Re Scotia Capital

IN THE MATTER OF:

The Rules of the Investment Industry Regulatory Organization of Canada (IIROC)

and

The Universal Market Integrity Rules (UMIR)

and

Scotia Capital Inc.

2013 IIROC 38

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District)

Heard: June 18, 2013
Decision: June 24, 2013

Hearing Panel:
Martin L. Friedland, C.C., Q.C. (Chair), Guenther W. K. Kleberg and Selwyn B. Kossuth
Appearances:
Andrew P. Werbowski, Senior Enforcement Counsel, IIROC
David Di Paolo, for the Respondent

REASONS FOR DECISION

INTRODUCTION

¶ 1   Staff of the Investment Industry Regulatory Organization of Canada ("IIROC") and the Respondent, Scotia Capital Inc. ("Scotia Capital" or "the Respondent"), entered into the attached Settlement Agreement, dated June 4, 2013. The settlement was in accordance with Part 3 of the Universal Market Integrity Rules ("UMIR"), Policy 10.8.

¶ 2   The Settlement Agreement was presented to the Hearing Panel for acceptance on June 18, 2013.

¶ 3   After hearing counsel for IIROC and the Respondent and considering the material filed, the Hearing Panel issued an order accepting the Settlement Agreement. These are our reasons for making that order.

ALLEGATIONS

¶ 4   The Enforcement Department Staff ("Staff") of IIROC conducted an investigation into the conduct of Scotia Capital and into the conduct of E*Trade Canada Securities ("E*Trade"). E*Trade was renamed Scotia iTRADE following its acquisition by Scotia Capital in 2008, and later became a division of Scotia Capital. Because of its acquisition by Scotia Capital, E*Trade is no longer an IIROC Dealer Member, the activities which were the subject of the investigation relate to activities which began at E*Trade.

¶ 5   The investigation alleged that Scotia Capital failed to comply with its trading supervision obligations contrary to UMIR Rule 7.1 and Policy 7.1 with respect to wash trading and artificial pricing transactions relating to high closing. In particular, IRROC alleged that

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"Between June 2009 and November 2011, it failed to have adequate policies and procedures in place or failed to implement those policies and procedures to prevent and detect potential wash trades; and

Between June 2009 and December 2010, it failed to adequately implement its policies and procedures to prevent and detect potential artificial pricing transactions relating to high closing."

¶ 6   Rule 7.1 provides, in part, under the heading "Trading Supervision Obligations": "Each Participant shall adopt written policies and procedures to be followed...that are adequate, taking into account the business and affairs of the Participant, to ensure compliance with these Rules and each Policy." And Policy 7.1 states: "The compliance department is responsible for monitoring and reporting adherence to rules, regulations, requirements, policies and procedures. In doing so, the compliance department must have a compliance monitoring system in place that is reasonably designed to prevent and detect violations."

SETTLEMENT AGREEMENT

¶ 7   Scotia Capital agreed that it failed to comply with its trading supervision obligations as alleged.

¶ 8   Scotia Capital agreed, with respect to wash trading – which, in brief, refers to transactions that give the appearance of activity but do not affect any change in beneficial ownership in the security – that:

> "Between June 2009 and November 2011, the Respondent failed to take adequate steps to prevent and detect potential wash trades. Specifically, it lacked adequate policies and procedures for reviewing potential wash trades or failed to properly implement those policies and procedures. The policies and procedures only required consideration and a review of trades between the same account number. The policies and procedures did not require consideration of trades by the same beneficial owner with a different account number."

¶ 9   As outlined in detail in the attached Settlement Agreement, it is obvious that a system that only picks up trades between the same account number can be easily circumvented.

¶ 10   Scotia Capital also agreed with the following with respect to artificial pricing:

> "Additionally, between June 2009 and December 2010, the Respondent failed to take adequate steps to prevent and detect potential artificial pricing transactions. Specifically, it failed to adequately implement some of its policies and procedures related to the detection of artificial pricing transactions. As a practice, the Respondent's compliance staff considered only two ... Alerts to supervise artificial pricing and high closing. This practice meant that trades could occur at the end of the day that set the closing price on an uptick and would go undetected by compliance staff."

¶ 11   Using only two Alerts to detect improper high closings is inadequate, considering that many times that number of tests are available. Again, this is more fully explored in the Settlement Agreement. Scotia Capital did not, for example, subscribe to the service supplying the daily closing reports from the TSX. Also, it was not reviewing filled trades as part of its artificial pricing review. Moreover, the system used did not pick up an order at the end of the day that set the closing price at an uptick if there had been a trade at the same or a higher price sometime during that day.

DISPOSITION

¶ 12   The Settlement Agreement provides for the following disposition:

> "For the contraventions ... Staff and the Respondents have agreed upon disposition on the basis of:
>
> > (i)   Payment by the Respondent Scotia Capital of a fine in the amount of $150,000; and
>
> > (ii)   Payment by the Respondent Scotia Capital of costs in the amount of $10,000."

STANDARD FOR REVIEWING A SETTLEMENT AGREEMENT

¶ 13   The standard for reviewing a Settlement Agreement was well-stated in a 2012 Pacific District hearing, *Re Johnson* (2012 IIROC 19) where the Panel stated:

> "The test applicable to a decision whether to accept or reject a settlement is well-known. Simply put, a panel should accept such an agreement unless it considers the penalty provided for clearly to fall outside a reasonable range of appropriateness."

¶ 14   That is just one of many cases stating a similar test: see, e.g., other 2012 cases: *Re Jiwa and Hoffar* (2012 IIROC 9); *Re Rotstein and Zackheim* (2012 IIROC 27), and *Re Ast* (2012 IIROC 38).

