account. In some cases, Participants incorrectly considered that the accounts in which ETF market making activity took place qualified as “arbitrage accounts” for which the SME marker should be used.

The current SME order definition is too narrow to capture practices generally referred to as ETF “market making” that commonly involve transactions in a single principal account with minimal exposed risk. Hedged positions in an account with minimal exposed risk are not permitted to be designated SME since the account is not “directionally neutral”<sup>5</sup> at end of day. Except for orders for an ETF security for which a person has Marketplace Trading Obligations, related ETF market making activity does not qualify for SME order marking under the current SME order definition.

## **1.3 Rationale for the Proposed Amendment**

IIROC consulted with certain Participants engaged in ETF market making to discuss IIROC’s interpretation of the SME order definition. These Participants expressed concern that restricting SME order marking to an account of a person with Marketplace Trading Obligations in respect of an ETF security and not permitting SME marking for the same ETF market making activity undertaken under an agreement with the ETF issuer for continuous distribution of an ETF leads to an arbitrary application of the SME marker. The Participants further indicated that both orders for an ETF and its underlying securities should be marked

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<sup>4</sup> See IIROC Notice [12-0300](#) – *Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations* (October 11, 2012).

<sup>5</sup> Whether an account is “directionally neutral” is determined by the position held in each particular security at the end of a trading day.



SME at the account level as all the activity in the account relates to ETF market making. Certain Participants noted that it would also be costly to operationalize the application of the SME designation to orders for the ETF security only and to mark those orders for the underlying securities short in the account.

IIROC acknowledges the costs and operational impracticalities that result when orders related to the same ETF market making activity are required to be marked differently and we recognize that the ETF market maker has the ability to create or redeem the ETF units in order to become flat at the end of the day.

IIROC is therefore proposing an amendment to appropriately broaden the definition of a SME order in order to simplify and promote uniform SME marking standards for ETF market makers, to assist in preserving the integrity of short selling data used and published by IIROC, and to avoid unnecessary administrative burden for the ETF market making function, without conferring any regulatory advantage.

#### **1.4 Scope of Proposed Amendment**

IIROC does not intend to extend SME order marking generally to all hedging or other strategies that hold positions and are not flat. Participants are expected to continue to engage in other traditional “directional” trading ideally using a separate account in which short sales are properly designated. IIROC is also clarifying, in proposed revised guidance<sup>6</sup>, that an account used for hedging activity, whether involving an ETF security and the underlying securities, or any other convertible or exchangeable security, is not an arbitrage account. An arbitrage account requires the account holder to make a usual practice of buying and selling securities which are or may become convertible or exchangeable by the terms of the securities or operation of law into other securities in order to take advantage of differences in prices between the securities. The result of the arbitrage activity requires that the account not have more than a nominal position at the end of the day or is effectively flat.

## **2. Analysis**

### **2.1 Current SME Order Definition**

Effective October 15, 2012, the SME order designation was implemented for use with a SME order as defined in UMIR, for the purchase or sale of a security by certain accounts that adopt

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<sup>6</sup> See IIROC Notice 15-0155 – Proposed Updated Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations (July 16).



a “directionally neutral” strategy in the trading of securities<sup>7</sup>. UMIR defines a “short-marking exempt order” as an order for the purchase or sale of a security from an account that is:

- (a) an arbitrage account<sup>8</sup>;
- (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.

## **2.2 Basis for Directionally Neutral Condition on SME Marking**

The definition of a SME order was associated with “directionally neutral” activity in order to segregate true short positions. The SME order definition did not allow for a hedging strategy with minimally exposed risk as significant short selling in a security may remain “open” for an extended period of time due to the acquisition of a convertible or exchangeable security or other related security. Thus an account which is “fully-hedged” which holds a long position in an ETF security that is hedged with a short position in the underlying securities was not considered to be “directionally neutral” at the end of a trading day as short sales of the underlying security on that trading day are not covered by purchases of the underlying security.

IIROC expected that Participants would be able to readily identify SME accounts and trading activity given that they were, in part, to match those accounts identified for the purposes of exemptions existing under UMIR available to arbitrage accounts and accounts with Marketplace Trading Obligations for particular securities<sup>9</sup>.

