

Short sales in Canada: current regulations and recent changes

SIMON ROMANO (sromano@stikeman.com), ALEX COLANGELO (acolangelo@stikeman.com) AND RAMANDEEP GREWAL (rgrewal@stikeman.com)



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The recent volatility in equity markets led to a variety of responses by regulators. A particularly popular response internationally was the introduction of limits to short sales of securities, a tool used in an attempt to ease the downward pressure on the value of certain companies. In the United States, for example, the Securities and Exchange Commission (SEC) prohibited short selling in the shares of financial companies in the fall of 2008, a move followed by the Ontario Securities Commission (OSC) restriction on short sales of securities of companies that were inter-listed on a US exchange and on the SEC's restricted list. While these particular restrictions soon lapsed, the general rules respecting short sales in Canada have been under consideration by regulators for some time. Further, the Investment Industry Regulatory Organization of Canada (IIROC) recently released two studies related to short sales, one of which considered the effects of the recently imposed restrictions. This update, meanwhile, seeks to review the current rules respecting short sales in Canada, recent amendments and the proposals for change.

Regulatory regime

In Canada, most of the rules respecting short sales are governed by the *Universal Market Integrity Rules* (UMIR or Rules), a common set of equity trading rules applicable across the country. Section 1.1 of UMIR defines a "short sale" as the sale of a security other than a derivative that "the seller does not own either directly or through an agent or trustee." The definition also lists a number of circumstances under which a seller will be (or will not be) considered to own a security. Under section 3.1 of UMIR, a Participant (dealer) may not make a short sale of a security unless the price is at or above the last sale price for that security, subject to certain exceptions (the tick-test or the "uptick rule"). This restriction is not subject to the liquidity of the security or the degree of difficulty of borrowing the security in order to settle the short sale. The policy rationale for the tick-test is the avoidance of undue downward pressure on the trading price of a particular security from sellers who do not own the security. Due to the repeal of the tick-test in the U.S., however, the prohibition was relaxed in Canada on July 6, 2007 with respect to shares inter-listed in the United States. Canadian regulators made the change to allow for consistent treatment of the securities of companies that list in both countries.¹ IIROC's *Dealer Member Rules*, meanwhile, prescribe the margin requirements applicable to securities, including rights and warrants, listed on any recognized stock exchange in Canada or the U.S. with respect to dealer members.

This newsletter was prepared by members of the Securities Group at Stikeman Elliott.

Contrasted with the U.S. requirements imposing a duty to locate shares in order to initiate a short sale, section 2.2 of UMIR provides that a Participant (dealer) must only have a “reasonable expectation” of settling the trade. The Rules also require that short sales be marked as being a short sale or as exempt and Participants must have adequate policies and procedures in place to ensure the proper marking of orders. Under section 10.10 of UMIR, Participants and Access Persons (ATS subscribers) must also prepare and file a short position report twice-monthly.

The disclosure of short positions by clients to dealers is also generally required under securities laws. In Ontario, for example, section 48 of the *Securities Act* requires that “[a]ny person or company who places an order for the sale of a security through an agent acting for him, her or it that is a registered dealer and who,

- a) at the time of placing the order, does not own the security; or
- b) if acting as agent, knows the principal does not own the security,

shall, at the time of placing the order to sell, declare to the agent that he, she or it or the principal, as the case may be, does not own the security.”

No distinction is made in the regulation between “naked” or “covered” short sales. However, the practice of “naked” short selling, while not specifically enumerated or proscribed as such, may violate other provisions of securities legislation or self-regulatory organization rules where the transaction fails to settle. Specifically, section 126.1 of the *Securities Act* prohibits activities that result or contribute “to a misleading appearance of trading activity in, or an artificial price for, a security or derivative of a security” or that perpetrate a fraud on any person or company. Part 3 of National Instrument 23-101 *Trading Rules* contains similar prohibitions against manipulation and fraud, although a person or company that complies with similar requirements established by a recognized exchange, quotation and trade reporting system or regulation services provider is exempt from their application. Under section 127(1) of the *Securities Act*, the OSC also has a “public interest jurisdiction” to make a wide range of orders that, in its opinion, are in the public interest in light of the purposes of the Securities Act (notwithstanding that the subject activity is not specifically proscribed by legislation). The TSX Rule Book also imposes certain obligations on its “participating organizations” in connection with trades that fail to settle (see, for example, Rule 5-301 *Buy-Ins*).