¶ 15   Several recent cases relating to issues similar to those in question in this hearing use a comparable test. In *Re Credit Suisse Securities (Canada) Inc.* (2011 IIROC 10) the Panel noted that "a hearing panel should not attempt to fine-tune a settlement agreement, but rather consider whether, in the circumstances of an individual case, the proposed settlement is a reasonable one." See, to the same effect, *Re Morgan Stanley Canada* (2011 IIROC 45).

¶ 16   A Settlement Agreement cannot be modified by a Hearing Panel. It can only be accepted or rejected.

CONSIDERATIONS

¶ 17   The conduct in this case is serious. The integrity of the capital markets and thus the ability of firms to raise capital requires that the stock market reflect true supply and demand. Wash trading is considered sufficiently detrimental that it is included as an offence under the Criminal Code (section 382) and carries a possible ten-year penalty.

¶ 18   The Settlement Agreement outlines a number of cases of wash trading and artificial pricing by clients of Scotia Capital, which took place and were undetected by Scotia Capital, but were later discovered by IIROC in its investigations.

¶ 19   Careful scrutiny of trades is required by Participants. This is particularly true in cases where clients, as in the present case, execute their own trades without the intervention of a broker as a potential gatekeeper. Direct Market Access is growing in Canada. It is estimated that such trading may account for double the amount of retail trading that take place with the help of a broker on stock exchanges in Canada. The need for heightened awareness and testing by Participants in such cases is recognized in Policy 7.1 of the Universal Market Integrity Rules.

¶ 20   Scotia Capital inherited the problem of the lack of adequate trading supervision when it acquired E*Trade. The Settlement Agreement notes that "at the time of the acquisition, Scotia Capital planned to improve E*Trade's compliance practices and procedures, including those that are the subject of this settlement agreement, by amalgamating E*Trade's compliance operations with its own. The plan was executed, but took longer than anticipated at the time of acquisition."

¶ 21   These deficiencies have now been resolved. As the Settlement Agreement states: "The breaches that form the subject matter of this settlement agreement are historical in nature and have been corrected by Scotia Capital."

¶ 22   The Agreement also states that "Scotia Capital provided its full co-operation at all times during Staff's investigation of this matter."

¶ 23   The penalty, which is a significant one, is in line with other comparable cases in recent years. See *Re Credit Suisse (Canada) Inc.* (2011 IIROC 10) where the fine was also $150,000 and *Re Morgan Stanley Canada* (2011 IIROC 45) where the fine was $175,000. Costs in these cases are also similar.

¶ 24   Not only does the Settlement Agreement *not* "fall outside a reasonable range of appropriateness," – to use one of the tests described above – we had no hesitation in concluding that it appears to us as sound and reasonable in this case.

CONCLUSION

¶ 25   For the above reasons, the Panel accepted the Settlement Agreement.

Dated at Toronto this 24th day of June 2013.

Martin L. Friedland, C.C., Q.C., Chair

Guenther W. K. Kleberg

Selwyn B. Kossuth

OFFER OF SETTLEMENT

INTRODUCTION

1.   The Enforcement Department Staff ("Staff") of the Investment Industry Regulatory Organization of Canada ("IIROC") has conducted an investigation (the "Investigation") into the conduct Scotia Capital Inc. ("Scotia Capital" or the "Respondent").   Staff of IIROC also conducted an investigation into the conduct of E*Trade Canada Securities Corporation ("E*Trade") which was renamed Scotia iTRADE following its acquisition by Scotia Capital.   E*Trade is no longer an IIROC Dealer Member by reason of its amalgamation with Scotia Capital but the facts set out in this Offer of Settlement and appended Settlement Agreement relate to activities which began at E*Trade.

2.   The Investigation has disclosed matters for which IIROC seeks certain sanctions against the Respondent pursuant to Rule 10.5 of the Universal Market Integrity Rules ("UMIR").

3.   If this Offer of Settlement is accepted by the Respondent, the resulting settlement agreement (the "Settlement Agreement") which has been negotiated in accordance with Part 3 of UMIR Policy 10.8, is conditional upon approval by a hearing panel appointed pursuant to IIROC Transitional Rule No. 1, Schedule C.1 (the "Hearing Panel").

4.   The Respondent agrees to waive all rights under UMIR to a hearing or to an appeal or review if the Settlement Agreement is approved by the Hearing Panel.

5.   The Respondent consents to be subject to the jurisdiction of IIROC and its relevant disciplinary process and rules in relation to this matter.

6.   Staff and the Respondent jointly recommend that the Hearing Panel accept this Settlement Agreement.

AGREEMENT AS TO REQUIREMENTS CONTRAVENED

7.   The Respondent agrees that it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1 in that:

    (i)   Between June 2009 and November 2011, it failed to have adequate policies and procedures in place or failed to implement those policies and procedures to prevent and detect potential wash trades; and

    (ii)   Between June 2009 and December 2010, it failed to adequately implement its policies and procedures to prevent and detect potential artificial pricing transactions relating to high closing.

ADMITTED FACTS

8.   For the purposes of this Settlement Agreement, Staff and the Respondent agree with and rely upon the admitted facts and conclusions which are set out in the Statement of Allegations attached as Appendix A to this Settlement Agreement.

DISPOSITION

For the contraventions in paragraphs 7(i) and 8(i) above, Staff and the Respondents have agreed upon disposition on the basis of:

(i)   Payment by the Respondent Scotia Capital of a fine in the amount of $150,000; and

(ii)   Payment by the Respondent Scotia Capital of costs in the amount of $10,000.

