

IIROC NOTICE

Rules Notice
Guidance Note
UMIR

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Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations

Executive Summary

This Rules Notice provides guidance on the marking of orders pursuant to UMIR to include “short sale” and “short-marking exempt” order designations. Any order to sell a security which the seller does not own either directly or through an agent or trustee must be marked “short” at the time of entry to a marketplace. An exception to this requirement is when the order is from an account for which purchase and sell orders are designated as “short-marking exempt”. ***If an account qualifies for the use of the “short-marking exempt” order designation, an order will only carry the “short-marking exempt” designation and should not also carry the “short sale” designation, even though the sale order may be from a short position.***

This Guidance is effective October 15, 2012. IIROC expects that Participants and Access Persons will use best efforts to comply with the new marking requirements on that date. IIROC recognizes that Participants may have implementation issues as requirements apply to specific fact situations. IIROC will be monitoring order activity and will be available to address questions as they arise. IIROC expects that Participants will have identified and addressed any



particular implementation issues by December 17, 2012. The use of the “short-marking exempt” designation is a requirement under Rule 6.2 of UMIR and its use on qualified orders is not optional.

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1. General Order Marking Requirement

Correct order designations are essential to maintaining an accurate and complete audit trail. A complete audit trail allows IIROC to effectively monitor trading activity on Canadian marketplaces and provides the supervisory personnel of each Participant with information that is necessary to enable them to carry out their supervisory obligations as required by Rule 7.1 of UMIR. IIROC has issued guidance on the procedures to be followed to correct the “markers” on executed trades. In particular, see IIROC Notice 08-0050 – Rules Notice-Guidance Note – UMIR – *User Guide for the Regulatory Marker Correction Form* (July 30, 2008).

Rule 6.2 of UMIR requires each order entered on a marketplace contain certain designations acceptable to IIROC, including the obligation of a Participant or Access Person to correctly designate whether an order is either:

- a “short sale” order; **OR**
- a “short-marking exempt” order.

If an account qualifies for the use of the “short-marking exempt” order designation, as described below, the entry of orders by the account will only carry the “short-marking exempt” designation and should not also carry the “short sale” designation, even though the sale order may be from a short position.

1.1 “Short Sale” Order Designation

UMIR defines a short sale as a sale of a security, other than a derivative instrument, which the seller does not own either directly or through an agent or trustee. A seller is considered to own a security if the seller:

- has purchased or has entered into an unconditional contract to purchase the security, but has not yet received delivery of the security;
- has tendered such other security for conversion or exchange or has issued irrevocable instructions to convert or exchange such other security;
- has an option to purchase the security and has exercised the option;
- has a right or warrant to subscribe for the security and has exercised the right or warrant; or
- has sold a security that trades on a “when issued” basis and the seller has entered into a contract to purchase such security, which is binding on both parties and subject only to the condition of issuance or distribution of the security.



A seller is considered **not** to own a security if:

- the seller has borrowed the security to be delivered on the settlement of the trade and the seller does not otherwise own the security (e.g. none of the five circumstances listed above apply to the seller);
- the security held by the seller is subject to any restriction on sale imposed by applicable securities legislation or by an Exchange or QTRS as a condition of the listing or quoting of the security; or
- the settlement date or issuance date pursuant to:
 - an unconditional contract to purchase,
 - a tender of a security for conversion or exchange,
 - an exercise or an option, or
 - an exercise of a right or warrant

would, in the ordinary course, be after the date for settlement of the sale.

1.2 “Short-Marking Exempt” Order Designation

UMIR defines a “short-marking exempt order” as an order for the **purchase or sale** of a security from an account that is:

- an arbitrage account;¹
- the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;² or
- a client, non-client or principal account:

¹ Rule 1.1 of UMIR provides that an “arbitrage account” means an account in which the holder makes a usual practice of buying and selling:

- (a) securities in different markets to take advantage of differences in prices available in each market; or
- (b) securities which are or may become convertible or exchangeable by the terms of the securities or operation of law into other securities in order to take advantage of differences in prices between the securities.

² Rule 1.1 of UMIR provides that “Marketplace Trading Obligations” means obligations imposed by:

- (a) Marketplace Rules on a member or user or a person employed by a member or user to guarantee:
 - (i) a two-sided market for a particular security on a continuous or reasonably continuous basis, or
 - (ii) the execution of orders for the purchase or sale of a particular security which are less than a minimum number of units of the security as designated by the marketplace; or
- (b) contract between a marketplace and a member, user or subscriber to guarantee the execution of orders for the purchase or sale of a particular security which are less than a minimum number of units of the security as stipulated by the terms of the contract provided such number is less than one standard trading unit and the orders for the member, user or subscriber are automatically generated by the trading system of the marketplace.



