



March 29, 2010

VIA EMAIL

Jean St-Gelais
Chair
Canadian Securities Administrators
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Dear Mr. St-Gelais:

Re: Short Sales

The recently published amendments to Regulation SHO that will affect short sale trading of U.S. listed securities have caused TMX Group to consider the Canadian short sale landscape and the possible impact that the Reg SHO amendments could have on the Canadian market.

It is our view that additional regulation of short sales in Canada is not warranted. For the reasons outlined below, we are confident that the UMIR short sale rules combined with vigilant surveillance and enforcement by IIROC provide protection to our market. We believe that trading activity during the recent financial crisis has shown that Canada has not experienced the degree of abusive or naked short selling that other jurisdictions may have experienced. In our view, adopting an SEC-style amendment (whereby intra-day price restrictions on short selling are triggered "circuit-breaker style") would add significant costs to the industry without resulting in a corresponding benefit to investors.

Short Sales in Canada

TMX Group has not seen any evidence of increasing failed trade levels or other abuses of short selling that would call for increased short sale regulation. The results of the IIROC study "*Recent Trends in Trading Activity, Short Sales and Failed Trades*"¹ show that, during the period of the study from May 1, 2007 to September 30, 2008 (Study Period), the Canadian market did not experience problems with abusive short selling and naked short selling.² In fact, over the Study Period, the number of failed trades as a percentage of overall trades generally declined, and the accumulated value of failed trades as a percentage of the value of trades generally declined.³

¹ IIROC Market Regulation Policy – *Recent Trends in Trading Activity, Short Sales and Failed Trades* (February 2009).

² Ibid. pg 10.

³ Ibid.

After the conclusion of the Study Period, IIROC implemented amendments to the UMIR short sale rules to enhance its ability to monitor for failed trades.⁴ These amendments, among other things, require that a report of a failed trade be made to IIROC if the reason for the failure is not resolved within ten trading days following the original settlement date of the trade. The amendments also provide that IIROC may designate particular securities or class of securities as being ineligible for short selling. This ability would permit IIROC to deal with potentially problematic short selling on an issue by issue basis.

SEC Proposal

There does not appear to be any evidence to show that the SEC's amendment to Reg SHO will benefit the U.S. market. (The SEC's amendment requires that a price test be triggered intra-day on any security whose price drops by 10% relative to its previous day's closing price.) TMX Group is not alone in the view that this is ineffective legislating. SEC Commissioner Casey stated the following in voting against the Reg SHO amendment: "...this is regulation by placebo; we are hopeful that the pill we've just had the patient take, although lacking in potency, will convince him that everything is all right."⁵ Supporting Commissioner Casey's view is Oliver Wyman's⁶ assertion that short sale restrictions such as bans are ineffective at preventing stock price declines.

There can be many valid reasons for a drop in stock price, such as relevant news released by the issuer. To insert a regulatory restriction on trading while investors are reacting rationally to corporate events will result in costs to the industry and investors without corresponding benefits.

To provide contextual reference, TMX Group has performed analysis on historical data to determine the frequency of occurrences when a security's price drops by 10% from previous closing prices. We measured the price drops on Toronto Stock Exchange for securities that are inter-listed between Toronto Stock Exchange and a U.S. exchange. Our analysis covers a period of more than three years – from January 1, 2007 to February 26, 2010. The data is set out at Appendix A and described below.

Our analysis shows that, on average, at least one inter-listed security would have triggered the SEC-style short sale circuit breaker every day. On average, 278 short sale threshold events (i.e. declines of 10% or more) were triggered per year across all inter-listed securities during the 38 month period studied. On a percentage basis this frequency is low (278 threshold events out of a possible 37,771). But viewed in absolute terms from another perspective, it is highly unlikely that manipulative shorting occurs every trading day in one of the inter-listed securities. It is even more unlikely that in each of these cases manipulative shorting was responsible for the 10% decline in the security's price. We reference IIROC's study showing that during its Study Period short sellers were a relatively small percentage of total sellers in the market.⁷ We believe that a

⁴ IIROC Notice 08-0143 – Rules Notice – Notice of Approval – UMIR – *Provisions Respecting Short Sales and Failed Trades* (October 15, 2008).