PROCEDURES FOR ACCEPTANCE OF OFFER OF SETTLEMENT AND APPROVAL OF SETTLEMENT AGREEMENT

9.   The Respondent shall have until the close of business on June 7, 2013 to sign this Settlement Agreement and serve an executed copy thereof on Staff.

10.   This Settlement Agreement shall be presented to the Hearing Panel at a hearing (the "Approval Hearing") held for the purpose of approving the Settlement Agreement, in accordance with the procedures described in UMIR Policy 10.8 in addition to any other procedures as may be agreed upon between the parties. The Respondent acknowledges that IIROC shall notify the public and media of the Approval Hearing in such manner and by such media as IIROC sees fit.

11.   Pursuant to Part 3.4 of UMIR Policy 10.8, the Hearing Panel may accept or reject this Settlement Agreement.

12.   In the event the Settlement Agreement is accepted by a Hearing Panel, the matter becomes final, there can be no appeal or review of the matter, the disposition of the matter agreed upon in this Settlement Agreement will be included in the permanent record of IIROC in respect of the Respondents and IIROC will publish a summary of the Requirements contravened, the facts, and the disposition agreed upon in the Settlement Agreement.

13.   In the event the Hearing Panel rejects the Settlement Agreement, IIROC may proceed with a hearing of the matter before a differently constituted Hearing Panel pursuant to Part 3.7 of UMIR Policy 10.8 and this Settlement Agreement may not be referred to without the consent of both parties.

14.   The Respondent agrees that, in the event it fails to comply with any of the terms of the Settlement Agreement, IIROC may enforce this settlement in any manner it deems appropriate.

15.   The Respondent agrees that neither it nor anyone on its behalf will make a public statement inconsistent with this Settlement Agreement.

IN WITNESS WHEREOF the parties have signed this Settlement Agreement as of the dates noted below.

DATED at Toronto on the 4th day of June, 2013.

"Witness"   "Scotia Capital Inc."

Witness Signature   **SCOTIA CAPITAL INC.**

Name of Witness

DATED at Toronto, Ontario on the 29th day of May, 2013.

Per: "Elsa Renzella"

           ELSA RENZELLA, ACTING VICE-PRESIDENT, ENFORCEMENT

           Investment Industry Regulatory Organization of Canada

           Suite 2000, 121 King Street West

           Toronto, Ontario M5H 3T9

This foregoing Settlement Agreement is hereby approved this 18th day of June, 2013, by the following hearing

panel constituted to review the terms thereof:

Per: "Martin Friedland"

      Panel Chair

Per: "Guenther Kleberg"

      Panel Member

Per: "Selwyn Kossuth"

      Panel Member

APPENDIX "A"

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

IN THE MATTER OF:

> **THE RULES OF THE INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**
>
> **AND**
>
> **THE UNIVERSAL MARKET INTEGRITY RULES**
>
> **AND**
>
> **SCOTIA CAPITAL INC.**

STATEMENT OF ALLEGATIONS

I.   REQUIREMENTS CONTRAVENED

1. It is alleged that the Respondent has failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1 as follows:

    (i)   Between June 2009 and November 2011, it failed to have adequate policies and procedures in place or failed to implement those policies and procedures to prevent and detect potential wash trades; and

    (ii)   Between June 2009 and December 2010, it failed to adequately implement its policies and procedures to prevent and detect potential artificial pricing transactions relating to high closing.

2. Schedule "A" sets out the text of the relevant UMIR Requirements.

II.   RELEVANT FACTS AND CONCLUSIONS

A. Overview

3. On July 18, 2008, Scotiabank Inc. announced the purchase of E*Trade Canada Securities Corporation ("E*Trade"). This acquisition was completed on September 24, 2008. On March 10, 2009, E*Trade was re-branded as Scotia iTRADE.

4. At the time of the acquisition, Scotia Capital planned to improve E*Trade's compliance practices and procedures, including those that are the subject of this settlement agreement, by amalgamating E*Trade's compliance operations with its own. The plan was executed, but took longer than anticipated at the time of acquisition.

5. Between June 2009 and November 2011, the Respondent to take adequate steps to prevent and detect

potential wash trades. Specifically, it lacked adequate policies and procedures for reviewing potential wash trades or failed to properly implement those policies and procedures. The policies and procedures only required consideration and a review of trades between the same account number. The policies and procedures did not require consideration of trades by the same beneficial owner with a different account number.

6. Additionally, between June 2009 and December 2010, the Respondent failed to take adequate steps to prevent and detect potential artificial pricing transactions. Specifically, it failed to adequately implement some of its policies and procedures related to the detection of artificial pricing transactions. As a practice, the Respondent's compliance staff considered only two Compliance Explorer or SMARTS Broker Alerts to supervise artificial pricing and high closing. This practice meant that trades could occur at the end of the day that set the closing price on an uptick and would go undetected by compliance staff.

7. A Participant must develop and implement procedures that are reasonably well designed to ensure that orders entered on a marketplace by or through a Participant are not part of a manipulative or deceptive method, act or practice nor an attempt to create an artificial price or a false or misleading appearance of trading activity or interest in the purchase or sale of a security.

B. Background

8. Scotia iTRADE is a discount broker providing direct access to retail clients for the online trading of securities. Orders are entered directly by clients and routed to a marketplace through Scotia iTRADE's trading system without the involvement of trade desk personnel.

9. In providing an order execution service, a Participant is not relieved from any obligations under UMIR with respect to the supervision of orders entered by its clients.