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<sup>7</sup> See IIROC Notice 12-0078 – *Provisions Respecting Regulation of Short Sales and Failed Trades* (March 2, 2012) at p.1.

<sup>8</sup> “Arbitrage account” is defined in UMIR as an account in which the holder makes a usual practice of buying and selling:  
(a) securities in different markets to take advantage of differences in prices available in each market; or  
(b) securities which are or may become convertible or exchangeable by the terms of the securities or operation of law into other securities in order to take advantage of differences in prices between the securities.

<sup>9</sup> UMIR does not provide exceptions for informal “market makers”.



Under the SME order definition, an order for an ETF security is a SME order only if for the account of a person with Marketplace Trading Obligations for that ETF security. Related ETF transactions are not eligible for SME order marking since the SME order definition does not include:

- an account used for hedging activity which does not adopt a “directionally neutral” strategy where each security in the account is flat at end of day;
- orders, whether long or short, for the underlying securities of an ETF for which the person does not have Marketplace Trading Obligations; or
- orders related to a Participant’s market making activity under an agreement with an ETF issuer for continuous distribution of an ETF security for which the Participant has no Marketplace Trading Obligations.

### **2.3 ETF Market Making**

ETFs trade on a marketplace but are comprised of a fixed basket of underlying securities. Market makers facilitate the trading of ETFs, in part, by participating in the ETF issuer’s process of creating and redeeming ETF units. In response to demand, the market maker will buy the underlying securities to create baskets to deliver to the ETF issuer and in exchange receive ETF units to sell in the market, or conversely will sell into the market the underlying securities received in exchange for ETF units delivered to the ETF issuer when an investor redeems the ETF units. Market makers may hold positions since ETF units are generally created and redeemed only in a prescribed number of units established by the ETF issuer.

In addition, since an ETF’s market price may trade at a premium or at a discount to its underlying value, the ETF market maker will undertake hedge transactions to minimize exposed risk and help keep the ETF price in line with its Net Asset Value (NAV) per unit. If the ETF is trading at a premium, the market maker short sells the ETF security while buying the fund’s underlying component securities. If the ETF is trading at a discount, the market maker will buy the ETF units while at the same time short selling the fund’s underlying component securities.



### **3. Impacts of the Proposed Amendment**

#### **3.1 Participant Impacts**

Participants that engage in ETF market making will be able to apply the SME marker to all orders for an ETF security and its underlying securities in a principal account that maintains a minimal exposed risk, whether the Participant has Marketplace Trading Obligations for the ETF security or has entered into an agreement with the ETF issuer for continuous distribution of the ETF security. Participants will be required to identify the accounts in which ETF market making activity occurs, for the purpose of SME order designation, and apply the SME marker consistently to all orders in the identified accounts.

It is IIROC's understanding that implementation of the Proposed Amendment will not impose a burden as most Participants engaged in ETF market making requested that IIROC make the Proposed Amendment, in part to facilitate order marking at the account level which is consistent with the operations that exist for ETF market makers. Participants indicated that the current narrower SME order definition would be too onerous to comply with if strictly enforced, given the costs and operational issues associated with it.

#### **3.2 Marketplace Impacts**

IIROC does not believe that the Proposed Amendment will impact marketplaces as they already support the SME order marker.

#### **3.3 Impact on IIROC's Short Sale Statistics**

IIROC publishes a bi-monthly Short Sale Trading Summary Report ("Report") which shows the aggregate proportion of short selling in the total trading activity of a particular security, based on data for trades marked "short sale". We would expect a change in the short sale statistics published in the Report if the Proposed Amendment is approved and implemented. IIROC would intend to provide an explanation of the changes to the use of SME order marking for reviewers of the Report and the impact on short sale statistics following implementation of the Proposed Amendment.





#### **4. Implementation Plan**

If approved, the Proposed Amendment would become effective no earlier than 60 days after publication of the Notice of Approval.

#### **5. Policy Development Process**

##### ***5.1 Regulatory Purpose***

The Proposed Amendment would simplify and promote uniform SME marking standards for ETF market makers to assist in preserving the integrity of short selling data used and published by IIROC. It would also provide consistent treatment of similar market making activity regardless of whether ETF market making is pursuant to Marketplace Trading Obligations or under an agreement with an ETF issuer for continuous distribution of the ETF.