- for which **order generation and entry is fully-automated**, and
- which, in the ordinary course, does not have, at the end of each trading day, more than a nominal position, whether short or long, in the **particular security**; or
- a principal account that has acquired during a trading day a position in a particular security in a transaction with a client that is unwound during the balance of the trading day such that, in the ordinary course, the account does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security.

Given the exemptions which currently exist under UMIR that are available to arbitrage accounts and accounts with Marketplace Trading Obligations for particular securities, IIROC would expect that Participants are able to readily identify such accounts and trading activity. IIROC expects that the category of client, non-client or principal accounts would include accounts operating algorithms and classified as “high-frequency traders”.³ There are two conditions for these client, non-client and principal accounts to qualify to use the “short-marking exempt” designation. The first condition is that order generation and entry is fully-automated. This means that the accounts must exclusively use “automated order systems”, as defined for the purposes of National Instrument 23-103 *Electronic Trading*, to generate orders. The second condition is that the trading activity conducted in the account be “directionally neutral” so that the account generally only has a nominal position, whether long or short, at the end of a trading day in any particular security.⁴

In order for Participants to be able to properly identify accounts which would be required to designate orders as “short-marking exempt”, IIROC would expect the Participant to adopt compliance policies and procedures to regularly review the status of each account, and to use its best judgment in making such determinations. For client and non-client accounts, the Participant may rely:

- solely on the trading information in the accounts within the control of the Participant;
- or

³ The term “high frequency trader” is not defined in UMIR. However, IIROC would expect that a “high frequency trader” would have direct electronic access to more than one marketplace to execute fully-automated trading strategies that seek to benefit from liquidity imbalances or other short-term pricing inefficiencies and the trading strategy is generally market-neutral or closed out by the end of each trading day.

⁴ Whether an account is “directionally neutral” is determined by the position held in each particular security at the end of a trading day. An account which is “fully-hedged” or with a “nominal net delta” by holding, for example, over a period of time a long position in a convertible security that is offset by a short position in the underlying security is not considered to be “directionally neutral” at the end of a trading day as short sales of the underlying security on that trading day have not been matched with purchases of the underlying security.



- on trading information in the accounts together with representations by the client or non-client as to the trading strategy or strategies for the particular account.

For example, if an account is engaged in cross-border arbitrage activity, the trading information in the particular account may not by itself indicate that the trading is directionally neutral. The Participant may rely on representations by the client unless the contrary is indicated by the actual trading information. If the Participant bases its determination in part on client representations, IIROC would expect that the Participant would monitor the trading patterns in the account to ensure that they are consistent with the client representations and that the Participant would confirm the client representations on a periodic basis.

As a general guideline, IIROC would accept that an account with automated order generation and entry would satisfy the requirements necessary to designate orders as “short-marking exempt” if the sole strategy of the account is to be “directionally neutral” on the price of securities traded. IIROC would accept this to be the case if on approximately 90% of the trading days in the previous month, the aggregate net position of the account in respect of any security at the end of the trading day, whether short or long, did not exceed 5% of the volume of that security traded by the account on that trading day. For principal accounts which are used exclusively for “facilitation” purposes, there is no requirement that order generation and entry be automated but IIROC would expect that the account be “directionally neutral” such that on 90% of the trading days in the previous month, the aggregate net position of the account in respect of any security at the end of the trading day, whether short or long, did not exceed 5% of the volume of that security traded by the account on that trading day.

IIROC recognizes that trading in securities of limited liquidity may result in temporary positions in a particular security even when the overall strategy for the account is to be “directionally neutral”. IIROC would expect Participants to exercise their best judgement when evaluating whether the overall trading strategy of the account is to be directionally neutral.

Participants may wish to encourage clients who conduct both “high frequency trading” and traditional “directional” investment, to do so in separate accounts. Generally speaking, if types of trading activity are co-mingled such that there is some activity which would qualify for the use of the short-marking exempt designation and other trading that would not, IIROC would expect that the short-marking exempt marker would not be used on any order and that short sales would be properly designated. (See Question 11 for a discussion of acceptable alternatives.)