10. On November 1, 2009, Scotia iTRADE was amalgamated with Scotia Capital and it became a division of Scotia Capital.

11. Between June 2009 and November 1, 2009 Scotia iTRADE was a Participant under UMIR. Scotia Capital is currently, and was at all material times, a Participant under UMIR.

C. Wash Trading

i - TCC Reviews

12. During the period June 2009 to November 2011, the Respondent's policies and procedures did not require a review for wash trades between the same beneficial owner using a different account number.

13. E*Trade's policies and procedures from 2008 were adopted and incorporated by Scotia iTRADE. In order to supervise wash trading, E*Trade would monitor a wash trading report and trade blotters on a daily basis.

14. In 2009, IIROC's Trade Conduct and Compliance ("TCC") department conducted a review of Scotia iTRADE's policies and identified three findings with respect to wash trading as follows:

(i) the written policies and procedures with regards to supervision of trading were identified as a significant deficiency. Specifically, TCC found the procedures were out-of-date and were not reflective of the current testing methodology for, among other things, beneficial change in ownership. TCC required the development of written policies and procedures to internally test all applicable issues;

(ii) there was insufficient evidence of internal testing for beneficial change of ownership. This was noted as a significant and repeat deficiency. TCC required the conduct of internal reviews and quantification and summarizing of the results of the testing in the monthly or quarterly summary; and

(iii) testing by TCC found a large, non-client cross with no beneficial change in ownership that was

not detected. TCC required the implementation of necessary steps to manage and mitigate the occurrences of wash trading.

15. In response to the 2009 TCC review, Scotia iTRADE updated its Trading Review Manual in the Spring of 2010. The new policy and procedure related to wash trading stated that they would conduct quarterly reviews using a sample period of three days. The procedures outlined a process whereby they would access their firm's trading data from their web-based application, click a "wash trade" button, and review the trades.

ii - Same Beneficial Owner / Different Account Numbers

16. The revised policies and procedures noted that "a client could trade stock between two different accounts of which they are the beneficial owner of both." The compliance review, however, only captured trades between the same account number.

17. Scotia iTRADE utilized SMARTS Broker, a third party service provider to assist in performing its trading supervision obligations. Compliance staff used the Alert: "Possible Wash Trade (A to A)" to supervise for wash trades. This Alert only identifies trades between the same account number.

18. In November 2011, new policies and procedures were adopted by the Respondent for supervising of wash trades in order to capture wash trades between the same beneficial owner using different account numbers. Clients are now assigned a Client ID number upon opening their accounts. On a daily basis, trades between identical Client IDs are flagged and reviewed for potential wash trading.

iii - Failure to Detect Client Trading Activity

19. The Respondent's failure to have adequate policies and procedures in place or to ensure the implementation of those policies and procedures resulted in a failure to detect and prevent certain wash trades in the accounts of a retail client ("the Client").

20. The Client maintained three accounts at E*Trade which were carried over to Scotia iTRADE. During the period June 1, 2009 to November 27, 2009, there were approximately 80 wash trades involving six securities in the Client's accounts, none of which were detected.

21. The Client's trading activity was detected by IIROC's Trade, Review & Analysis ("TR&A") department during a routine compliance review and, upon the request of TR&A, Scotia iTRADE's compliance staff contacted the Client. The Client advised that he was unaware of rules regarding trading with no change in beneficial ownership.

22. In the fall of 2010, as a result of concerns regarding the trading activity in the Client's accounts, the Respondent requested that the client transfer out the accounts. However, the Client refused on the basis that a court order was in place which precluded the transfer or withdrawal of the assets in the accounts. The court order had been put in place in connection with a family law matter involving one of the account holders.

D. Artificial Pricing / High Closing

i - TCC Reviews

23. E*Trade's 2008 policies and procedure manual, in place until the Spring of 2010, indicated that it would review end of day trading on a daily basis via the Final Hour Report to determine whether prohibited trading activities were occurring on a repeat basis. It would also review the daily closing report from the TSX in order to identify whether any of their clients were engaged in manipulative, deceptive, restricted or overly concentrated trading practices. Neither E*Trade nor Scotia iTRADE subscribed to the CARS Reports (which includes the daily closing reports from the TSX) during 2008 and 2009 and therefore compliance staff would not have been able to review them.

24. During TCC's 2009 review, it was noted that Scotia iTRADE was not quantifying or summarizing the results of its internal testing related to artificial pricing, such as high closing, spoofing, and unexecuted

orders entered at or near the close. This was a significant deficiency.

25.   In response to the 2009 review, Scotia iTRADE's 2010 Trading Review Manual outlined a procedure whereby the compliance officer would review applicable Alerts in order to supervise for artificial pricing. It was noted that trades that had a price change of greater than 1.5% for a liquid stock and a minimum of 2.5% for a generally illiquid stock should be reviewed. In addition, a list of nine Alerts from SMARTS Broker to be considered for review was included in the manual.

ii – The Practice of using two Alerts

26.   Scotia iTRADE relied on only two Alerts to supervise for high closing as follows:

(i)   **"Pattern Alert (Establishing Day High/Low Close)"**

This alert identifies instances where a trade established the closing price at the day's high or low on a sufficient number of trading days to meet the conditions for a pattern. The alert does not require that the trading participant establish the closing price via the last trade of the day. Accordingly, where a broker executes a trade at a price that is the highest (or lowest) price of the day and this price is also the same as the last trade of the day, the alert will show the broker that first executed the trade at the day's high (or low) price, regardless of whether that broker was responsible for the last trade of the day.

