INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Dear Sir/Madam:

Re: Provisions Respecting Regulation of Short Sales and Failed Trades

The Investment Industry Association of Canada ("IIAC" or the "Association") appreciates the opportunity to comment on the above noted regulation (the "Proposed Rules"). We applaud IIROC for undertaking research to determine the existence and nature of the issue prior to implementing regulatory solutions. We are concerned, however, that the rationale for certain of the Proposed Rules are based on US problems and solutions, which have developed in a significantly different framework and as such are unnecessary and inappropriate for the Canadian market.

Implementation of regulation without clear justification results in significant increases in time, resources and costs being borne by the industry, making it less efficient and diverting scarce resources from areas that warrant closer attention. We recommend that IIROC re-examine the provisions of Proposed Rules identified below to ensure that they are addressing a demonstrated Canadian problem that would justify the increased regulatory burden.

Comments on the Proposed Amendments

Price Restrictions or Short Sales

We support IIROC's decision to repeal the tick test based on empirical evidence that it has no appreciable impact on pricing. We are concerned, however, that despite this evidence, additional regulatory measures have been proposed that appear to counterbalance the removal of the price restrictions. These new measures, including pre-borrowing, should be examined separately and the removal of the tick test should not be tied to new regulatory provisions. In particular, replacing the tick test with pre-borrowing will impose significant new burdens on the marketplace, and have a number of serious negative unintended consequences without any evidence that they will address any existing regulatory problem.

Pre-Borrow Requirement

The pre-borrow requirements appear to be an example of regulation without clear justification. The studies do not demonstrate that there is a current problem in this regard that would necessitate such measures. If the intent of the Proposed Rules are to avoid market manipulation, the requirements do not add anything to the existing prohibition against abusive and manipulative practices currently contained in the regulation.

We are concerned that the pre-borrow requirements, which have their genesis in US regulation, are inappropriate and potentially harmful in the Canadian context. It is important to understand the significant differences in the nature of practice in the Canadian markets which make the need for pre-borrowing unnecessary and in some cases, counterproductive.

We understand that prior to the implementation of Regulation SHO, in the US, the regulations operated in a manner that resulted in chains of failed trades being created and the settlement system becoming "bogged" down. It should also be noted that the US system does not have a mechanism to allow the purchaser to force delivery of the purchased position so failed positions cannot be resolved other than by DTC freezing clearing for the security. Finally US margin rules operate to permit a 50% margin which does not ensure a properly secured trade. SHO Regulations were created to solve some of these issues which are unique to the US system. These are problems that cannot occur under the Canadian regulatory system.

In Canada each short is reflected as an outstanding settlement position for the firm, resulting in the buyer having a claim against the firm, which can only be met by making delivery to CDS and settling the trade. The purchaser may also force settlement and obtain the purchased securities in the form of a "Cash Market". In respect of margining, there is no margin value assigned for securities that have a value under $1.50, which means that the security must be fully paid for, so that there must be equity in the account to cover its purchase. It also means that they must be segregated and cannot be loaned out if held in a cash account.

Sellers in Canada are required to mark to market daily and post full security or margin to collateralize the trade and secure the purchaser. Further, IIROC's segregation rules that strictly require that any under segregated positions be closed within given time

periods, could be interpreted to apply to “borrow” situations and make further regulation unnecessary.

It also is extremely important to note that although there are borrowing facilities in the Canadian market, it is not practically possible to borrow most venture stocks. Given that there is no effective visible loan post for such securities there would likely be "extended fails" which would require pre-borrowing - which could not occur. As a result, a requirement to pre-borrow would simply result in a prohibition of shorting in the venture markets. If this is the regulatory intent, then a simple prohibition would be less burdensome. It should be noted, however, that the current practice of “naked” short selling has long been utilized in the junior markets, in particular by western based firms, and is viewed by those dealers as an effective tool that prevents junior stocks from being bid up to unreasonable levels.

