

13.1.3 RS Market Integrity Notice – Notice of Amendment Approval – Provisions Respecting Short Sales

August 27, 2004

No. 2004-023

**RS MARKET INTEGRITY NOTICE
NOTICE OF AMENDMENT APPROVAL
PROVISIONS RESPECTING SHORT SALES**

Summary

Effective August 27, 2004, the Alberta Securities Commission, British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and, in Quebec, the Autorité des marchés financiers (the “Recognizing Regulators”) approved amendments to the Universal Market Integrity Rules (“UMIR”) to:

- provide that a person shall be considered to be “short” a security if they hold a right to acquire the security that will not settle within the ordinary settlement period of trade date plus three days; and
- provide an exemption from the pricing restrictions for trades in Exchange-traded Funds.

Summary of the Amendments

• **Completion of Acquisition of Securities After Settlement of Subsequent Sale**

The basic concept of a “short sale” is that the person entering an order to sell a security does not own the security which they are selling. A person is considered to “own” a security if they have, among other circumstances:

- entered into an unconditional contract to purchase the security but have not received delivery of the security;
- tendered a security for exchange or conversion into the security which is the subject of the sale;
- exercised an option to purchase the security; or
- exercised a right or warrant to subscribe for the security.

Prior to the amendments, UMIR provided that a seller would be considered not to own a security if:

- the seller had borrowed the security to be delivered on the settlement of the trade and is not otherwise considered to own the security; or
- the security held by the seller was subject to any restriction on sale imposed by securities legislation or marketplace requirement.

In certain cases, it had been suggested that a person should be considered “long” the security even though the date for issuance of the security or the closing of unconditional contract would be after the date of settlement of the trade. In several of these cases, the person would not actually acquire the security for a period of a year or more. The amendment provides that a person would be considered to own a security in these four enumerated cases only where the securities which that person will acquire will be settled or issued, in the ordinary course, on or before the date the person would be required to settle any sale on a marketplace. If the completion of the acquisition of securities by a person would, in the ordinary course, be after the settlement date of the sale made on a marketplace, the sale on the marketplace would be considered a “short sale” and the sale would have to be so marked and could not be made at a price which was less than the last sale price as disclosed in a consolidated market display.

• **Exemption from the Price Restrictions on Short Sales of Exchange-traded Funds**

The amendment expands the ability to make a “short exempt” sale in a security that is an “Exchange-traded Fund”. Exchange-traded Funds have a number of features that distinguish them from other listed or quoted securities. In addition to trading on a marketplace, an Exchange-traded Fund must be redeemable at the option of the holder in accordance with a formula specified in the mutual fund document. An added feature of the current Exchange-traded Funds is the fact that a “prescribed number” of the units may be redeemed or exchanged for a “basket” of the securities held by the fund. With the requirement that the funds be in “continuous distribution”, units of the fund will be distributed on an on-going basis at the net asset value of each unit of the fund (determined by reference to the market price of the

securities held by the fund). These features, which are unique to Exchange-traded Funds, act to maintain the market price of units of the fund at a “fair level”. As such, Exchange-traded Funds are not prone to the same manipulative pressures that may be present as a result of the improper short sale of other securities.

Impact of the Amendments

- **Definition of a “Short Sale”**

The adoption of the amendment will prevent a person entering into a contractual arrangement to acquire a particular security and then undertaking a sale of that security on regular settlement terms on a marketplace at a price that is less than the last sale price if the closing date for the acquisition of the securities under the contractual arrangement would, in the ordinary course, be later than the settlement date of the sale undertaken on the marketplace. The amendment ensures that a person is considered “long” a security only in circumstances where the seller could use their holdings to settle the trade.

- **Exchange-traded Funds**

As a result of the approval of the amendments, RS hereby designates as an “Exchange-traded Fund” each of the following seventeen securities that are listed on the Toronto Stock Exchange as of the date of the approval of the amendments.