(ii)   **"Entry of High Closing Bid or Low Closing Ask"**

This alert identifies small value buy orders that were entered in the last "x" minutes of trading and that increased the best bid to a price higher than the last trade price, with that order being present at the close of the market, thereby establishing the closing price for the day (vice versa for small value sell orders).
This alert captures only unfilled orders and not trades.

27.   By using only these two Alerts to supervise for high closing, a gap is left whereby trades could occur at the end of the day that set the closing price at an uptick. As long as the closing price was not the high price of the day, the trade would not necessarily be identified. Even where the closing price was the high price of the day, if there was an earlier trade during the day at the same high price, the alert would only flag the broker that first executed a trade at the high price, regardless of whether that broker was responsible for the last trade.

28.   Throughout 2009, Scotia iTRADE's compliance staff was not reviewing filled trades as part of their artificial pricing reviews.

iii - Failure to Detect Clients' Trading Activity

29.   The Respondent's failure to ensure the proper implementation of its policies and procedures resulted in a failure to detect and prevent some artificial pricing / high closing transactions in the accounts of two retail clients.

30.   Over the three month period June – October 2009, one client engaged in approximately 60 artificial pricing transactions in three securities; during that same period, a second client engaged in approximately 27 artificial pricing transactions in two securities.

31.   In addition, in 2009 no gatekeeper reports were filed by E*Trade or Scotia iTRADE to IIROC.

III.   MITIGATING FACTORS

32.   For the purpose of this settlement agreement, Staff and the Respondent have agreed as follows:

(i)   Scotia Capital provided its full co-operation at all times during Staff's investigation of this matter: and

(ii)   The breaches that form the subject matter of this settlement agreement are historical in nature and have been corrected by Scotia Capital.

IV. CONCLUSION

33.   Orders entered by order-execution clients that are routed to the order management system of a Participant without the involvement of employees of the Participant present heightened risks to both the integrity of the markets and the Participant through whom the order is routed.

34.   The lack of involvement by employees of the Participant (an investment advisor or trader handling an order) eliminates a significant opportunity to act as a gatekeeper to help prevent and detect contraventions of applicable Requirements.

35.   A Participant must have policies and procedures and compliance testing which addresses the additional risk exposure posed by orders entered directly by clients and routed to a marketplace through its trading system.

36.   Between June 2009 and November 2011 the Respondent lacked adequate policies and procedures or failed to implement those policies and procedures to prevent and detect potential wash trades.

37.   Between June 2009 and December 2010 the Respondent failed to adequately implement its policies and procedures to prevent and detect potential artificial pricing transactions relating to high closings.

38.   As a result of these deficiencies, the Respondent failed to prevent and detect patterns of potentially manipulative trading by two clients.

May 29, 2013

Investment Industry Regulatory Organization of Canada

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SCHEDULE "A"

EXCERPTS FROM THE UNIVERSAL MARKET INTEGRITY RULES

7.1   Trading Supervision Obligations

(1)   Each Participant shall adopt written policies and procedures to be followed by directors, officers, partners and employees of the Participant that are adequate, taking into account the business and affairs of the Participant, to ensure compliance with these Rules and each Policy.

(2)   Prior to the entry of an order on a marketplace by a Participant, the Participant shall comply with:

(a)   applicable regulatory standards with respect to the review, acceptance and approval of orders;

(b)   the policies and procedures adopted in accordance with subsection (1); and

(c)   all requirements of these Rules and each Policy.

(3)   Each Participant shall appoint a head of trading who shall be responsible to supervise the trading activities of the Participant in a marketplace.

(4)   The head of trading together with each person who has authority or supervision over or responsibility to the Participant for an employee of the Participant shall fully and properly supervise such employee as necessary to ensure the compliance of the employee with these Rules and each Policy.

POLICY 7.1 – TRADING SUPERVISION OBLIGATIONS

Part 1 – Responsibility for Supervision and Compliance

For the purposes of Rule 7.1, a Participant shall supervise its employees, directors and officers and, if applicable, partners to ensure that trading in securities on a marketplace (an Exchange, QTRS or ATS) is carried out in compliance with the applicable Requirements (which includes provisions of securities legislation, UMIR, the Trading Rules and the Marketplace Rules of any applicable Exchange or QTRS). An effective supervision system requires a strong overall commitment on the part of the Participant, through its board of directors, to develop and implement a clearly defined set of policies and procedures that are reasonably designed to prevent and detect violations of Requirements. The board of directors of a Participant is responsible for the overall stewardship of the firm with a specific responsibility to supervise the management of the firm. On an ongoing basis, the board of directors must ensure that the principal risks for non-compliance with Requirements have been identified and that appropriate supervision and compliance procedures to manage those risks have been implemented.

Management of the Participant is responsible for ensuring that the supervision system adopted by the Participant is effectively carried out. The head of trading and any other person to whom supervisory responsibility has been delegated must fully and properly supervise all employees under their supervision to ensure their compliance with Requirements. If a supervisor has not followed the supervision procedures adopted by the Participant, the supervisor will have failed to comply with their supervisory obligations under Rule 7.1(4).

When the Market Regulator reviews the supervision system of a Participant (for example, when a violation occurs of Requirements), the Market Regulator will consider whether the supervisory system is reasonably well designed to prevent and detect violations of Requirements and whether the system was followed.

The compliance department is responsible for monitoring and reporting adherence to rules, regulations, requirements, policies and procedures. In doing so, the compliance department must have a compliance monitoring system in place that is reasonably designed to prevent and detect violations. The compliance department must report the results from its monitoring to the Participant's management and, where appropriate, the board of directors, or its equivalent. Management and the board of directors must ensure that the compliance department is adequately funded, staffed and empowered to fulfil these responsibilities.

