

## CSA/IIROC Notice 23-315

*Summary of Comments on CSA/IIROC Notice 23-312 Request for  
Comments – Transparency of Short Selling and Failed Trades*

February 28, 2013

## Introduction

The Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC) published for comment a joint notice (Joint Notice) on transparency of short selling and failed trades on March 2, 2012.<sup>1</sup> This notice summarizes the comments received on the Joint Notice and provides the CSA's and IIROC's response to those comments and an update on recent international developments.

## Substance & Purpose

The purpose of the Joint Notice was to:

- explain the approach taken by a working group (the “Working Group”) of CSA and IIROC staff to issues regarding the regulation of short sales and failed trades;
- provide a background on CSA and IIROC regulation of short sales and failed trades in Canada;
- provide an overview of recent international developments regarding the regulation of short sales and failed trades; and
- solicit feedback on whether further measures are needed or desirable to:
  - (i) enhance the regulatory reporting and transparency of short sales, or
  - (ii) introduce some transparency of failed trades in Canadian markets.

The comment period closed on May 31, 2012. We received six<sup>2</sup> comment letters in response to the Joint Notice. We have considered the comments received and thank all of the commenters for their submissions. A list of those who submitted comments and summary of the comments are attached as **Appendix A** to this notice.

There was no clear consensus among the commenters that specific improvements were needed; the majority of respondents believe that the current requirements in the Universal Market

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<sup>1</sup> See Request for Comment - CSA-IIROC Joint Notice 23-312 *Transparency of Short Selling and Failed Trades*, March 2, 2012 (2012) 35 OSCB 2099.

<sup>2</sup> An additional comment letter was received that commented only on IIROC Notice 12-0079 – Rules Notice – Request for Comments – UMIR - *Proposed Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations* (March 2, 2012) and is not summarized in this notice. That comment letter is summarized in IIROC Notice 12-0301 - Rules Notice – Request for Comments – UMIR – *Summary of Comments Received Respecting Proposed Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations* (October 11, 2012).

Integrity Rules (UMIR), including amendments that became effective on October 15, 2012<sup>3</sup> (UMIR Amendments), are adequate. The UMIR Amendments included IIROC's new short-marking exempt order rule, which requires purchase and sale orders for accounts that in the ordinary course do not take a directional position with respect to the trading of a security to be identified as such.<sup>4</sup> Orders that are marked as "short-marking exempt" no longer are marked as "short".

### **Response to the Comments**

After reviewing the comments, data on short sales and failed trades and recent international developments in the regulation of short sales and failed trades, the Working Group does not believe that additional measures are needed or desirable at this time beyond those described above.

IIROC intends to update empirical studies it previously undertook to determine the effect, if any, of the UMIR Amendments on trends in trading activity, short sales and failed trades.<sup>5</sup> The updates by IIROC of the empirical studies will include data for the one year period following the implementation of the UMIR Amendments. The Working Group believes that it would be prudent to await the results of the empirical studies which will help to inform the discussion of whether additional measures may be either needed or desirable in the regulation of short sales and failed trades or to improve transparency.

The Working Group will also continue to monitor international developments<sup>6</sup> in the regulation of short sales and failed trades, as well as other short-selling and failed-trades related issues that may need to be addressed in future notices or regulatory proposals.

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<sup>3</sup> See IIROC Notice 12-0078 - Rules Notice – Notice of Approval – UMIR - *Provisions Respecting Regulation of Short Sales and Failed Trades* (March 2, 2012) and IIROC Notice 12-0158 - Rules Notice – Notice of Implementation – UMIR - *Changes to Implementation Date for Provisions Respecting Regulation of Short Sales and Failed Trades and for Provisions Respecting Dark Liquidity* (May 8, 2012).

<sup>4</sup> UMIR 6.2(1)(b)(ix). Generally speaking, client accounts which would use the "short-marking exempt" designation must have fully-automated order generation and entry and have at the end of each trading day only a nominal position, either long or short, in a particular security. For more information on the use of the short-marking exempt order designation, see IIROC Notice 12-0300 – Rule Notice – Guidance Note – UMIR - *Guidance on "Short Sale" and "Short-Marking Exempt" Order Designations* (October 11, 2012).

<sup>5</sup> See IIROC Notice 11-0078 – Rules Notice – Technical – UMIR – *Trends in Trading Activity, Shorts Sales and Failed Trades (for the period May 1, 2007 to April 30, 2010)* (February 25, 2011) and IIROC Notice 11-0077 – Rules Notice – Technical – UMIR – *Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange (for the period May 1, 2007 to April 30, 2010)* (February 25, 2011).

<sup>6</sup> The following is a summary of international developments in the regulation of short sales and failed trades since the issuance of the Joint Notice on March 2, 2012:

- European Union (EU) - Effective November 1, 2012, the *Regulation on Short Selling and Credit Default Swaps* seeks to ensure member states have clear powers to intervene in

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exceptional situations, create a harmonized framework for coordinated action by the European Securities and Markets Authority (ESMA), 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. In particular, the *Regulation on Short Selling and Credit Default Swaps*:

1. Introduces a requirement that investors disclose significant net short positions in shares to regulators at 0.2% of the issued share capital, and to the public at 0.5%;
2. Introduces 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;
3. Gives ESMA the power to intervene in response to threats to financial markets, if 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. Gives 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 EU or a Member State;
5. Gives the EU national regulators the power to restrict short selling or limit transactions in a financial instrument 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 with the restriction lasting up to the end of the trading day following the day the price of the financial instrument fell, unless the price falls further);
6. Introduces 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. Requires 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. Introduces a ban on holding an uncovered credit default swap position in EU sovereign debt; and
9. Provides an exemption from the regulation for market making and primary market operations, and for shares whose principal trading venue is outside the EU.

