Appendix B

International developments

a) IOSCO

In the wake of the 2008 global financial crisis, IOSCO established a task force to work to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions. Certain CSA staff on the Working Group participated on the IOSCO task force. The IOSCO task force also examined how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions that are critical to capital formation and to reducing market volatility. The task force published the report *Regulation of Short Selling* ("IOSCO Report") in June 2009, which contains four high-level principles for the effective regulation of short selling.[1] The four IOSCO principles are designed to assist regulators in their consideration of a regulatory regime for short selling. We briefly discuss the four principles below.[2]

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

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

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

The Working Group does not believe that a compulsory buy-in requirement is needed in Canada. As noted in this Joint Notice, there has not been a significant problem with failed trades and trade failures are primarily associated with administrative problems with long sales. We note that there are buy-in procedures available for buyers whose trades have failed, and that IIROC requires reporting of extended failed trades and can prohibit short sales in a particular

---

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

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

security if warranted. The UMIR Amendments will give IIROC the power to require pre-borrowing for certain accounts or securities if warranted.

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

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

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

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

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

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

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

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

UMIR currently contains exemptions from the UMIR Tick Test for market maker and arbitrage activities and for certain types of securities, such as ETFs and securities inter-listed on U.S. stock exchanges. With the removal of the UMIR Tick Test on implementation of the UMIR Amendments, these exemptions will no longer be needed. The UMIR Amendments also contain

an exemption from the short sale marking requirement for sell orders from non-directional accounts. Such accounts will be required to mark both purchase and sell orders as "short-marking exempt". See Appendix C for more details.

b) United States

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

After having repealed all short sale price restrictions (tick/uptick tests) in July 2007, the SEC in April 2009 introduced Rule 201 of Regulation SHO, which sets out a short sale "circuit breaker" triggered price restriction ("Rule 201"). Rule 201, which became effective on February 28, 2011,[3] prohibits short sales of National Market System ("NMS") securities at a price that is less than or equal to the current national best bid if the price of the security decreases intra-day by 10% or more from the prior day's closing price. This short sale price restriction remains in effect for the remainder of the day and the next trading day.

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

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

(iii) *SEC naked short selling antifraud rule*

The SEC also adopted Rule 10b-21 under the 1934 Act, a "naked" short selling antifraud rule. Under that rule, a civil fraud violation occurs if a short seller misleads a broker-dealer about its intention or ability to deliver securities by settlement date and fails to deliver securities by settlement date. [4]

---

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

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

(iv) *Transparency developments*

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

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

The above short sale information is in addition to the current twice-monthly SRO short position reporting requirement imposed on dealers,[5] which is similar to IIROC's short position reporting requirement in Canada. The SEC also introduced the twice-monthly publication of fail-to-deliver data on its website for all equity securities processed through National Securities Clearing Corporation ("NSCC")[6] in the U.S., regardless of the fails level.

(v) Dodd-Frank Act

The Dodd-Frank Act, which became law on July 21, 2010, requires the SEC to prescribe new rules governing the public disclosure of short sales, at least monthly, by institutional investment managers that are subject to section 13(f) of the 1934 Act (i.e., generally those with $100 million and over in assets under management). It also mandates the SEC's Division of Risk, Strategy, and Financial Innovation to conduct a study within a year of the feasibility, benefits, and costs of requiring reporting publicly, in real time, of short sale positions in publicly listed securities, or, in the alternative, reporting such short positions in real time only to the SEC and FINRA.[7] Moreover, within two years of the date of enactment, the SEC is required to conclude a study on the state of short selling after recent rule changes and the incidence of failures to deliver shares sold short on the fourth day following a short sale transaction (T+4). The SEC is also required to submit a report to Congress regarding the study, including recommendations for market improvements.