⁵ SEC Commissioner Kathleen L. Casey. *Statement at Open Meeting Short-Sale Restrictions* (February 24, 2010).

⁶ Oliver Wyman (2010): *The effects of short selling public disclosure regimes on equity markets*: "In 2008, instead of stopping or slowing the declines in financial equity prices, the short-selling bans had at best a neutral effect on prices. A significant amount of academic work has concluded that short-selling bans in reality decreased liquidity, impaired price discovery and widened bid/ask spreads."

⁷ IIROC Notice 09-0037 – Administrative Notice – *Recent Trends in Trading Activity, Short Sales and Failed Trades* (February 4, 2009): "monthly short positions amounted to approximately 16% of trading volume in TSX-listed securities as compared to just over 1% of trading volume for securities listed on TSXV and CNSX..."

logical conclusion to be drawn from our analysis is that the price drops were in fact occurring due to market forces and were not caused by manipulative or abusive short selling practices.

Harmonization Concerns

It would be extremely difficult for Canadian short sale rules to harmonize to the SEC amendments. This would be true even if the Canadian short sale rules were the same as existing SEC rules, which they are not. Currently, only securities that are inter-listed⁸ on a Canadian and U.S. exchange are not subject to the UMIR short sale tick test whereas the SEC's short sale uptick rule was repealed in 2007 for all U.S. listed issues.

A number of practical concerns would arise when attempting to transport the SEC amendments cross-border. For example, would the Canadian price test be triggered by the drop in price in the U.S. market or a drop in the price of the listed security in Canada? If it is a Canadian price test, who monitors for the change in price – IIROC or each marketplace? Would IIROC have the ability to override the circuit breaker if it was clear that corporate news or another tangible event were the cause of the price drop (i.e. can the circuit breaker be reversed if the sellers are selling long rather than short?)

If Canadian regulations do not follow the SEC amendments, there will be times when an inter-listed security becomes temporarily subject to a short sale price test in the U.S. while the same security can be sold short on a Canadian marketplace without a price test. TMX Group does not believe that these events would prove detrimental to the Canadian market given that our regulatory regime for short sales is robust and short selling is appropriately surveilled and enforced by IIROC.

We note that when the OSC issued its order prohibiting the short sale of securities of certain inter-listed financial issuers on September 19, 2008 to follow the SEC's temporary measure, the action was taken by the OSC as a precautionary measure to: (i) prevent regulatory arbitrage; and (ii) promote fair and orderly markets in Ontario for the trading of those financial issuers. A subsequent study by IIROC⁹ found that the OSC's order appeared to have a significant impact on market quality for those financial issuers by reducing liquidity available in those securities and increasing the average bid/ask spread. In other words, the OSC's attempt to prevent regulatory arbitrage resulted in less efficient trading with wider bid/ask spreads and greater price volatility.

We believe that the Canadian market and its short sale rules and practices are robust such that any short sale trading that migrates to Canadian marketplaces would not result in our market being compromised. Given that IIROC's study on financial sector issuers has shown that mimicking SEC regulation can negatively impact the liquidity of our market and widen spreads, we submit that our market should be permitted to continue to operate under existing rules. IIROC could consider studying the impact of short selling on inter-listed issues whenever price tests are applied in the U.S., to determine whether there is any evidence of increased failed trades or other short sale abuses during the periods that securities in the U.S. are subject to such a test.

⁸ There are approximately 162 securities that are inter-listed between Canadian and U.S. exchanges.

⁹ IIROC – *Study on the Impact of the Prohibition on the Short Sale of Inter-Listed Financial Sector Issuers* (February 2009).

Looking Forward

As discussed above, we do not believe that importing rules similar to the SEC Reg SHO amendment would benefit our market. Further, we urge the CSA to review the issue of short sale price restrictions generally.

TMX Group believes that with previous amendments to UMIR to address failed trades, and with strong real-time surveillance and enforcement capabilities at IIROC, the short sale regulatory framework in Canada can support the removal of Canada's current short sale tick tests in all securities. IIROC operates real-time surveillance of trading activity and has the capability and the jurisdiction to detect manipulative short selling in real-time and stop the activity. IIROC also has the ability to declare a security as short sale ineligible if a situation requires this regulatory action.

