Appendix A

Background on short sales and failed trades

a) Introduction

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

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

The terms "short sale" and "failed trade" are not defined in securities legislation, but are defined in UMIR.[1] Short selling is colloquially divided into "naked" and "covered". There is no legal definition of "naked short selling" in Canada. The concept appears to have different meanings in different jurisdictions. In some jurisdictions, it refers to short selling without borrowing in time to make delivery on T+3. In others, a "naked" short sale is viewed as a sale where the seller does not own, and has not borrowed or made arrangements to borrow, securities at the time of the sale. A "covered" short sale is generally considered to be a sale of a security that has been "borrowed" by the seller at the time of the sale. Others have taken a wider interpretation and would include as a "covered" short sale any sale of a security where the seller has arranged or taken steps to borrow the security at the time of the short sale, but will only take delivery of the borrowed security after the sale has been executed.

Short selling is a legitimate trading practice which contributes to market liquidity, efficiency and price discovery. For example, it allows market makers to provide liquidity even when they do not hold a particular security, which helps to stabilise prices. Short selling can contribute to more

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[1] UMIR Rule 1.1 defines "short sale" as a sale of a security, other than a derivative instrument, which the seller does not own either directly or indirectly or through an agent or trustee. The provision further describes circumstances when a seller is considered to own and not own a security.

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

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

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

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

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

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

efficient pricing of securities by moderating both price increases and declines. Short selling can also be an important part of an investor's hedging and risk management strategy.

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

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

b) Overview of Canadian short selling and settlement discipline regulation

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

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

(i) *Direct constraints*

Most rules in Canada governing short selling are contained in UMIR. Until the UMIR Amendments become effective, UMIR prohibits a Participant or Access Person from making a short sale of a security unless the price is at or above the last sale price for that security (the "UMIR Tick Test").[2] The UMIR Amendments will repeal the UMIR Tick Test effective September 1, 2012.

Since October 2008, UMIR contains a provision that authorizes IIROC, with the approval of the CSA, to designate a security as a "Short Sale Ineligible Security". Such a designation prevents a Participant or Access Person from entering a short sale order on a marketplace in the particular security.3 A key purpose of this provision is to provide IIROC with the flexibility to respond to evolving developments in the trading of a particular security or class of securities. The Working Group believes that the power to intervene in the markets on an emergency basis and ban short selling in particular securities is an important regulatory tool. Since the introduction of this provision, no circumstance has existed which has warranted the designation of a security as a Short Sale Ineligible Security.

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

[3] See UMIR Rule 3.2(1)(b).

(ii) Short sale reporting and transparency measures

UMIR requires that Participants and Access Persons identify those orders placed on a marketplace that, on execution, would constitute a short sale.[4] The UMIR Amendments will effect a change to the marking regime for short sales such that various accounts which, in the ordinary course, do not take a "directional" position when undertaking a short sale will be expected to mark the order as "short-marking exempt" rather than "short".

Also, Participants and Access Persons are required under UMIR to provide a report twice monthly of the aggregate short position of each individual account in respect of each listed and quoted security.[5] The TSX collects this information with respect to securities listed on the TSX and TSXV and produces the Consolidated Short Position Report ("CSPR") which is made available to IIROC.[6] The TSX also sells the CSPR as a data product and publishes a list of the 20 largest short positions and 20 largest changes in short positions on its website.[7]

(iii) Settlement discipline regime

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

- Clause (h) of Part 2 of UMIR Policy 2.2, which interprets the anti-manipulative and deceptive trading provisions of Rule 2.2 of UMIR, provides that entering an order on a marketplace for the sale of a security without, at the time of entering the order, having the *reasonable expectation* of settling any trade that would result from the execution of the order would constitute a manipulative and deceptive trading activity. A similar policy exists for trades off-marketplace in the Companion Policy 23-101CP. A person who enters an order to either purchase or sell a security without having the *ability and intention* to settle the trade would be considered to be violating express anti-manipulation/anti-fraud rules in NI 23-101.[8]
- Rules of self-regulatory organizations ("SROs") and exchanges generally require trades to be settled within a T+3 settlement cycle.[9]

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

[5] UMIR Rule 10.10.

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

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

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

[9] See, for example, IIROC Dealer Member Rule 800.27 and TSX rule 5-103(1). These settlement cycle rules are designed to allow some degree of settlement failure. That is, sometimes legitimate reasons may exist for failures to deliver on time; e.g.

- The exchanges and CDS have "buy-in" rules to enforce settlement, which allow a purchaser, at its discretion, to require the purchase of securities in the market for delivery to the purchaser, with the seller obliged to pay for the costs of the purchase and thereby forcing the settlement obligation of the seller.[10]
- NI 24-101 requires registered firms trading for or with an institutional investor to have policies and procedures designed to match a "DAP/RAP trade" as soon as practical after the trade is executed, but no later than noon on T+1. Furthermore, NI 24-101 contains a principles-based settlement rule that requires registered dealers to establish, maintain and enforce policies and procedures designed to facilitate settlement of trades by no later than the standard settlement date.[11]
- UMIR Rule 7.10, discussed above, which requires Participants to report extended fails to settle.[12]

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improperly endorsed certificates received from a client, back-office glitches or human error. In essence, the SRO rules allow market participants to fix such problems if they do so reasonably quickly.

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

11 This settlement rule applies to all trades, not just DAP/RAP trades.

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

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

For more details, see the IIROC Notice.