If a Participant undertaking a client “facilitation” trade may carry a significant proportion of the position for more than one trading day, the trade should be conducted through an account which does not apply the “short-marking exempt” order designation.

2. Questions and Answers

The following is a list of questions regarding when an order must be designated as a “short sale” or “short-marking exempt” upon entry to a marketplace:

1. Must an order be marked as a “short sale” if it is a bundled order that is comprised of orders from accounts that are both “long” and “short” the security?

Yes. Orders are sometimes bundled when a Participant is “working” several orders for the same security for different clients and any executions are allocated proportionately among the clients. If at least one of the clients is a “short-seller”, each bundled order must contain the short sale designation.

While “bundling” is generally not encouraged, IIROC is of the view that, in this particular situation, it would be appropriate to designate the entire order as a short sale upon entry to a marketplace. However, the Participant would be required to submit to IIROC a Regulatory Marker Correction Form⁵ to “un-bundle” the long portion of any quantity executed which was allocated to any account which was long the security. The Regulatory Marker Correction Form should be filed as soon as practicable after the execution of the trade, and in any case, by the later of 5:00 p.m. and 15 minutes following the close of trading on the marketplace on which the trade was executed.

2. Can a “short-marking exempt” order be bundled with other orders including a “short sale” order?

Yes. However, given the role of the “short-marking exempt” designation in IIROC’s monitoring of trading activity, the “bundling” of a “short-marking exempt” order with other orders is generally discouraged (and, for practical reasons, may be limited to orders from accounts with Marketplace Trading Obligations or arbitrage accounts or for principal facilitation since other accounts qualified to use the short-marking exempt designation must have fully-automated order generation and entry). Having said that, if such bundling becomes necessary IIROC is of the view that:

⁵ For details on the use of the Regulatory Marker Correction Form, see IIROC Notice 08-0050 – Rules Notice- Guidance Note – UMIR – *User Guide for the Regulatory Marker Correction Form* (July 30, 2008).



- upon entry to a marketplace, the entire order should be designated as “short” if the bundle contains a short sale and “short-marking exempt” if the bundle does not; and
- the Participant would be required to submit to IIROC a Regulatory Marker Correction Form to “un-bundle” the non-“short-marking exempt” portion of any quantity executed, which was allocated to any account which was not eligible to use the “short-marking exempt” designation.

The Regulatory Marker Correction Form should be filed as soon as practicable after the execution of the trade, and in any case, by the later of 5:00 p.m. and 15 minutes following the close of trading on the marketplace on which the trade was executed. For details on the use of the Regulatory Marker Correction Form, see IIROC Notice 08-0050 – Rules Notice- Guidance Note – UMIR – *User Guide for the Regulatory Marker Correction Form* (July 30, 2008).

3. *If an account operates an inter-listed arbitrage strategy, should sell orders entered when the account is in a short position be designated as “short sales”?*

No. UMIR stipulates that the activity which occurs in an arbitrage account will be marked as “short-marking exempt”. Accordingly, all orders from an arbitrage account, either for the purchase or sale of a security, would be designated as “short-marking exempt” upon entry to a marketplace.

4. *If a Participant has agreed to buy a block of stock from a client and is “moving the market” down to the agreed print price, should an order entered for the purpose of displacing the market be designated as a “short sale”?*

No. These orders are not required to be designated as short sales. In this situation, the Participant is considered to be “long” as the Participant committed to purchase the position from the client prior to displacing the market

5. *Is a client who accesses a marketplace through a dealer-sponsored access arrangement subject to the order designation requirements?*

Yes. All orders entered on a marketplace must be properly designated. A Participant that provides clients with dealer-sponsored access to a marketplace must ensure that orders entered through such sponsored access arrangement are correctly designated. IIROC expects the Participant to review the designation of orders by clients with



sponsored access as part of the Participant's supervisory procedures required by Rule 7.1 of UMIR.

If the client is an "institutional customer", the Participant should determine if the trading pattern of the account of the institutional customer is such that orders for the purchase or sale of a particular security should carry the designation "short-marking exempt". The Participant should review periodically, and no less frequently than monthly, whether an account should be designating purchase and sale orders for particular securities as "short-marking exempt".

Similarly, if an institutional customer maintains an account with a Participant for which order entry is fully-automated (but does not have dealer-sponsored access to a marketplace), the Participant should review periodically, and no less frequently than monthly, whether the account should be designating purchase and sale order for particular securities as "short-marking exempt".

