

CSA AND IIROC SEEK STAKEHOLDER FEEDBACK ON REGULATORY FRAMEWORK FOR SHORT SELLING

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On December 8, 2022, the Canadian Securities Administrators (the “**CSA**”) and the Investment Industry Regulatory Organization of Canada (“**IIROC**”) jointly published [Staff Notice 23-329: Short Selling in Canada](#) (the “**Short Selling Notice**”), which reviews the current regulatory requirements and initiatives with respect to short selling and seeks public feedback on areas for regulatory consideration. **The comment period relating to the Short Selling Notice ends on March 8, 2023.** For further information regarding the short selling regulatory regime and recommendations for changes thereto, see [An Analysis of the Short Selling Landscape in Canada: A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risk](#).

Accompanying the Short Selling Notice is [CSA Staff Notice 25-306: Activist Short Selling Update](#) (the “**Activist Update**”), which provides a summary of comments in response to the previously issued CSA Consultation Paper 25-403: *Activist Short Selling*. On the same date, IIROC also published a [report](#) on its failed trade study, which examines the settlement failure of trades executed on Canadian equity marketplaces (the “**Failed Trade Study**”).

Short Selling Notice

Background

The Short Selling Notice provides background information on short selling and its existing regulatory framework and flags concerns raised by stakeholders regarding Canadian regulations related to short selling and failed trades. “Short selling” is a practice defined by IIROC’s Universal Market Integrity Rules (“**UMIR**”) as involving the sale of a security other than a derivative instrument which the seller does not own, either directly or through an agent or trustee. Although the term “failed trade” is not defined in securities legislation, the Short Selling Notice refers to a failed trade as a failure to deliver securities on the settlement date, but also notes that it is generally understood in the market to also occur when a buyer fails to pay the funds when delivery/payment is due on the settlement date.

Current Regulatory Framework

Predominantly, IIROC manages compliance with the current short selling regulatory framework, which comprises both Canadian securities legislation and IIROC requirements. Manipulative and/or deceptive activities, which may occur with short sales, are prohibited. The framework includes a detailed reporting regime that provides IIROC with pertinent information, allowing it to monitor and supervise short selling activities and determine compliance with the regulations.

As part of the short selling regulatory framework, Canadian securities legislation requires a person who placed an order for the sale of a security through a registered dealer to declare to the dealer at the time of placing the order if such person does not own the security. The Short Selling Notice provides a summary of IIROC's requirements under UMIR applicable to dealers or marketplace users. Such requirements include:

- the obligation to mark short sales as either “short” or “short-marking exempt”;
- the obligation to report extended failed trades (“**EFT**”); and
- a requirement described in the Short Selling Notice as “a requirement that, if an [EFT] Report is filed with IIROC, further short sales generally cannot be made by that Participant, acting as principal or agent, without having made prior arrangements to borrow the securities necessary for settlement”.^[1]

UMIR also has a prohibition of manipulative and/or deceptive activities, which includes practices such as a dealer entering an order for the sale of a security without, at the time of placing the order, having a reasonable expectation of settling any trade that would result from the execution of the order on the settlement date. For additional information, please see the [McMillan bulletin on IIROC's response to naked short selling concerns](#).

Request for Comments

In addition to requesting general comments, the Short Selling Notice contains a list of questions for stakeholders to consider when making submissions. Topics include whether:

- the repeal of the “tick test” has had an impact on the market;
- the existing regulatory regime around pre-borrowing should be strengthened and if Canadian regulators should adopt pre-borrow requirements similar to those in the U.S.;
- the definition of a “failed trade” set out in the Short Selling Notice is appropriate;
- a timeline shorter than ten days following the expected settlement date should be considered with respect to failed trades;
- additional public transparency requirements of short selling activities or short positions should be considered;
- additional reporting requirements regarding short selling activities should be imposed by securities regulatory authorities;

- specific reporting, transparency or other requirements should be considered for junior issuers, given that the Failed Trade Study showed that the correlations between short sales and settlement issues in junior securities were more significant, and that securities of junior issuers experience more settlement issues compared to other securities; and
- mandatory close-out or buy-in requirements similar to those in the U.S. and the European Union would be beneficial for the Canadian capital markets.

Failed Trade Study

IIROC's Failed Trade Study was conducted as a follow-up to the 2007 study originally published by Market Regulation Services Inc. and in response to requests by stakeholders,^[2] and further analyzes settlement failure of trades executed on Canadian equity marketplaces. For the purposes of the study, "failed trade" includes both a failure to deliver securities and a failure to deliver payment on the settlement date.

The Failed Trade Study relies on settlement data from the CDS Clearing and Depository Services Inc. ("**CDS**") over a five-year period between April 1, 2015, and March 31, 2020 in addition to other internal IIROC data sources. More specifically, the datasets from CDS are related to outstanding continuous net settlement ("**CNS**"), buy-in activity and trade-for-trade settlement ("**TFT**") transactions.

The Failed Trade Study identifies, among others, the following conclusions:

- securities listed on junior exchanges generally had more settlement issues compared to securities listed on senior exchanges – including a higher percentage of failed trades, longer times before TFT failed trades were settled and stronger correlations between measures of short selling and measures of CNS settlement issues;
- there was a strong positive correlation between CNS failure and short positions for all listed securities, while the correlation between TFT failure and the amount of short selling was relatively low;
- the most common specific reasons given by dealers for settlement failure (both CNS and TFT) were related to short selling; and
- securities in certain sectors – such as metals & mining, energy, basic materials, healthcare and financial services – were identified as outliers, where there was more evidence of settlement issues relative to securities in other sectors.

Activist Update

The CSA's Activist Update provides a summary of comments in response to the CSA Consultation Paper 25-403: *Activist Short Selling*, which was initially published to facilitate a discussion relating to activist short selling and its impact on Canadian capital markets.

Several themes were observed amongst the comments received by the CSA. For instance, commentators raised concerns regarding the impact of social media – in particular, the speed at which information and disinformation can be conveyed via modern communication technologies. Activist short sellers are not subject to any specific regulation when they disseminate their views on social media, which was a cause for concern for many issuers, investors, and other stakeholders. In response to such feedback, the CSA has stated that additional regulatory measures would be considered if there is evidence of problematic conduct related to activist short selling. The CSA addressed other issues raised by commentators that focused on the general Canadian short selling regulatory regime in the Short Selling Notice.

McMillan LLP intends to use our considerable expertise in short selling to provide a response to the Short Selling Notice with input from our clients and other market participants. If you have any comments related to the current Canadian short selling regulatory framework and the issues surrounding failed trades, please contact any member of our Capital Markets group.

[1] We note that this description appears to confuse a Participant (as defined in the UMIR) and its client. The rule referred to in the Short Selling Notice has two separate parts: (i) if a Participant or Access Person (as defined in the UMIR) has reported an EFT in respect of a security, then the Participant or Access Person may not make any principal trades in that security, but the Participant may still make client trades (i.e. trades as agent) in that security without pre-borrowing such security and (ii) if a client has an EFT in respect of a security, no Participant may make a trade for that client without ensuring pre-borrowing.

[2] CSA Staff Notice 25-306: [Activist Short Selling Update](#), online: Ontario Securities Commission; see summary of comments made in response to questions 3, 4, and 9.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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