

investment funds and asset management group bulletin

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OSC Prohibits Short Selling of Certain Financial Stocks

On September 19, 2008,¹ the Ontario Securities Commission (“OSC”) issued a temporary order prohibiting the short sale of securities of a number of financial sector companies (the “Temporary Order”).² The Temporary Order was slightly amended on September 22, 2008, in order to address certain technical and operational concerns arising from the Temporary Order (the “Amended Temporary Order”).³ Under the Amended Temporary Order, market participants are prohibited from short selling⁴ securities of the following issuers (“Financial Sector Issuers”):

- Aberdeen Asia-Pacific Income Investment Company Ltd. (Ticker: FAP)
- Bank of Montreal (BMO)
- Bank of Nova Scotia (BNS)
- Canadian Imperial Bank of Commerce (CM)
- Fairfax Financial Holdings Limited (FFH)
- Kingsway Financial Services Inc. (KFS)
- Manulife Financial Corporation (MFC)
- Quest Capital Corp. (QC)
- Royal Bank of Canada (RY)
- Sun Life Financial Inc. (SLF)
- Thomas Weisel Partners Group Inc. (TWP)
- Toronto-Dominion Bank (TD)
- Merrill Lynch & Co., Canada Ltd. (MLC)

¹ Ontario Securities Commission News Release, “OSC Issues Temporary Order Prohibiting Short Selling of Certain Financial Sector Issuers” (September 19, 2008), available at http://osc.gov.on.ca/Media/NewsReleases/2008/nr_20080919_osc-issue-temp-order.jsp.

² The text of the Temporary Order is available at http://osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20080919_cert-fin-sect-issuers.pdf.

³ The Amended Temporary Order is available at http://osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20080922_amend_cert-fin-sect-issuers.pdf.

⁴ According to section 1.1 of the Universal Market Integrity Rules (UMIR), a “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; see http://www.iroc.ca/English/Documents/Rulebook/UMIR0101_en.pdf.

The Temporary Order followed in the wake of a similar order by the U.S. Securities and Exchange Commission (“SEC”).⁵ As the Financial Sector Issuers are interlisted in the United States,⁶ the OSC’s action was needed to forestall regulatory arbitrage opportunities between the Canadian and the US markets. **Unless it is extended, the Amended Temporary Order applies until October 3, 2008.**

There are a limited number of exemptions in the Amended Temporary Order, some of which reflect provisions of the Investment Industry Regulatory Organization of Canada’s (“IIROC”) Universal Market Integrity Rules (“UMIR”). Among the exemptions are the following:

- *Block facilitation* – A dealer may short sell securities, where the dealer acts as a principal to facilitate a client’s transaction of \$200,000 or more, provided that the position is liquidated or hedged as soon as possible.
- *Facilitation of principal take-on trades* – If a dealer has agreed with a client on the size and price of a principal take-on trade, the dealer may short sell from inventory to move the market down to a level that facilitates the execution of such trades.
- *Program trades* – A short sale can be executed if it is in accordance with rules related to a “program trade” (as defined in UMIR).
- *Expiry of prior options and futures contracts* – Short sales that result from the automatic exercise or assignment of an equity option or in connection with the settlement of a futures contract are exempt if the option or the futures contract was held prior to the issuance of the Amended Temporary Order.
- *Pre-existing hedged derivative position* – Short sales are permissible if they are made to maintain the existing risk exposure under a pre-existing hedged derivative position.

Because short-selling is governed primarily by UMIR, IIROC has published a helpful guidance note (the “Guidance Note”) that clarifies some of the parameters of the Amended Temporary Order and the UMIR short selling provisions:⁷

- *No orders in any marketplace, no OTC transactions* – The prohibition in the Amended Temporary Order covers not only trading on the TSX, but also in any other marketplace⁸ the Financial Sector Issuers trade on as well as over-the-counter (“OTC”) transactions.
- *Only common shares* – The Amended Temporary Order only affects trades in common shares of the Financial Sector Issuers.
- *Outstanding orders, direct market access, gatekeeper report* – Dealers are not allowed to enter short sale orders even if the order was placed before the issuance of the Amended Temporary Order. Dealers must also take steps to block clients who have “direct market access” facilities from entering short sale orders in respect of the Financial Sector Issuers. If that is not possible, these clients must be immediately notified by the dealer of the terms of the Amended Temporary Order, and their accounts must be monitored. If a dealer determines that the short sale prohibition has been violated, the dealer must notify IIROC by filing a “Gatekeeper Report.”

The Guidance Note also reminds dealers that UMIR prohibits a dealer from entering a client’s short sell order in securities of the Financial Sector Issuers (and all issuers) if the dealer knows or should know that the client or the client’s counterparty will not be able to cover the short sale by borrowing the particular security, i.e. a “naked short”.

Finally, IIROC specifically notes that the TSX and other marketplaces will likely not be able, at least in the short term, to institute a marketplace level solution to prevent ineligible short sales of the Financial Sector Issuers, and

⁵ U.S. Securities and Exchange Commission Press Release 2008-211, “SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets” (September 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-211.htm>.

⁶ Merrill Lynch & Co. is not interlisted in the US, but its securities are interchangeable into securities of Merrill Lynch & Co. Inc., which is listed in the US.

⁷ IIROC Notice 08-0101, “Restated Reminder Respecting Obligations in the Conduct of Short Sales” (September 23, 2008), available at <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=4FF90709EB024D4EB6766356B18C0971&Language=en>.

⁸ For example: Pure Trading, ChiX Canada ATS Limited, Liquidnet Canada, BlockBook, Omega ATS, MATCH Now, TriAct Canada Marketplace.

that the individual market participants (including portfolio managers and other who have direct market access) are therefore primarily responsible for compliance with the Amended Temporary Order. IIROC has also indicated that it intends to devote additional attention and resources to

ensure compliance with the Amended Temporary Order and with the UMIR short selling rules, generally, at least until the securities regulators have decided on a further course of action.

Written by Thomas Trachsler

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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For more information about the how the Amended Temporary Order will affect dealers and other market participants, please contact your McMillan lawyer or one of the lawyers listed below:

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