The *Canada Business Corporations Act* also prohibits certain insiders from effecting short sales, subject to limited exceptions, as well as from dealing in puts or calls on securities of the applicable corporation.

2007 proposals

On September 7, 2007, Market Regulation Services (RS), the precursor to IIROC, released a Request for Comments regarding proposals to amend the UMIR Rules on short selling (the 2007 Proposals). In the release, RS noted that various studies suggested that the tick-test was of limited use in stemming market declines and that its possible negative impact on price discovery may outweigh any beneficial effect. As stated by the Notice, the review of the academic literature on short selling “concluded that price restrictions typically act to restrict price discovery by limiting arbitrage and creating overpricing of securities, thus affecting overall market efficiency and liquidity.”

As such, the proposed amendments called for:

- i. the repeal of the tick test, instead allowing the regulator to designate a particular security or class of securities as being ineligible for short selling;
- ii. repealing the twice-monthly requirement for short position reports once adequate information on short sales was generally available;
- iii. requiring notice to regulators if a trade was varied after the execution of a short sale;
- iv. providing a definition of “failed trade” and requiring that the reason for failure be reported if it was not resolved within ten days;
- v. providing that a regulator may cancel, under certain circumstances, a failed trade;
- vi. deleting provisions for the “short exempt” order marker (used for, among other things, the resale of U.S.-legended securities); and

- vii. clarifying the requirements surrounding whether a seller was considered the owner of securities at the time of sale.

Measures similar to U.S. locate and “close-out” requirements, however, were not proposed by RS “based on the results of empirical studies in Canada indicating that the rates of trade failure are significantly lower than in the U.S.” and the lack of connection between short sales and trade failures in Canada. RS invited comments on its proposed amendments until October 9, 2007.

Market challenges

Increased volatility, however, began plaguing the markets before any of the proposed amendments were adopted. While equity markets began their decline in 2007, the challenges facing American financial and investment institutions in the summer and fall of 2008 caused a precipitous drop in markets and increased pressure on the value of securities. In the U.S., the SEC responded on September 17, 2008 by prohibiting “naked” short selling, requiring that securities at issue in a short sale be delivered by the end of business on the settlement date. The action was taken due to the SEC’s concern regarding “the possible unnecessary or artificial price movements based on unfounded rumors regarding the stability of financial institutions and other issuers exacerbated by ‘naked’ short selling.” The next day, meanwhile, the SEC prohibited the short selling of a number of financial firms (with certain exceptions) in an attempt to further protect those firms. On September 19, 2008, the OSC moved to restrict short selling in certain TSX-listed financial companies that were inter-listed in the U.S. or that had outstanding securities that were exchangeable into shares of a financial company listed in the SEC order. The stated purpose of the OSC’s order was “to prevent regulatory arbitrage with respect to short selling in Ontario of...and promote fair and orderly markets in Ontario” for the relevant securities. The OSC and SEC orders prohibiting short sales of the securities of financial companies expired on October 8, 2008. On October 15, 2008, the SEC released an interim final temporary rule with respect to the disclosure of short sales and short positions by institutional investment managers. The U.K. Financial Services Authority, meanwhile, also banned short sales with respect to certain financial securities, a temporary measure that lapsed in January 2009.