The obligation to supervise applies whether the order is entered on a marketplace:

*   *by a trader employed by the Participant,*

*   *by an employee of the Participant through an order routing system,*

*   *directly by a client and routed to a marketplace through the trading system of the Participant, or*

*   *by any other means.*

In performing the trading supervision obligations, the Participant will act as a "gatekeeper" to help prevent and detect violations of applicable Requirements.

Where an order is entered on a marketplace without the involvement of a trader (for example by a client with a systems interconnect arrangement in accordance with Policy 2-501 of the Toronto Stock Exchange), the Participant retains responsibility for that order and the supervision policies and procedures should adequately address the additional risk exposure which the Participant may have for orders that are not directly Part 7 – Trading in a Marketplace UMIR 7.1-2 May 26, 2006 handled by staff of the Participant. For example, it may be appropriate for the Participant to sample for compliance testing a higher percentage of orders that have been entered directly by clients than the percentage of orders sampled in other circumstances.

In addition, the "post order entry" compliance testing should recognize that the limited involvement of staff of the Participant in the entry of orders by a direct access client may restrict the ability of the Participant to detect orders that are not in compliance with specific rules. For example, "post order entry" compliance testing may be focused on whether an order entered by a direct access client:

*   *has created an artificial price contrary to Rule 2.2;*

*   *is part of a "wash trade" (in circumstances where the client has more than one account with the*

Participant);

• *is an unmarked short sale (if the trading system of the Participant does not automatically code as "short" any sale of a security not then held in the account of the client); and*

• *has complied with order marking requirements and in particular the requirement to mark an order as from an insider or significant shareholder (unless the trading system of the Participant restricts trading activities in affected securities).*

Part 2 – Minimum Element of a Supervision System

For the purposes of Rule 7.1, a supervision system consists of both policies and procedures aimed at preventing violations from occurring and compliance procedures aimed at detecting whether violations have occurred.

The Market Regulator recognizes that there is no one supervision system that will be appropriate for all Participants. Given the differences among firms in terms of their size, the nature of their business, whether they are engaged in business in more than one location or jurisdiction, the experience and training of its employees and the fact that effective jurisdiction can be achieved in a variety of ways, this Policy does not mandate any particular type or method of supervision of trading activity. Furthermore, compliance with this Policy does not relieve Participants from complying with specific Requirements that may apply in certain circumstances. In particular, Participants are reminded that, in accordance with subsection (2) of Rule 10.1, the entry of orders must comply with the Marketplace Rules on which the order is entered and the Marketplace Rules on which the order is executed. (For example, for Participants that are Participating Organizations of the TSE, reference should be made to the Policy on "Connection of Eligible Clients of Participating Organizations").

Participants must develop and implement supervision and compliance procedures that exceed the elements identified in this Policy where the circumstances warrant. For Part 7 – Trading in a Marketplace UMIR 7.1-3 May 26, 2006 example, previous disciplinary proceedings, warning and caution letters from the Market Regulator or the identification of problems with the supervision system or procedures by the Participant or the Market Regulator may warrant the implementation of more detailed or more frequent supervision and compliance procedures.

Regardless of the circumstances of the Participant, however, every Participant must:

1. *Identify the relevant Requirements, securities laws and other regulatory requirements that apply to the lines of business in which the Participant is engaged (the "Trading Requirements").*

2. *Document the supervision system by preparing a written policies and procedures manual. The manual must be accessible to all relevant employees. The manual must be kept current and Participants are advised to maintain a historical copy.*

3. *Ensure that employees responsible for trading in securities are appropriately registered and trained and that they are knowledgeable about the Trading Requirements that apply to their responsibilities. Persons with supervisory responsibility must ensure that employees under their supervision are appropriately registered and trained. The Participant should provide a continuing training and education program to ensure that its employees remain informed of and knowledgeable about changes to the rules and regulations that apply to their responsibilities.*

4. *Designate individuals responsible for supervision and compliance. The compliance function must be conducted by persons other than those who supervised the trading activity.*

5. *Develop and implement supervision and compliance procedures that are appropriate for the Participant's size, lines of business in which it is engaged and whether the Participant carries on business in more than one location or jurisdiction.*

6. *Identify the steps the Participant will take when a violation or possible violation of a Requirement or any regulatory requirement has been identified. These steps shall include the procedure for the reporting of the violation or possible violation to the Market Regulator if required by Rule 10.16. If there has been a violation or possible violation of a Requirement identify the steps that would be*

taken by the Participant to determine if:

•   *additional supervision should be instituted for the employee, the account or the business line that may have been involved with the violation or possible violation of a Requirement; and*

•   *the written policies and procedures that have been adopted by the Participant should be amended to reduce the possibility of a future violation of the Requirement.*

7.   *Review the supervision system at least once per year to ensure it continues to be reasonably designed to prevent and detect violations of Requirements. More frequent reviews may be required if past reviews have detected problems with supervision and compliance. Results of these reviews must be maintained for at least five years.*

8.   *Maintain the results of all compliance reviews for at least five years.*

9.   *Report to the board of directors of the Participant or, if applicable, the partners, a summary of the compliance reviews and the results of the supervision system review. These reports must be made at least annually. If the Market Regulator or the Participant has identified significant issues concerning the supervision system or compliance procedures, the board of directors or, if applicable, the partners, must be advised immediately.*

Part 3 - Minimum Compliance Procedures for Trading on a Marketplace

A Participant must develop and implement compliance procedures for trading in securities on a marketplace that are appropriate for its size, the nature of its business and whether it carries on business in more than one location or jurisdiction. Such procedures should be developed having regard to the training and experience of its employees and whether the firm or its employees have been previously disciplined or warned by the Market Regulator concerning the violations of the Requirements.