Issuer Name	Symbol
CP HOLDRS	HCH
iUnits Government of Canada 5 Year Bond	XGV
iUnits Government of Canada 10 Year Bond	XGX
iUnits S&P/TSX 60 Index Fund	XIU
iUnits S&P 500 Index RSP Fund	XSP
iUnits S&P/TSX 60 Capped Index Fund	XIC
iUnits MSCI International Equity RSP Fund	XIN
iUnits S&P/TSX Midcap Index Fund	XMD
iUnits S&P/TSX Capped Energy Index Fund	XEG
iUnits S&P/TSX Capped Financial Index Fund	XFN
iUnits S&P/TSX Capped Gold Index Fund	XGD
iUnits S&P/TSX Capped Information Technology Fund	XIT
iUnits S&P/TSX Capped REIT Index Fund	XRE
TD S&P/TSX Composite Index Fund	TTF
TD S&P/TSX Capped Composite Index Fund	TCF
TD Select Canadian Growth Index Fund	TAG
TD Select Canadian Value Index Fund	TAV

In the future, RS will consider the designation of other securities which become a listed security or a quoted security. It would be the intention of RS that the designation of a security would be done after consultation with the Ontario Securities Commission or other applicable securities regulatory authority. Acceptance of the designation by applicable securities regulatory authorities would be a pre-condition to any designation of a security as an “Exchange-traded Fund”. Other factors which RS would take into account are:

- the liquidity or public float of the security (or the underlying securities which comprise the portfolio of the mutual fund);
- whether the units are redeemable at any time for a “basket” of the underlying securities in addition to cash;
- whether a “basket” of the underlying securities may be exchanged at any time for units of the fund;
- whether the fund tracks a recognized index on which information is publicly disseminated and generally available through the financial media; and
- whether derivatives based on units of the fund, the underlying index or the underlying securities are listed on a marketplace.

None of these additional five factors is determinative in and of itself and each security will be evaluated on its own merits before a request is made to the applicable securities regulatory authority to concur in the designation.

Text of the Amendments

The text of the amendments to the Rules, as approved by the Recognizing Regulators, is set out in Appendix "A". Appendix "B" contains the text of the relevant provisions of the Rules as they read following the adoption of the amendments and highlights the changes from the original proposal as set out in Market Integrity Notice 2004-012 dated April 23, 2004.

Responses to the Request for Comments

The comment letters which RS received in response to the Request for Comments on the proposed amendments set out in Market Integrity Notice 2004-012 and the response of RS to those comments are summarized in Appendix "B".

Questions

Questions concerning this notice may be directed to:

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Appendix "A"

Universal Market Integrity Rules

Amendments Respecting Short Sales

The Universal Market Integrity Rules are amended as follows:

1. Rule 1.1 is amended by adding the following definition of "Exchange-traded Fund":
"Exchange-traded Fund" means a mutual fund:
 - (a) the units of which are:
 - (i) a listed security or a quoted security, and
 - (ii) in continuous distribution in accordance with applicable securities legislation; and
 - (b) designated by the Market Regulator.
2. Rule 1.1 is amended by adding the following as clause (h) of the definition of "Short Sale":
 - (h) the settlement date or issuance date pursuant to:
 - (i) an unconditional contract to purchase,
 - (ii) a tender of a security for conversion or exchange,
 - (iii) an exercise of an option, or
 - (iv) an exercise of a right or warrantwould, in the ordinary course, be after the date for settlement of the sale.
3. Subsection (2) of Rule 3.1 is amended by adding the following as clause (g):
 - (g) a trade in an Exchange-traded Fund.

Appendix "B"

Comments Received on Proposed Amendments
Respecting Short Sales

On April 23, 2004, RS issued Market Integrity Notice 2004-012 requesting comments on proposed amendments to UMIR respecting short sales. In response to that Market Integrity Notice, RS received comments from the following persons:

Barclays Global Investors Canada Limited ("BGI")
 BMO Nesbitt Burns Inc. ("BMO")
 Penson Financial Services Canada Inc. ("Penson")
 Raymond James Ltd. ("Raymond James")
 RBC Dominion Securities Inc. ("RBC Investments")
 TD Securities Inc. ("TD Newcrest")

The following table presents a summary of the comments received together with the response of RS to those comments. The table summarizes only the comments received which relate directly to the proposed amendments and provides RS's responses to the comments, where applicable. Additional comments relating to regulation of short sales in the United States have not been included. Column 1 of the table also indicates the revisions to the amendments as published on April 23, 2004 that are proposed by RS in response to the comments.