IIROC Notice of Approval - October 15, 2008

On October 15, 2008, IIROC published a Notice of Approval (the 2008 Amendments) respecting the adoption of certain provisions from the 2007 Proposals. The proposed removal of the tick-test, however, was deferred “in light of recent actions taken by the SEC on a temporary basis to restrict or prohibit short sales on securities of financial issuers or issuers generally and given the concern expressed in the media that the repeal of price restrictions on short sales in the United States may have contributed to any volatility experienced in U.S. markets”, as was the proposed requirement to file short position reports. The 2008 Amendments also did not proceed with the proposals that would have allowed a regulator to cancel failed trades. Interestingly, more recently in April 2009, the SEC also voted to seek public comments on proposals to impose further restrictions on short sales, including the re-introduction of uptick restrictions.

In summary, the 2008 Amendments:

- i. require that notice be provided to a regulator if a trade is varied or cancelled after the execution of a trade. The purpose of the provision is to ensure that such action “is not effected outside the normal processes of the marketplaces and CDS (the depository that is active in the settling process) unless IIROC is notified...and has the opportunity to review the change for possible market integrity concerns”;
- ii. allow a regulator to designate a particular security or class of securities as being ineligible for short selling, subject to a number of exemptions. IIROC states that such restrictions will likely be relatively rare, however, this tool is being created “to provide additional flexibility to the Market Regulator to respond to developments in trading of a particular security or class of securities if rates of failed trades become...excessive.” Criteria to be considered in determining whether to enact such a restriction on short sales are also set out in the 2008 Amendments;
- iii. provide a definition of “failed trade” and require a report of failed trades if the reason for failure is not resolved within ten trading days following the original settlement date. The report is intended to allow IIROC “to determine if the trade has failed to settle for an ‘improper’ reason”; and

- iv. clarify certain requirements that must be met for sellers to be considered the owner of securities.

The provisions related to providing notice of extended failed trades and reports of trade variations and cancellations were originally deferred until March 1, 2009, but IIROC has since advised that the implementation date will be further deferred to a future date to be announced. IIROC is also expected to publish a notice setting out the specific content and procedures for such reports. Further, IIROC intends to undertake a study with respect to the impact of the 2008 Amendments, the effects of the exemptions to interlisted issuers and the potential effects of a repeal of all price restrictions on short sales.² The impact study is to be completed by a third party and the results of the study are to be released for public comment.

Conclusion

Thus, while the 2008 Amendments adopted a number of the provisions of the 2007 Proposals, short sales are permitted but the tick-test remains in effect in Canada for non-inter-listed securities. As well, failed, cancelled and amended trades will be subject to greater regulation, and specific securities can be declared ineligible to be sold short. Further, as discussed above, the proposal to implement pre-borrow requirements is expected from IIROC shortly, while the study on the effects of price restrictions and the impact of the 2008 Amendments may lead to further proposals for change.

For further information, please contact your Stikeman Elliott representative or any member of our Corporate Finance and Securities Group listed at www.stikeman.com

¹ It should be noted, however, that the SEC has recently announced that it is considering proposals to impose restrictions on short sales, which include uptick restrictions. The SEC voted on April 8, 2009 to seek public comment on these "Short Sale Price Test and Circuit Breaker Restrictions".

² It should be noted that subsequent to the release of the 2008 Amendments, IIROC released two studies related to short sales. The first study, "Recent Trends in Trading Activity, Short Sales and Failed Trades", reviewed trading trends during the period of May 1, 2007 to September 30, 2008 with a particular focus on short selling and failed trades. The study found that despite the fact that the average number of daily trades increased "significantly" during the study period, "there was no significant change" with respect to short sales. The second study released was the "Study on the Impact of the Prohibition on the Short Sale of Inter-Listed Financial Sector Issuers". The purpose of this study was to review the impact of recent restrictions by the OSC in September and October of 2008 to curb short selling in the face of increased market volatility. Notably, the study found that the OSC orders "did not appear to have had any appreciable effect on the price" of either the securities of restricted or non-restricted financial issuers. The orders, however, had "a significant impact on market quality" for the trading of restricted financial securities, as the orders reduced the liquidity available in the restricted financials and increased the spread between the ask price and closing bid. The effect of the studies on future regulatory action is not yet clear, however, IIROC's release stated that the studies "provide data and analysis that are integral to our effective policy-making."