In developing compliance procedures, Participants must identify any exception reports, trading data and/or other documents to be reviewed. In appropriate cases, relevant information that cannot be obtained or generated by the Participant should be sought from sources outside the firm including from the Market Regulator.

The following table identifies minimum compliance procedures for monitoring trading in securities on a marketplace that must be implemented by a Participant. The compliance procedures and the Rules identified below are not intended to be an exhaustive list of the Rules and procedures that must be complied with in every case. Participants are encouraged to develop compliance procedures in relation to all the Rules that apply to their business activities.

The Market Regulator recognizes that the requirements identified in the following table may be capable of being performed in different ways. For example, one Participant may develop an automated exception report and another may rely on a physical review of the relevant documents. The Market Regulator recognizes that either approach may comply with this Policy provided the procedure used is reasonably designed to detect violations of the relevant Rule. The information sources identified in the following table are therefore merely indicative of the types of information sources that may be used.

Minimum Compliance Procedures for Trading Supervision

Rules and Policies	*Compliance Review Procedures*	*Potential Information Sources*	*Frequency and Sample Size*

Synchronization of Clocks *Rule 10.14*	• confirm accuracy of clocks and computer network times • remove unused or non-functional machines	• *time clocks* • *Trading Terminal system time* • *OMS system time*	• *Daily*
Audit Trail Requirements *Rule 10.11*	• ensure the presence of: - *time stamp* - *quantity* - *price (if limit order)* - *security name or symbol* - *identity of trader (initial or sales code) -client name or account number-special instructions from any client* - *information required by audit trail requirements* • for CFOd orders, ensure the presence of second time stamp and clear quantity or price changes	• *order tickets* • *the Diary List*	• *quarterly* • *check 25 original client tickets selected randomly over the quarter*
Electronic Records *Rule 10.11*	• *verify that electronic order information is:* *-being stored* *-retrievable* *-accurate*	• *firm and service bureau systems*	• *annually*

Manipulative and Deceptive Trading *Rule 2.2(1), (2)* *Policy 2.2*	• *review trading activity for:* *-wash trading* *-unrelated accounts that may display a pattern of crossing securities* *-off-market transactions which require execution on a Marketplace*	• *order tickets* • *the diary list* • *new client application forms* • *monthly statements*	• *quarterly* • *review sampling period should extend over several days*
Establishing Artificial Prices *Rule 2.2(1), (3)* *Policy 2.2*	• *review tick setting trades entered at or near close* • *look for specific account trading patterns in tick setting trades* • *review accounts for motivation to influence the price* • *review separately, tick setting trades by Market on Close (MOC) or index related orders*	• *order tickets* • *the diary list* • *Equity History Report (available on TSE market data website for TSE-listed securities)* • *closing report from Market Regulator (delivered to Participants)* • *new client application forms*	• *monthly* • *emphasis on trades at the end of month, quarter or year (for trades not on MOC or index related)* • *for MOC or index related orders, check for reasonable price movement*
Grey or Watch List *Rule 2.2*	• *review for any trading of Grey or Watch List issues done by proprietary or employee accounts*	• *order tickets* • *the diary list* • *trading blotters* • *firm Grey List or Watch List* • *monthly statements*	• *daily*
Restricted List *Rule 2.2* *Rule 7.8* *Rule 7.9*	• *review for any trading of restricted list issues done by proprietary or employee accounts*	• *order tickets* • *the diary list* • *trading blotters* • *firm Restricted List* • *monthly statements*	• *daily*

Frontrunning *Rule 4.1*	• review trading activity of proprietary and employee accounts prior to: - large client orders - transactions that would impact the market	• order tickets • the diary list • equity history report	• quarterly • sample period should extend over several days
Sales from Control Blocks *Securities legislation incorporated by Rule 10.1*	• review all known sales from control blocks to ensure regulatory requirements have been met • review large trades to determine if they are undisclosed sales from control block	• order tickets • trading blotter • new client application form • OSC bulletin • Exchange company bulletins	• as required • sample trades over 250,000 shares
Order Handling Rules *Rule 5.1* *Rule 5.3* *Rule 6.3* *Rule 8.1*	• review client-principal trades of 50 standard trading units or less for compliance with order exposure and client principal transactions rules • verify that orders of 50 standard trading units or less are not arbitrarily withheld from the market	• order tickets • equity history report • trading blotters • the diary list	• quarterly • sample, specifically: -trader managed orders of 50 standard trading units
Order Markers *Rule 6.2* *Marketplace Rules incorporated by Rule 10.1 (for marketplaces on which the order is entered or executed)*	• verify that appropriate client, employee, and proprietary trade markers are being employed • ensure that client orders are not being improperly entered with pro markers • verify that appropriate order designations are included on orders	• order tickets • trading blotters • the diary list	• quarterly • samples should include one full day of trading for orders not entered through the OMS system
Trade Disclosures *Securities legislation incorporated by Rule 10.1*	• verify appropriate trade disclosures are made on client confirmations -principal -average price -related Issuer	• trading blotters • client confirmations • the diary list • order tickets	• quarterly • sample should include non-OMS trades

Normal Course Issuer Bids	• review NCIBs for:	• order tickets	• quarterly
Marketplace Rules (e.g. Rule 6-501 and		• the diary list	
Policy 6-501 of TSE and Policy 5.6 of CDNX)	-maximum stock purchase limits of 5% in 1 year or 2% in 30 days are observed	• trading blotters	
		• new client application form	
	-purchases for NCIBs are not occurring while a sale from control is being made		
	-purchases are not made on upticks		
	-trade reporting to Exchange (if the firm reports on behalf of issuer)		

Part 4 – Specific Procedures Respecting Client Priority and Best Execution

Participants must have written compliance procedures reasonably designed to ensure that their trading does not violate Rule 5.3 or 5.1. At a minimum, the written compliance procedures must address employee education and post-trade monitoring.