The Proposed Amendment does not impose significant costs or restrictions on the activities of market participants, but rather avoids adding unnecessary administrative burden to the ETF market making function.

##### ***5.2 Regulatory Process***

The Board of Directors of IIROC (“Board”) has determined the Proposed Amendment is in the public interest and on June 25, 2015 approved it for public comment. The Market Rules Advisory Committee of IIROC considered this matter as proposed in concept by IIROC.

After considering the comments on the Proposed Amendment received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend that revisions be made to the Proposed Amendment. If the revisions are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the Proposed Amendment as revised will be subject to approval by the Recognizing Regulators. If the revisions are material, the Proposed Amendment as revised will be submitted to the Board for approval for republication.



## **Appendix A – Proposed Amendment**

1. The definition of “short-marking exempt order” in UMIR 1.1 is hereby amended as follows:
    - (a) adding the word “an” before the words “account that is:” in the first sentence of the definition;
    - (b) deleting the word “or” at the end of paragraph (c);
    - (c) deleting “.” at the end of paragraph (d) and replacing it with “; or”; and
    - (d) adding the following paragraph after paragraph (d) of the definition:
      - (e) a principal account for a Participant that has:
        - (i) Marketplace Trading Obligations in respect of an Exempt Exchange-traded Fund, or
        - (ii) entered into an agreement for the continuous distribution of an Exempt Exchange-traded Fund;
- if the order is for the Exempt Exchange-traded Fund security or one of its underlying securities to hedge a pre-existing position in the Exempt Exchange-traded Fund security or one of its underlying securities and in the ordinary course, the account does not have, at the end of each trading day, more than a minimal exposed risk.



## Appendix B - Text of UMIR to Reflect Proposed Amendment to the Short-marking Exempt Order Definition

| Text of UMIR Provisions Marked to Reflect Adoption of the Proposed Amendment   | Text of UMIR Following Adoption of the Proposed Amendment   |
|--|---|
| <p><b>UMIR 1.1</b><br/> <b>“short-marking exempt order”</b> means an order for the purchase or sale of a security from an account that is:</p> <ul style="list-style-type: none"> <li>(a) an arbitrage account;</li> <li>(b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;</li> <li>(c) a client, non-client or principal account:               <ul style="list-style-type: none"> <li>(i) for which order generation and entry is fully-automated, and</li> <li>(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;<del>or</del></li> </ul> </li> <li>(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<del>;</del> <b>or</b></li> <li>(e) a principal account for a Participant that has:               <ul style="list-style-type: none"> <li>(i) Marketplace Trading Obligations in respect of an Exempt Exchange-traded Fund, or</li> <li>(ii) entered into an agreement for continuous distribution of an Exempt Exchange-traded Fund;</li> </ul> <p style="margin-left: 20px;">if the order is for the Exempt Exchange-traded Fund security or one of its underlying securities to hedge a pre-existing position in the Exempt Exchange-traded Fund security or one of its underlying securities and in the ordinary course, the account does not have, at the end of each trading day, more than a minimal exposed risk.</p> </li> </ul> | <p><b>UMIR 1.1</b><br/> <b>“short-marking exempt order”</b> means an order for the purchase or sale of a security from an account that is:</p> <ul style="list-style-type: none"> <li>(a) an arbitrage account;</li> <li>(b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;</li> <li>(c) a client, non-client or principal account:               <ul style="list-style-type: none"> <li>(i) for which order generation and entry is fully-automated, and</li> <li>(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;</li> </ul> </li> <li>(d) a principal account that has acquired during a trading day a position in a particular security in a transaction with a client that is unwound during the balance of the trading day such that, in the ordinary course, the account does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security; or</li> <li>(e) a principal account for a Participant that has:               <ul style="list-style-type: none"> <li>(i) Marketplace Trading Obligations in respect of an Exempt Exchange-traded Fund, or</li> <li>(ii) entered into an agreement for continuous distribution of an Exempt Exchange-traded Fund;</li> </ul> <p style="margin-left: 20px;">if the order is for the Exempt Exchange-traded Fund security or one of its underlying securities to hedge a pre-existing position in the Exempt Exchange-traded Fund security or one of its underlying securities and in the ordinary course, the account does not have, at the end of each trading day, more than a minimal exposed risk.</p> </li> </ul> |