Text of Provisions Following Adoption of Proposed Amendments As Revised	Commentator and Summary of Comment	Response to Comment
<p>1.1 Definitions</p> <p>"Exchange-traded Fund" means a mutual fund:</p> <p>(a) the units of which are:</p> <p>(i) a listed security or a quoted security, and</p> <p>(ii) in continuous distribution in accordance with applicable securities legislation; and</p> <p>(b) designated by the Market Regulator.</p>	<p>BGI – Indicated that future developments in the form of exchange-traded funds make it impossible to clearly define the term and indicated that designation by RS is an appropriate method of determining whether a security is an exchange-traded fund.</p>	<p>RS agrees with the comment. Initially RS will designate the 17 securities identified in Market Integrity Notice 2004-012 being all of the exchange-traded funds presently listed for trading. As noted in the Market Integrity Notice 2004-012, any designation would only be made with the concurrence of the applicable securities regulatory authorities. Presently, RS has identified the following factors which would be taken into account when making a determination:</p> <ul style="list-style-type: none"> • the liquidity or public float of the security (or the underlying securities which comprise the portfolio of the mutual fund); • whether the units are redeemable at any time for a "basket" of the underlying securities in addition to cash; • whether a "basket" of the underlying securities may be exchanged at any time for units of the fund; • whether the fund tracks a recognized index on which information is publicly disseminated and generally available through the financial media; and

Text of Provisions Following Adoption of Proposed Amendments As Revised	Commentator and Summary of Comment	Response to Comment
		<ul style="list-style-type: none"> whether derivatives based on units of the fund, the underlying index or the underlying securities are listed on a marketplace.
<p>1.1 Definitions</p> <p>“short sale” means a sale of a security, other than a derivative instrument, which the seller does not own either directly or through an agent or trustee and, for this purpose, a seller shall be considered to own a security if the seller:</p> <p>(a) has purchased or has entered into an unconditional contract to purchase the security, but has not yet received delivery of the security;</p> <p>(b) has tendered such other security for conversion or exchange or has issued irrevocable instructions to convert or exchange such other security;</p> <p>(c) has an option to purchase the security and has exercised the option;</p> <p>(d) has a right or warrant to subscribe for the security and has exercised the right or warrant; or</p> <p>(e) is making a sale of 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 of distribution of the security,</p> <p>but a seller shall be considered not to own a security if:</p> <p>(f) the seller has borrowed the security to be delivered on the settlement of the trade and the seller is not otherwise considered to own the security in accordance with this definition;</p>	<p>BGI and TD Newcrest – Indicated support of the proposed amendment to the definition of “short sale”.</p> <p>BMO – Expressed a concern that the requirement that the exercise of a stock option “settle” prior to being considered to own a security would render the exemption ineffective. They agreed that there are times that the delivery of stock as a result of the option will be delayed as a result of delays by the transfer agent or reduced liquidity. BMO suggested that the provision of instructions together with the delivery of the exercise documentation and payment should be considered settlement for the purpose of this amendment.</p> <p>Penson – Expressed a concern that the proposed amendment to the definition of “short sale” could adversely affect the use of single stock futures for the purpose of hedging.</p>	<p>This proposed amendment is intended to address settlement risks inherent where a party executes the sale of a security where the security is not available for delivery in settlement of the trade. The amendment clarifies the definition of short sale by indicating that a sale should be considered short where the Participant or Access Person involved in entering the sell order is aware that the securities that will be acquired would not be available to be delivered in satisfaction of the sale.</p> <p>If a Participant or Access Person is aware, relying upon the ordinary business practices of transfer agents, corporate trustees or other financial intermediaries, that the transfer of a security, a tender for conversion or the exercise of a right, warrant, or option will not be recorded on the issuer’s corporate register until after the settlement date of the sale, the sale should be considered to be “short”.</p> <p>If the Participant or Access Person involved in the sale is aware that all necessary steps have been completed to ensure that the underlying securities, which are the subject of the sale, will be issued and in the ordinary course they will be issued on or before the settlement date of the sale, the sale will not be considered to be a “short sale”. RS would propose to revise the proposed amendment to include the concept of “in the ordinary course”.</p> <p>The purpose of the amendment was to ensure that there was a direct connection between ownership of the security and the ability to undertake a sale at a price below the last sale price. Ownership of a single stock future with an expiry date at some time in the “distant” future means any sale must be settled with the borrowing of securities. In the view of RS, the ownership of the future is akin to being party to long term forward contract or share issuance</p>