6. Should all orders entered by a person with Marketplace Trading Obligations be designated as "short-marking exempt"?

No. A person with Marketplace Trading Obligations should only designate purchase and sale orders for securities for which that person has responsibility as "short-marking exempt". Orders for other securities would not be designated as "short-marking exempt". An order for the short sale of a security for which the person does not have Marketplace Trading Obligations should be designated as a "short sale".

7. A person holds an option and intends to pay the exercise price of the option from the proceeds of the sale of the securities that will be issued on the exercise of the option. Must the sell order be designated as a "short sale"?

Yes. The definition of "short sale" in Rule 1.1 of UMIR states that a seller shall be considered to own a security if the seller "has an option to purchase the security and has exercised the option". Since the holder of the option has not done everything required to exercise the option (including the payment of the exercise price) at the time of the proposed sale, any sell order for the underlying securities must be designated as "short" upon entry to a marketplace.



8. Is there any difference in the order designation requirements if the order is entered on a marketplace prior to the marketplace opening for execution of trades?

No. A short sale order entered on a marketplace in the “pre-opening” is required to be designated as a “short sale”. Orders entered on a marketplace during the “pre-opening” by an account that meets the definition of “short-marking exempt order”, whether a buy order or a sell order, must be designated as “short-marking exempt”.

9. I own shares of an issuer which are subject to a regulatory hold period that has not yet expired. While I am not able to sell the particular shares that are subject to the hold period, is any order to sell this security required to be designated as a “short sale”?

Yes, assuming that the seller does not also hold a long position in the security which is not restricted. For the purposes of the UMIR definition of a “short sale”, a person will not be considered to own a security if the security is subject to a restriction on the sale imposed by applicable securities legislation or by a marketplace as a condition of listing or quoting the security. As such, a holder of a security which is subject to such a sale restriction who enters an order on a marketplace for the sale of a security before the expiration of the sale restriction must designate the sale order as a “short sale”. This obligation to mark the order as “short sale” applies even if the regulatory hold period will expire prior to the settlement of the trade.

10. I am long warrants and wish to hedge my exposure by selling the underlying securities. Is the order required to be designated as a “short sale”?

Yes. The order would be required to be designated as a “short sale” upon entry to a marketplace. For the purposes of the UMIR definition of “short sale”, a long position in a warrant does not constitute a deemed long position of the underlying security unless irrevocable instructions to exercise the warrants have been submitted **and** the shares received through the exercise of the warrants would, in the ordinary course, settle prior to or on the settlement date of any sale affected through a marketplace.

Similar marking requirements would apply to a person holding rights or convertible securities. Any sale of the underlying securities would have to be marked as a “short sale” unless the rights have been exercised or instructions to convert or exchange the convertible securities have been submitted and the person would, in the ordinary course, expect to receive the securities prior to or on the settlement date of the sale.



11. What should a Participant do if an account that is directionally neutral in its trading and qualifies for the use of the “short marking exempt” designation wants to take a position in one or more particular securities?

Participants may wish to encourage clients who conduct both algorithmic or “high frequency trading” and traditional “directional” investment, to do so in a separate account. Generally speaking, if types of trading activity are co-mingled such that there is some activity which would qualify for the use of the short-marking exempt designation and other trading that would not, IIROC would expect that the short-marking exempt marker would not be used on any order and that short sales would be properly designated.

IIROC would accept co-mingling of trading activity in an account which otherwise qualifies for the use of the “short-marking exempt” designation if the client or the Participant knows that a particular order or series of orders will not be directionally neutral and:

- the client or Participant overrides any default setting to apply the “short-marking exempt” designation and instead applies the “short” designation on orders that are intended to create a short position in the particular security; or
- the Participant uses the Regulatory Marker Correction System on the date of the trade to remove the “short-marking exempt” designation from any trades that created a long or short position in the particular security and to add the “short” designation on trades that created a short position in the particular security.

3. Impact on Existing Guidance

This Rules Notice repeals and replaces, effective as of October 15, 2012, the guidance set out in:

- ***Market Integrity Notice 2005-024 – Guidance – Short Sales Made in Furtherance of Market Maker Obligations (July 27, 2005);***
- ***Market Integrity Notice 2005-025 – Guidance – Bundling Orders from a Long and Short Position (July 27, 2005); and***
- ***Market Integrity Notice 2006-010 – Guidance – Short Sale Designations and Restrictions (April 7, 2006).***