On September 17, 2012, ESMA published a consultation paper, setting out draft guidelines on market making and the application of exemption for market making activities and primary market operations under the *Regulation on Short Selling and Credit Default Swaps*.

- Hong Kong - On June 18, 2012, the Securities and Futures Commission of Hong Kong (the "SFC-HK") adopted a rule that, among other things,

## Recent Developments

Effective June 1, 2011, IIROC implemented a requirement to file an “Extended Failed Trade Report” if a trade that was executed on a marketplace and was to settle through the continuous net settlement (CNS) facilities of CDS Clearing and Depository Services Inc. (CDS) failed to settle on the settlement date and remained unresolved for ten trading days following the settlement date. Since its introduction, IIROC has received an average of 24 Extended Failed Trade Reports per month (during a period when the number of trades per month ranged from a low of almost 24 million to a high of 39 million). The number of Extended Failed Trade Reports which has been filed to date is in line with expectations and these reports have not indicated any unusual patterns or trends. Effective April 15, 2013, the requirement to file an Extended Failed Trade Report will be extended to trades using the “Trade-for-Trade” settlement facility of CDS (which generally represents less than 10% of trades in listed equity securities).<sup>7</sup> Based on test data which IIROC has received from CDS, IIROC expects to receive only a limited number of additional reports when the requirement is extended to “Trade-for-Trade” settlements.

CDS also provides regular information to the Ontario Securities Commission (OSC) on failed trades in CDS’ CNS system. This information has not shown any trends that would give rise to concerns about fails. We will continue to monitor this information.

As of January 2013, IIROC is publishing semi-monthly a summary of short sales on Canadian marketplaces for every listed security.<sup>8</sup> This short sale summary is in addition to the “Consolidated Short Position Report,” which will continue to be produced on the same semi-monthly basis.

Also commencing in 2013, new international standards governing financial market infrastructures (FMIs) will require FMIs such as CDS to disclose to the public certain basic data

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1. introduces 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 applies to both covered and uncovered short positions;
  2. applies to positions taken through the Hong Kong Stock Exchange or an authorized automated trading system specified by the SFC-HK;
  3. applies 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. allows the SFC-HK to require daily reporting of short positions when needed, if the financial stability of Hong Kong is threatened.

<sup>7</sup> For details on the extension of the reporting requirement, see IIROC Notice 13-0014 - Rules Notice – Technical – UMIR - *Implementation Date for the “Trade-for-Trade” Reporting of Extended Failed Trades* (January 14, 2013).

<sup>8</sup> The report is available on the IIROC website at: <http://www.iroc.ca/news/Pages/Short-Sale.aspx> . For details on the report, see IIROC Notice 13-0020 - Rules Notice – Technical – UMIR – *Issuance of Initial Short Sale Trading Summary Report* (January 21, 2013).

on transaction volumes and values, including information on the timeliness of settlements.<sup>9</sup>

## Questions

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

Bonnie Kuhn  
Manager, Legal  
Alberta Securities Commission  
403-355-3890  
bonnie.kuhn@asc.ca

Michael Brady  
Senior Legal Counsel  
British Columbia Securities Commission  
604-899-6561  
mbrady@bcsc.bc.ca

Paula White  
Manager Compliance and Oversight  
Manitoba Securities Commission  
204- 945-5195  
paula.white@gov.mb.ca

Chris Pottie  
Manager, Compliance,  
Policy and Market Regulation Branch  
Nova Scotia Securities Commission  
902-424-5393  
pottiec@gov.ns.ca

Maxime Paré  
Senior Legal Counsel, Market Regulation  
Ontario Securities Commission  
416-593-3650  
mpare@osc.gov.on.ca

Serge Boisvert  
Analyste en réglementation  
Direction principale de l'encadrement des  
structures de marché  
Autorité des marchés financiers  
1-877-525-0337 ext. 4358  
serge.boisvert@lautorite.qc.ca

James Twiss  
Chief Market Policy Adviser,  
Investment Industry Regulatory Organization  
of Canada  
416-646-7277  
jtwiss@iiroc.ca

Jason Alcorn  
Legal Counsel  
New Brunswick Securities Commission  
506-643-7857  
jason.alcorn@nbsc-cvmnb.ca

Timothy Baikie  
Senior Legal Counsel, Market Regulation  
Ontario Securities Commission  
416-593-8136  
tbaikie@osc.gov.on.ca

Dean Murrison  
Director, Securities Division  
Saskatchewan Financial Services Commission  
306-787-5879  
Dean.Murrison@gov.sk.ca

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<sup>9</sup> See Principle 23 on the disclosure of rules, key procedures and market data of the April 2012 report *Principles for Financial Market Infrastructures* published by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) (available online at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf>). The CPSS and IOSCO are currently developing a framework for setting out a common set of quantitative information that an FMI should disclose regularly.