The Dodd-Frank Act amends the 1934 Act to prohibit any "manipulative short sale of any security", and authorizes the SEC to issue rules to enforce this provision. It also requires brokers to notify customers that they may elect not to allow their securities to be used in connection with short sales, and brokers must disclose that they may receive compensation for lending their customers' securities. The SEC is authorized to specify by rule the form, content,

---

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

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

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

time and manner of delivery of such customer notifications. Moreover, the Dodd-Frank Act amends the 1934 Act to grant the SEC explicit authority to issue rules regarding securities lending. It also requires the SEC, within two years after enactment, to promulgate rules designed to increase the transparency of information available regarding securities lending.

c) European Union

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

Building on CESR's proposals, the European Commission published a Consultation Paper in June 2010, where it sought views of market participants, regulators and other stakeholders about possible measures related to short selling and credit default swap issues that could be included in a legislative proposal. On September 15, 2010, the European Commission adopted a proposal for regulation of short sales and certain aspects of credit default swaps (the "September 15, 2010 Proposal"). On May 17, 2011, the Council of the EU agreed with the general approach of the proposal. On November 15, 2011, the European Parliament adopted the *Regulation of the European Parliament and Council on Short Selling and Certain Aspects of Credit Default Swaps* (the "*Regulation on Short Selling and Credit Default Swaps*").[8] If the Council of the EU approves the regulation unaltered, it will come into force on November 1, 2012.

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

1. Introducing a requirement that investors disclose significant net short positions in shares to regulators at 0.2% of the issued share capital, and to the public at 0.5%;

---

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

2. Introducing a requirement that investors notify regulators of significant net short positions in EU sovereign bonds, including notification of significant credit default swap positions relating to sovereign debt issuers;[9]

3. Giving ESMA the power to intervene in response to threats to financial markets, where the EU national regulator has either failed to act or to do so adequately, and adopt temporary measures with the effect of prohibiting or restricting short selling;

4. Giving the EU national regulators the power to require further transparency or restrict short selling and certain derivative transactions for a wide range of instruments in the case of adverse developments that constitute a serious threat to financial stability or market confidence in the European Union or a Member State;

5. Giving the EU national regulators the power to restrict short selling or limit transactions in a financial instrument[10] if the price of that financial instrument falls by a significant amount (10% from the previous day's close in the case of liquid shares). The restriction will last up to the end of the trading day following the day the price of the financial instrument fell, unless the price falls further;

6. Introducing a pre-borrow or "locate" type requirement where an investor, before entering a short sale for shares or for sovereign debt, would be required:
    - to have borrowed the instruments concerned,
    - to have entered into an agreement to borrow the instruments in order to deliver them by the settlement date, or
    - to have an arrangement with a third party to locate the instruments concerned and to have a "reasonable expectation" of being able to borrow them to affect settlement when it is due ;

7. Requiring central counterparties in the EU to ensure that there are adequate arrangements in place for the buy-in of shares if there is a failure to settle a transaction, and requiring that daily fines be imposed for non-settlements.

8. Introducing a ban on holding an uncovered credit default swap position in EU sovereign debt; and

9. Providing an exemption from the regulation for market making and primary market operations, and for shares whose principal trading venue is outside the EU.

The preamble to the regulation[11] suggests that the European Commission consider requiring investment firms to provide information about short sales in transaction reports to EU national regulators.[12]

---

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

10 These powers extend to a wide range of instruments.

11 See *Regulation on Short Selling and Credit Default Swaps*, Preamble (13). See note 29.

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

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

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

More recently, on August 11, 2011, some authorities in the EU imposed or extended existing short-selling bans or restrictions in their respective countries due to recent volatility in the European financial markets.[14] ESMA stated, "While short-selling can be a valid trading strategy, when used in combination with spreading false market rumours this is clearly abusive." On the same day, the regulatory authorities in several jurisdictions (France, Italy, Spain and Belgium) announced new bans on short-selling or on the holding of short positions. By banning, restricting and requiring the disclosure of short sales, such countries' regulators are seeking to maintain confidence in their own markets and complement the measures taken by other EU regulators.

d) Hong Kong

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

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

---

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

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

The rule comes into force on June 18, 2012.

e) Other jurisdictions

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