

IIROC ADDRESSES CERTAIN NAKED SHORT SELLING CONCERNS – IIROC NOTICE 22-0130

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Introduction

On August 17, 2022, the Investment Industry Regulatory Organization of Canada (“**IIROC**”) published Notice 22-0130: *Guidance on Participant Obligations to Have Reasonable Expectation to Settle any Trade Resulting from the Entry of a Short Sale Order* (the “**Guidance**”).^[1] The Guidance provides additional clarity with respect to the requirement under the Universal Market Integrity Rules (“**UMIR**”) that a registered investment dealer who is a member of IIROC (a “**Participant**”) have a reasonable expectation that sufficient securities will be available to cover the settlement of a short sale trade prior to entering a short sale order.

Summary of the Notice

Under section 2.2(2) of UMIR, a Participant shall not enter an order or execute a trade, including a short sale order, if the Participant knows or ought reasonably to know that the trade would create or could reasonably be expected to create:

- (a) a false or misleading appearance of trading activity in or interest in the purchase or sale of the security; or
- (b) an artificial ask price, bid price or sale price for the security or a related security.^[2]

One of the activities that constitutes a violation of section 2.2(2) of UMIR is entering into an order for the sale of a security, without, at the time of entering the order (which includes short sale orders), having the “reasonable expectation” of settling any trade that would result from the execution of the order.^[3]

The Guidance indicates that to meet this “reasonable expectation” standard, a Participant needs “reasonable certainty” that it can access sufficient securities to settle any resulting trade by the settlement date. The Guidance further clarifies that “[i]f the Participant knows or ought reasonably to know that sufficient securities will not be available and accessible to deliver on settlement date, the order is not permitted to be entered.”

Moreover, the Guidance provides that a Participant may not be able to demonstrate a reasonable expectation where (i) the person on behalf of whom the short sale order is entered has previously executed trades where

securities were not available to deliver on the settlement date; or (ii) the securities in question are difficult to borrow. Furthermore, a Participant cannot have a reasonable expectation where the Participant expects to receive the securities after the settlement date. Additionally, a Participant is not considered to own and have sufficient securities available where the securities are subject to statutory resale restrictions or the issuance date of the security is after the settlement date of the short sale order.

Impact of the Notice

As IIROC has not defined the meaning of “reasonable expectation” in UMIR, the Guidance provides some clarification. IIROC’s predecessor has previously stated that the “reasonable expectation” standard “*merely* requires that the vendor not make a sale *knowing* that the securities cannot be borrowed and that the vendor take ‘reasonable steps’ to attempt to borrow the securities to make delivery on closing” [emphasis added].^[4] The Guidance imposes a higher standard, requiring that the vendor have “reasonable certainty” that it can access sufficient securities to settle the trade, and that a vendor must not enter a short sale order if it “*knows or ought reasonably to know*” that sufficient securities will not be available for settlement. This should place more of an onus on a Participant to take steps to ensure that it can settle the short sale order prior to execution of the order, but it is unclear as to what such steps might entail.

The Guidance may bring Canadian short selling rules more in line with other jurisdictions, of which Canada has been and remains an outlier.^[5] For example, the U.S. requires that broker-dealers “identify a source of borrowable stock” before executing a short sale trade.^[6] It may be that in order for a Participant to have “reasonable certainty” that such Participant has access to sufficient securities to settle a short sale trade, the Participant necessarily has to identify a source of securities to cover the trade. However, without more guidance as to the meaning of “reasonable certainty”, it is difficult to assess what is required of a Participant, absent future examples of enforcement.

Observations

We would note that the benefits and importance of short selling in providing liquidity and facilitating price discovery are undeniable. Short selling is critical to the vibrancy and efficiency of Canada’s relatively small capital markets. However, short selling regulations in Canada are out of step with those in other jurisdictions, and in order to improve investor confidence and market efficiency while appropriately reducing systemic risk, we had recommended that certain key changes be made to the regulations in Canada governing short selling.^[7]

The Guidance is an important first step forward by IIROC in seeking to address concerns raised by us and others regarding naked short selling in Canada,^[8] and IIROC is to be commended for this initial step. Unfortunately, the Guidance seeks to address only one concern – that being whether naked short selling is

legal in Canada.

[1] *Guidance on Participant Obligations to Have Reasonable Expectation to Settle any Trade Resulting from the Entry of a Short Sale Order*, Notice 22-0130, online: *Investment Industry Regulatory Organization of Canada*.

[2] *Manipulative and Deceptive Activities*, Universal Market Integrity Rule 2.2 at 2, online (pdf): *Investment Industry Regulatory Organization of Canada*.

[3] Part 2 of Policy 2.2 of UMIR.

[4] *Request for Comments – Provisions Respecting Manipulative and Deceptive Activities*, RS Market Integrity Notice No. 2004-017 (13 August 2004) at 25-26, online (pdf): Market Regulations Services Inc.

[5] For a detailed comparison and analysis of short selling regulations in Canada and other jurisdictions, please see our paper: Paul Davis et al, “An Analysis of the Short Selling Landscape in Canada: A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risk” (October 2019) McMillan LLP [McMillan, “An Analysis of the Short Selling Landscape in Canada”].

[6] Office of Investor Education and Advocacy, “Key Points About Regulation SHO”, (8 April 2015), online: [US Securities and Exchange Commission](#).

[7] McMillan, “An Analysis of the Short Selling Landscape in Canada” *supra* note 5 at 155.

[8] *Ibid* at 114-122.

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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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