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<p>(g) 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</p> <p>(h) the settlement date or issuance date pursuant to:</p> <p>(i) an unconditional contract to purchase,</p> <p>(ii) a tender of a security for conversion or exchange,</p> <p>(iii) an exercise of an option, or</p> <p>(iv) an exercise of a right or warrant</p>		<p>agreement and the holder of the future should not be considered “long” unless the expiry date of the future is concurrent with the settlement date of any sale. Presently, Nortel Corporation is the only security on which there is a listed single stock future in Canada. The liquidity of Nortel is such that the pricing restrictions on a short sale should not impact the ability to hedge a position held in a futures contract.</p>
<p>is <u>would, in the ordinary course, be after the date for</u> settlement of the sale.</p>	<p>Raymond James – Agreed in principle with this proposed amendment but expressed a concern regarding the compliance and supervision obligations that will be imposed upon dealers to ensure that clients are able to deliver shares by the settlement date. Raymond James indicated that they believed that RS should publish guidelines outlining the expectations which would be placed on dealers as a result of the change.</p>	<p>The amendment is not intended to impose additional obligations on Participants to ensure that clients are able to deliver the securities sold prior to the date of settlement of a sale. Presently, when a Participant is handling the sale of a security which is not held in the name of the Participant or otherwise on deposit with the Participant, the Participant must assess the credit risk and settlement risk associated with such a sale. As a result of the amendment, a Participant must, as part of that assessment, determine whether or not the securities would be available and a Participant is entitled to rely upon industry standards relating to trade settlement, turnaround times on the exercise of rights, options or warrants, or the issue of securities as a result of tendering a security for conversion.</p> <p>RS intends to clarify the application of the rule in a Market Integrity Notice to be released concurrently with the implementation of the amendment.</p>
	<p>RBC Investments – Expressed a concern that participants may be in violation of UMIR where the Participant, relying on the belief that a purchase, conversion or exercise will settle prior to the settlement date for the sale, does not mark a sale as a “short” sale and the purchase, conversion or exercise upon which they are relying fails.</p>	<p>(See response to BMO comment above.)</p> <p>The proposed amendment does not impose an absolute obligation on the selling party to ensure that the transfer, conversion, or settlement does occur prior to the settlement date of the sale but only requires that the selling party have a reasonable belief that the trade, exercise or conversion will settle before the settlement date of their trade. Where the trade (or conversion or exercise) where the seller is to acquire the securities fails through no fault of the seller they will not be considered to have violated UMIR.</p>

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<p>3.1 Restrictions on Short Selling</p> <p>(2) A short sale of a security may be made on a marketplace at a price below the last sale price if the sale is:</p> <p>(a) a Program Trade in accordance with Marketplace Rules;</p> <p>(b) made in furtherance of the applicable Market Maker Obligations in accordance with the Marketplace Rules;</p> <p>(c) for an arbitrage account and the seller knows or has reasonable grounds to believe that an offer enabling the seller to cover the sale is then available and the seller intends to accept such offer immediately;</p> <p>(d) for the account of a derivatives market maker and is made:</p> <p>(i) in accordance with the market making obligations of the seller in connection with the security or a related security, and</p> <p>(ii) to hedge a pre-existing position in the security or a related security;</p> <p>(e) the first sale of the security on any marketplace made on an ex-dividend, ex-rights or ex-distribution basis and the price of the sale is not less than the last sale price reduced by the cash value of the dividend, right or other distribution;</p> <p>(f) the result of:</p> <p>(i) a Call Market Order,</p>	<p>BGI, Penson and TD Newcrest – Indicated that they agreed with the exemption of exchange-traded funds from short sale price restrictions.</p> <p>Raymond James – Indicated that they believe that Exchange-traded Funds were not prone to manipulation as a result of short sales and agreed that short trades involving such funds should be exempt from price restrictions.</p>	

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(ii) a Market-on-Close Order, or (iii) a Volume-Weighted Average Price Order; or (g) a trade in an Exchange-traded Fund.		