CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

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

2 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[3] (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.[4] 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.[5] 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[6] 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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3 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).

4 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).

5 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).

6 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

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).[7] 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.[8] 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.

[7] 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).

[8] The report is available on the IIROC website at: http://www.iiroc.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.[9]

Questions

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[9] 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.

Appendix A
Summary of Comments

Comment letters were received from:

- TD Asset Management
- OpsRisk Limited
- Investment Industry Association of Canada (IIAC)
- Caisse de dépôt et placement du Québec
- CNSX Markets Inc.
- Canadian Foundation for Advancement of Investor Rights (FAIR Canada)

The comment letters are available on the OSC's and IIROC's websites (www.osc.gov.on.ca; www.iiroc.ca)

Question 1: Do you believe that more frequent aggregate short sale summaries should be made publicly available? If so, what should be the frequency of such short sale summaries (e.g. weekly, daily)? What would be the costs and benefits to issuers, investors and Participants from making this information public?

One commenter believed that existing order marking requirements were sufficient to detect abusive activity. Further, if a reporting requirement is implemented, it should only be to the regulator, as a short sale summary report could be misleading without access to trade data on all domestic and foreign markets on which a security trades. Publishing the report could also result in gaming. Another commenter believed that more current data may inform better investment decisions.

There was no consensus on the ideal frequency of short sale summaries, with one commenter suggesting weekly, another semi-monthly and a third suggesting that monthly reporting would not be sufficient.

As noted above, IIROC now publishes a semi-monthly summary of short sales on Canadian marketplaces in addition to the consolidated short position report.

Question 2: In addition to semi-monthly (or more frequent) aggregate short sale summaries, should there be public disclosure of individual short sale transaction data on an anonymous basis? If so, should the publication of this information be time deferred (e.g. one day, one month, etc.)? What would be the costs and benefits to market participants from making this information public?

Letters that specifically responded to this question did not support disclosure of individual short sale data. One noted that short sales are often part of a complex strategy and details of individual sales would not be useful. Another agreed that anonymous information would not provide

sufficient information to discern patterns or a trading strategy, and so would not be more useful than aggregate data.

One commenter noted that the short sale marker is intended to identify potentially abusive behaviour, not to provide information, and that the information could be misleading as many short positions are offset.

Another commenter stated that if this requirement is adopted, it should be on an anonymous basis unless there is a size threshold for public disclosure. The commenter added that it should not be necessary to defer publication provided an investor has an opportunity to request an exemption from immediate reporting.

Question 3: Should data on the usage of the "short-marking exempt" designation in relation to trading activity of a particular security be made publicly available? If so, what should be the frequency of the release of such data?

Two commenters believed the information would be of limited or no use. Another believed it would be useful, but not as useful as information on directional short sales, and might not need to be reported as frequently as directional short sales.

Question 4: Is the existing public disclosure of short positions adequate? If not, should the information be available for unlisted securities such as debt securities and foreign-listed securities traded on alternative trading systems? Should there be one report covering all securities traded on marketplaces? Should custodians and dealers that are not Participants report their short positions?

Two commenters believed that in theory short reports should cover all securities and entities. However, they noted that it may be unduly costly to expand the requirement, there may not be demand for information about foreign-listed and debt securities, and requiring custodians and non-Participants to report may not result in data that is materially different from what is contained in existing reports.

One commenter believed the current data is inaccurate and misleading, and regulators should rely instead on IIROC's ability to monitor short selling activity.
One commenter believed the 100 largest short positions in TSX-listed securities and the 100 largest changes in short position in those securities should be published. In addition, public disclosure of individual short positions should be required when a threshold (e.g. 5%) is crossed.

Question 5: Is the information in the Consolidated Short Position Report (CSPR) timely? Should this information be made available on a more frequent basis?

One commenter believed that CSPR information is timely and sufficient and the cost of more frequent reporting needs to be considered. Another believed the CSPR is inaccurate and should be discontinued.

Question 6: Currently, are measures for failed trades transparency warranted? If you agree:

- ***What types of information on failed trades would be most useful to participants (some options are described above) and what should be the frequency of such disclosure?***
- ***In addition to equity and other securities processed through the CNS facilities at CDS, do other types of securities or products (e.g. fixed income securities) have FTD rates suggesting that similar failed trade transparency measures should apply to those securities? Please be specific in your answer.***
- ***What would be the costs and benefits, if any, to market participants in implementing such measures?***

If you believe that measures for failed trades transparency are currently not required, why do you think this information would not be helpful to issuers, investors or Participants?

Two commenters noted that previous IIROC studies showed that fails are not a problem in Canada and that IIROC and the OSC receive fails-to-deliver data from CDS. One of those commenters added that it will be difficult for Participants to assess and analyse the data. The other commenter suggested that, instead, regulators consider a larger, full review of aged fails, both long and short and including debt securities, with a focus on recurring names and Participants.

One commenter believed more extensive failed trade reporting was needed. Data on fails and short interest are necessary for ongoing monitoring and analysis of operational risk, and better data is available in the United States. The commenter stated that the magnitude, volatility and pattern of short selling and fails are operational risks.

One commenter believed that failed trade reporting might better inform trading decisions, but that the current UMIR failed trade reporting provisions were sufficient to identify problems.

General Comments

One commenter generally supported the proposed measures.

One commenter noted with respect to several of the options that any additional costs must be weighed against the benefits.

One commenter generally believed that measures to increase transparency of short selling and failed trades would only be useful to indicate potential problems in borrowing a security.