We note that IIROC's Study Period spans a period of time where inter-listed trading was first subject to a tick test, and then exempt from the rule. IIROC noted in its study that granting the exemption from the tick rule to the inter-listed securities did not have any discernable effect on the pattern or attributes of short sales of these securities, other than a slight increase in the proportion of trades that were short sales (as was anticipated on the granting of the exemption).

The UMIR short sale price test in its current form has little value because it can be circumvented in a number of ways. Professional traders are capable of deploying synthetic shorting strategies that have the same result as unrestricted short selling in the equities market. Short sales on call markets are not subject to the UMIR price restriction, thus TriAct Match Now's call market allows short sales without price restrictions even though trades are executed every five seconds. The current UMIR short sale price restrictions are not uniformly implemented across Canadian marketplaces applying different interpretations of the tick-test methodology, resulting in variations in the manner that price restrictions are effected. Ultimately, because the current UMIR short sale price restrictions are more restrictive than U.S. regulation, trades in Canadian listed issuers are being executed in the U.S. OTC market rather than on our public equity markets.

While IIROC's study on short sale and failed trade trends supports the view that removing the tick test would not have a negative impact on the market, any CSA concern with this change might be addressed by revising other short sale practices. We suggest that IIROC could revisit whether capital charges should be levied against participants for unresolved failed trades. IIROC could also review whether the period for reporting a failed trade should be shortened from the current ten trading day period.

Conclusion

We urge the CSA to continue to inform itself as short sale rules are reviewed and debated in many jurisdictions. TMX Group believes that the costs of following the SEC's current approach on short sales will far outweigh any possible benefits to our market. Further, studies have shown that removing Canada's short sale price test on inter-listed securities has not had a negative impact on our market. Meanwhile, IIROC has continued to enhance the short sale rules in UMIR. With these factors in mind, we urge the CSA to take a decision on short sales that is contrary to the SEC's politically driven amendment to Reg SHO. TMX Group supports the removal of the short sale price test for all exchange-listed securities in order for Canadian participants to operate under one rule.

I would be pleased to discuss this topic further at your discretion.

Yours truly,

A handwritten signature in black ink, appearing to read "Thomas A. Kloet". The signature is fluid and cursive, with the first name being the most prominent.

Thomas A. Kloet
Chief Executive Officer
TMX Group Inc.

cc. Brenda Leong, *British Columbia Securities Commission*
Bill Rice, *Alberta Securities Commission*
David Wilson, *Ontario Securities Commission*
Susan Wolburgh-Jenah, *Investment Industry Regulatory Organization of Canada*

Appendix A

Incidences where the SEC short sale bid test, applied in Canada, would have been triggered for the period January 1, 2007 to February 26, 2010

Incidences of short sale price threshold triggered in Canada (38 month period January 1, 2007 to February 26, 2010)			Average number of incidents per year
For stocks where Canada's share of Canada/US inter-listed volume between 60% - 100%	Total # of Symbols	44	
	Sample Size	31,704	10,012
	10% threshold triggered	101	32
	% of time 10% threshold triggered	0.3%	
For stocks where Canada's share of Canada/US inter-listed volume between 40% - 60%	Total # of Symbols	46	
	Sample Size	33,840	10,686
	10% threshold triggered	273	86
	% of time 10% threshold triggered	0.8%	
For stocks where Canada's share of Canada/US inter-listed volume less than 40%	Total # of Symbols	72	
	Sample Size	54,063	17,073
	10% threshold triggered	507	160
	% of time 10% threshold triggered	0.9%	
For all Canada/US inter-listed stocks	Total # of Symbols	162	
	Sample Size	119,607	37,771
	10% threshold triggered	881	278
	% of time 10% threshold triggered	2.1%	

Total # of Symbols: the number of Canada/US inter-listed issues both overall and in sub-categories defined by Canada's relative dominance in inter-listed trading volume (Canada's share of trading relative to the US).

Sample Size: the number of symbols multiplied by the number of active trading days for each stock.

10% threshold triggered: the number of times a symbol breached the 10% price change comparing the previous day's close to the current day's low price.

% of time 10% threshold triggered: 10% threshold triggered divided by Sample Size.