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

Susan Copland, B.COMM, LLB.
Director

October 9, 2007

James E. Twiss
Chief Policy Counsel
Market Policy and General Counsel's Office
Market Regulation Services
Suite 900
145 King Street West
Toronto, ON M5H 1J8

Dear Mr. Twiss:

Re: Market Integrity Notice 2007-017 – Provisions Respecting Short Sales and Failed Trades

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the proposed amendments to the UMIR in respect of the above noted provisions.

Regulatory Issues

We are very supportive of the removal of the price restrictions on the short sale of securities and the elimination of the filing requirements for the Short Position Reports.

Our members have, however, expressed some concerns with the new focus on reporting failed trades. The fundamental problem with the proposal is its failure to recognize that there are a number of factors that may cause a fail, so that a uniform response is not appropriate. Given that many of these factors do not relate strictly to the actual trade, the UMIR are not the most appropriate place to address the issue.

For instance, in respect of failures to settle a retail transaction on the buy side, existing mechanisms such as the cash account rule and margin account rules are in place to ensure proper payment. Failures to settle an institutional transaction on the buy side may be the result of issues caused by the custodian or prime broker.

Failures to settle a retail transaction on the sell side may be the result of a short or long sale. Long sales may fail if a firm is under segregation. The under segregation issue must be resolved before the firm can settle any sells (long or short). Again, there are existing mechanisms to clear those transactions (such as buy-ins). Failures to settle an institutional transaction on the sell side may be the result of issues caused by the custodian or prime brokers or they may be the result of delayed legend removals.

All of the different scenarios do not lend themselves to the generic approach contained in the proposed amendments. Most of the issues relate to clearing and settlement which are activities that do not properly fall within the scope of the UMIR.

Rather than create a new structure within the UMIR to deal with such issues, we suggest that RS monitor its areas of concern as NI 24-101 Institutional Trade Matching and Settlement becomes fully operational. We expect that many of the trades of concern will be dealt with through the operation of this instrument.

If RS wishes to deal with a specific issue such as naked short selling, it should be explicitly disclosed as an objective with amendments focused on achieving that goal. The existing provisions in the UMIR may also be helpful in addressing areas of concern such as price manipulation.

It should be noted that RS cannot cancel a failed trade under the circumstances provided in the proposal. In the interests of fairness to both parties participating in the trade, and the marketplace participants who base decisions on reported trades, we suggest that rather than cancel the trade there should be a requirement that the position be closed out within 10 days (as is stipulated in the US rules).

Further, the proposed requirement to report failed trades within 10 days following the original settlement date will create an enormous burden for dealers in situations where securities are seized up due to circumstances such as a reorganization or due to cross border issues. The result will be that every trade (long and short) will be deemed to have failed and will require a report,

We also question the provision that enables RS to designate which security or class of securities is ineligible to be sold short based on subjective criteria at the discretion of the regulator. In the absence of specific criteria and guidelines, RS should allow market fundamentals and the operation of an efficient market to dictate what happens to a security in a no-tick restriction environment.

Although we are very supportive of the removal of the tick rule, we wish to ensure that the proposal to remove the tick-rule does not signal an imminent move to a US-style “pre borrow” system which eliminates the practice of naked short sales, which have not been shown to be a problem in Canada. We believe that such a move would eliminate the advantages of the elimination of the tick rule, particularly for smaller firms. The majority of the stock borrowing in Canada is controlled by the larger industry participants, and the stock lending market in Canada is much less mature than in the United States. The requirement to pre-borrow would result in smaller firms being placed at a financial disadvantage, so that they would quite possibly be unable to participate in the short market, as the ability to borrow would be limited and /or the cost of borrowing may become prohibitive.

Given that the existing locate and borrow requirements have not been tied to any market problems, and do not favour one type of firm over another, we are of the view that the existing locate and borrow requirements should remain in place.

Cost / Benefit Issues

The proposed reporting requirements will result in firms having to set up new systems to integrate certain operations and compliance functions, potentially creating overlapping functions within both departments.

The proposal also will introduce some complexities around introducing and carrying broker fails. The proposed amendments may require firms to develop surveillance systems (using IT and Compliance resources) which adds costs, which ultimately get passed onto the clients.

We are concerned that the proposed reporting requirements, with the accompanying technology and process costs, create another regulatory initiative for which costs are disproportionately borne by smaller firms which do not have the scale of operations and compliance departments as the larger dealers, and may not be able to absorb the costs as effectively. If RS wishes to collect this information, they should work with CDS in developing the required reporting from a single source. It should be noted that in the US the NASD obtains its information from the clearing corporation. Reporting to RS represents an unnecessary burden if such information can be collected in this manner. Further, we note that reporting to RS would duplicate some of the fail reporting requirements created by NI 24-101.

Although the proposed rules may assist in identifying certain problematic market behaviours, RS should carefully examine the existing regulatory tools that are available to ensure that the problems are targeted within the proper framework. In addition, the costs to address the issues must be examined and balanced carefully against the real versus the perceived problems stemming from failed trades.

Thank you for considering our comments.

Yours truly,

Susan Copland
Director, IIAC

cc: Cindy Petlock (OSC)