It should be noted that IIROC Notice 08-0143 notes that fails, even in the junior market, were extremely low. In the study, failed trades accounted for 0.27% of the total number of trades executed; and while the more “junior” the marketplace in terms of the type of security traded, the higher the incidence of failed trades; the number was still very low (between 0.90% and 2.22%), with less than 6% of total fails resulting from the sale of a security involved short sales.

Given that the Canadian regulatory framework ensures that failed trades are settled, it is unclear why such a measure would be necessary. Imposing a pre-borrow requirement is likely to have an extremely negative effect on the market integrity in this important market sector. Short selling is a critical tool that keeps junior stocks from experiencing the price manipulation and abuse that is present in the OTC market in the US, where there is virtually no short selling.

If the concept of pre-borrowing is retained, we recommend that it be based on a threshold, where the number of shorts against a stock becomes an impairment to the settlement process. Imposing a circuit breaker that would bar shorts on securities with a high fail rate would be consistent with US practice and would more appropriately target the regulation to deal with specific harm in the marketplace.

However, given that a current problem has not been demonstrated, it is important to take the time to do proper research to understand if and where actual potential problems exist. If statistical evidence shows that there is are regulatory issues, regulators should then establish the appropriate thresholds at levels where problems emerge. Untargeted regulation is likely to impose unnecessary burdens and have potential negative effects on a significant sector of the market.

Extended Failed Trades

In respect of the Extended Failed Trade (EFT) concept that triggers the pre-borrow requirements, we have a number of questions and comments.

A client based application of EFT will be virtually impossible to track at the dealer level, given that it applies to all securities, and not just the one that was subject to the EFT. Such a requirement will require significant technological investments to develop and support systems that will have very limited effectiveness. Given that the perceived harms of short sales are systemic in nature (eg: potential for “death spirals” where stock

prices are unreasonably driven down and settlement issues), targeting individual clients will be unlikely to address the issue. In addition, the system could easily be averted by client moving to another firm. We also note that it is not clear how long a client is to remain on a list.

In determining whether an EFT should trigger a pre-borrow requirement, it must be established that the EFT is not an administrative based fail rather than one that causes regulatory concern. We also question why this administrative exception does not apply to proprietary trades. The process of determining whether the EFT is an administrative fail (which should be defined to ensure clarity) or otherwise, involves judgment, and is a grey area where manual processes are necessary. As such, the process cannot be automated. Tracking and classifying EFTs will therefore become a significant burden.

There are significant system issues that will have to be resolved in order to determine how to operationalize a means to extract the relevant information to identify and track EFTs from the back office, particularly with respect to discounted and online trading. The proposed requirements are problematic in that they operate at both a securities class level, and at three separate account class levels (client, non-client and dealer). As a result of establishing this multi-level regulation, technology will be required to support policies and procedures which filter for EFTs, pre-borrow securities and short sale ineligible securities. Additionally a dealer may be forced to review every EFT to determine if they arose due to an administrative error. This will create a significant compliance burden on firms, which is not necessary in the current environment.

Change in the Use of "Short Exempt" Designation

We support the proposed change to the short exempt designation if the tick test is repealed. Given that the stated objective is to facilitate monitoring of short sales that have a directional strategy, we recommend that accounts that utilize the short- exempt marker should be expanded to proprietary dealer accounts that are directionally neutral strategies, such as those in which "facilitation trades" are conducted.

IIROC Questions

1. Are there any policy reasons, other than those identified in this Request for Comments, that IIROC should consider in pursuing the proposed repeal of the existing "tick test" (short sales must be made at a price not less than the last sale price)? If you disagree with the proposal to repeal the tick test, please indicate why it should be retained.

   IIAC supports the repeal of the tick test. Please see our reasons above.

2. If restrictions on the price of a short sale are to be retained, should UMIR adopt a "bid test" at the time of order entry (e.g. a short order may only be entered on a marketplace at a price above the best bid price)?

   We do not support the retention of the tick test and have no comment on this question.