The purpose of the Participant's compliance procedures is to ensure that pro traders do not knowingly trade ahead of client orders. This would occur if a client order is withheld from entry into the market and a person with knowledge of that client order enters another order that will trade ahead of it. Doing so could take a trading opportunity away from the first client. Withholding an order for normal review and order handling is allowed under Rules 5.3 and 5.1, as this is done to ensure that the client gets a good execution. To ensure that the Participants' written compliance procedures are effective they must address the potential problem situations where trading opportunities may be taken away from clients.

Potential Problem Situations

Listed below are some of the potential problem situations where trading opportunities may be taken away from clients.

1. Retail brokers or their assistants withholding a client order to take a trading opportunity away from that client.

2. Others in a brokerage office, such as wire operators, inadvertently withholding a client order, taking a trading opportunity away from that client.

3. Agency traders withholding a client order to allow others to take a trading opportunity away from that client.

4. Proprietary traders using knowledge of a client order to take a trading opportunity away from that client.

5. Traders using their personal accounts to take a trading opportunity away from a client.

Written Compliance Procedures

It is necessary to address in the written compliance procedures the potential problem situations that are applicable to the Participant. Should there be a change in the Participant's operations where new potential problem situations arise then these would have to be addressed in the procedures. At a minimum, the written compliance procedures for employee education and post-trade monitoring must include the following points.

Education

• Employees must know the Rules and understand their obligation for client priority and best execution,

particularly in a multiple market environment.

• *Participants must ensure that all employees involved with the order handling process know that client orders must be entered into the market before non-client and proprietary orders, when they are received at the same time.*

• *Participants must train employees to handle particular trading situations that arise, such as, client orders spread over the day, and trading along with client orders.*

Post-Trade Monitoring Procedures

• *All brokers' trading must be monitored as required by Rule 7.1.*

• *Complaints from clients and Registered Representatives concerning potential violations of the rule must be documented and followed-up.*

• *All traders' personal accounts and those related to them, must be monitored daily to ensure no apparent violations of client priority occurred.*

• *At least once a month, a sample of proprietary inventory trades must be compared with contemporaneous client orders.*

• *In reviewing proprietary inventory trades, Participants must address both client orders entered into order management systems and manually handled orders, such as those from institutional clients.*

• *The review of proprietary inventory trades must be of a sample size that sufficiently reflects the trading activity of the Participant.*

• *Potential problems found during these reviews must be examined to determine if an actual violation of Rule 5.3 or 5.1 occurred. The Participant must retain documentation of these potential problems and examinations.*

• *When a violation is found, the Participant must take the necessary steps to correct the problem.*

Documentation

• *The procedures must specify who will conduct the monitoring.*

• *The procedures must specify what information sources will be used.*

• *The procedures must specify who will receive reports of the results.*

• *Records of these reviews must be maintained for five years.*

• *The Participant must annually review its procedures.*

Part 5 – Specific Procedures Respecting Manipulative and Deceptive Activities and Reporting and Gatekeeper Obligations

Each Participant must develop and implement compliance procedures that are reasonably well designed to ensure that orders entered on a marketplace by or through a Participant are not part of a manipulative or deceptive method, act or practice nor an attempt to create an artificial price or a false or misleading appearance of trading activity or interest in the purchase or sale of a security. The minimum compliance procedures for trading supervision in connection with Rule 2.2 and Policy 2.2 are set out in the table to Part 3 of this Policy.

In particular, the procedures must address:

• *the steps to be undertaken to determine whether or not a person entering an order is:*

 o *an insider,*

 o *an associate of an insider, and*

 o *part of or an associate of a promotional group or other group with an interest in effecting an*

artificial price, either for banking and margin purposes, for purposes of effecting a distribution of the securities of the issuer or for any other improper purpose;

• *the steps to be taken to monitor the trading activity of any person who has multiple accounts with the Participant including other accounts in which the person has an interest or over which the person has direction or control;*

• *those circumstances when the Participant is unable to verify certain information (such as the beneficial ownership of the account on behalf of which the order is entered, unless that information is required by applicable regulatory requirements);*

• *the fact that orders which are intended to or which effect an artificial price are more likely to appear at the end of a month, quarter or year or on the date of the expiry of options where the underlying interest is a listed security; and*

• *the fact that orders which are intended to or which effect an artificial price or a false or misleading appearance of trading activity or investor interest are more likely to involve securities with limited liquidity.*

A Participant will be able to rely on information contained on a "New Client Application Form" or similar know-your-client record maintained in accordance with requirements of securities legislation or a self-regulatory entity provided such information has been reviewed periodically in accordance with such requirements and any additional practices of the Participant.

While a Participant cannot be expected to know the details of trading activity conducted by a client through another dealer, nonetheless, a Participant that provides advice to a client on the suitability of investments should have an understanding of the financial position and assets of the client and this understanding would include general knowledge of the holdings by the client at other dealers or directly in the name of the client. The compliance procedures of the Participant should allow the Participant to take into consideration, as part of its compliance monitoring, information which the Participant has collected respecting accounts at other dealers as part of the completion and periodic updating of the "New Client Application Form".