3. If restrictions on the price of a short sale are to be retained, whether in the short-term or on a long-term basis, should there be an exemption provided to securities inter-listed on an exchange in the United States?

If the tick test is retained, the exemption for securities interlisted on an exchange in the US should be retained to prevent regulatory arbitrage.

4. If restrictions on the price of a short sale are repealed, what regulatory arbitrage opportunities may exist in the case of an inter-listed security, where a circuit breaker has been triggered in the United States giving rise to short sale price restrictions? What measures could be taken, if any, to limit this potential regulatory arbitrage?

In this circumstance, regulatory arbitrage may operate to the benefit of Canadian markets. If the Canadian regulators have determined that there is not a regulatory risk in repealing the tick test, there is no reason why the arbitrage opportunity should not be permitted to exist, to the benefit of Canadian markets.

5. The Proposed Amendments would "reuse" the existing "short exempt" designation to indicate accounts that qualify for the "short-marking exempt" designation. Are there any specific operational considerations for marketplaces or Participants from this change in use? Would there be any benefits to introducing a separate, new designation if marketplaces, service providers and Participants still have to modify their system to remove functionality and provision for the existing "short exempt" designation?

Our members note that the short exempt market cannot really be "reused". For most marketplaces in Canada "Short Exempt" is a transaction type (Buy, Sell, Short, Short Exempt). This is specified using one field in FIX protocol – tag 54. Using FIX in the standard manner, an order cannot be both a Buy and Short Exempt. A separate tag will be required to make this work. CNQ/Pure already do this by designating a short exempt order with two tags: 54=1 to represent "Short", and 6755=Y to represent "Short Exempt". We would recommend IIROC mandate marketplaces to provide a new tag/marker that would be uniform across all venues that would be consistently be applied by all affected parties.

6. Are there any other operational considerations for marketplaces or Participants that would arise as a result of the adoption of the Proposed Amendments, beyond those identified in this Request for Comments?

As noted above, there are significant technological implications arising from the Proposed Amendments. The time and resources required to scope and develop systems to operationalize and monitor compliance with the requirements may be disproportionate to the regulatory benefits obtained, particularly given that IIROC's evidence does not demonstrate that a problem exists in this realm.

7. If the Proposed Amendments are approved, IIROC is proposing to delay the implementation for a period of one hundred and eighty (180) days in order to provide Participants, marketplaces and service providers the time to make

necessary changes to their systems, policies and procedures. Should the implementation period be longer, and, if so, why?

It is difficult to determine what time period will be sufficient at this point. However, given the time it will take establish the scope of the technological requirements, and undertake the investment and alterations, we believe that at least one year will be required..

8. The requirement to mark a sell order as a "short sale" is determined based on the aggregate holdings of the "seller" (across multiple accounts which may in fact be held at multiple Participants or dealers) while the requirement of a Participant to file a short position report is based on the position of each individual account. If the tick test is repealed, should the basis for determining the marking orders and filing short position reports be harmonized? Would it be preferable for the marking of orders to be determined based on the holdings in the account entering the sell order at the time the order is entered?

   Marking should be at an aggregate level for clients, as if the short marker is not implemented on an aggregate basis, it will be misleading. For example, in the case of Prime Broker relationships where the client is long at Broker A, and executing a short at Broker B – the position will be net flat, but if it is not aggregated, it will not be reflected that way. However, for dealers' proprietary trades, they should have the option of choosing the methodology for short position reporting at the aggregate or account level.

The IIAC working group formed to comment on the Proposed Rules and the IIROC Proposed Guidance on Short Sale and Short Marking Exempt Order Designations would be pleased to meet with IIROC representatives to discuss these issues in more detail. The group is comprised of a cross section of dealers of various sizes, business concentrations and geographic locations and as such, can provide a fulsome view of the issues raised by the proposals

Thank you for considering out input. If you have any questions or comments, please do not hesitate to contact me.

Yours sincerely,

Susan Copland