

Re Interactive Brokers Canada

IN THE MATTER OF:

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

and

The Universal Market Integrity Rules

and

Interactive Brokers Canada Inc.

2013 IIROC 45

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

Heard: July 16, 2013 in Montréal

Decision: July 25, 2013

Hearing Panel

Robert Monette (Chair), Guy L. Jolicoeur, Normand Durette

Appearances

Me Sébastien Tisserand, Counsel for IIROC

Me Julie Loranger, Counsel for the Respondent

DECISION ON SETTLEMENT, WITH REASONS

¶ 1 At a hearing held on July 8, 2013, the Hearing Panel heard the pleadings of the legal counsels for both parties who were requesting the approval of the Settlement Agreement¹ concluded between the parties on May 28, 2013.

¶ 2 This request for approval is pursuant to the terms and conditions stated in the policy adopted by virtue of Part 10.8 of the Universal Market Integrity Rules (UMIR) and is submitted in accordance with part 3.4 of the aforesaid Policy 10.8.

¶ 3 After hearing arguments by the legal counsel for both parties and examining the documentation in the file, the Hearing Panel issued an order to approve the Settlement Agreement, while reserving its right to file reasons at a later date.

¶ 4 Before proceeding with the discussion and reasons, the Hearing Panel will summarize briefly the facts described at the hearing and in the Statement of Allegations.

¹ The Settlement Agreement and Statement of Allegations are appended to this decision and are deemed to be an integral part hereof.

SETTLEMENT AGREEMENT

- ¶ 5 The Respondent is registered as an investment dealer and is a Participant under UMIR.
- ¶ 6 The Respondent admits to the following contravention:
- Between November 2007 and April 2008, it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1.
- ¶ 7 The Respondent acknowledges that it did not adopt an effective supervision system that would enable it to prevent and detect violations of the securities legislation, more particularly in respect of certain trading activities and orders entered and routed directly by one of its clients.
- ¶ 8 More specifically, as described in the Statement of Allegations, Respondent failed to prevent manipulative trading activities by a client who entered a large number of “closing trades on an up-tick” on the stock COV in order to avoid a consequent margin call.
- ¶ 9 The client’s manipulative trading activities occurred more than 100 times during the material period.
- ¶ 10 Following a notice from Market Regulation Services Inc., Respondent intervened with the client without success, although the client did admit to the allegations in a settlement agreement in 2011.
- ¶ 11 The terms of settlement agreed to between the parties are:
- a fine of \$50,000 payable to IIROC, and
 - costs in the amount of \$10,000, payable to IIROC.

DISCUSSION

- ¶ 12 The role of a hearing panel in the context of a settlement hearing is clear².
- ¶ 13 The Hearing Panel must not substitute its own view for that of the parties, but must strictly ensure that the settlement is not unreasonable and that the sanctions meet the objectives sought by the disciplinary rules, notably the protection of the public and of the reputation of the securities industry.
- ¶ 14 The Disciplinary Sanction Guidelines provide a foundation for the Hearing Panel to exercise its discretionary role. In addition, since every case is different, the Hearing Panel must also consider the specific facts, the aggravating and mitigating factors connected with a case.
- ¶ 15 In the matter before us, the contravention concerns a failure to comply with its trading supervision obligation; for this contravention, the guidelines authorize the Hearing Panel to consider a substantial fine, up to \$1 million.
- ¶ 16 The parties each submitted a series of mitigating factors to the Hearing Panel, of which the following are noteworthy.
- ¶ 17 There has been no evidence of any significant economic loss or illicit profit being made.
- ¶ 18 Respondent admitted its liability and cooperated fully in the investigation by Staff of IIROC.
- ¶ 19 Respondent retained the services of an expert in order to review its internal supervision procedures and develop new screening policies that will more easily detect manipulative and deceptive trading activities.
- ¶ 20 Corrective measures were therefore taken by the Respondent and were presented to IIROC.
- ¶ 21 The Hearing Panel also studied the decisions cited by the parties³.
- ¶ 22 Of this list, the matter of *Standard Securities Capital Corporation* DN 2006-008 is the most relevant even though the misconduct appears to have gone on for a longer period. The size of the companies being

² *Re Milewski*, (1999) IDACD 17, *Re BMO Nesbitt Burns*, (2010) 39

³ *Re BMO Nesbitt Burns* (2012) IIROC 21; *Re Credit Suisse Securities* (2011) IIROC 10

comparable, the respective sanctions are more easily evaluated⁴.

¶ 23 The Hearing Panel is satisfied that the sanctions recommended in this settlement fall within the range of appropriate sanctions imposed in a similar matter, taking into account of course the specific facts in each case.

CONCLUSION

¶ 24 The Hearing Panel acknowledges that the integrity of the market must be protected.

¶ 25 Respondent has corrected the shortcomings in its trading supervision procedures and the penalty imposed on it takes into account the conduct in question and supports deterrence.

¶ 26 Keep in mind that the Hearing Panel must not substitute its own discretion to perfect the parties' discussions in reaching their settlement agreement.

¶ 27 The settlement was negotiated by the parties who were accompanied by counsel and they have declared themselves satisfied with it.

¶ 28 The agreement reached is not unreasonable.

¶ 29 Consequently, the Hearing Panel confirms its acceptance of the Settlement Agreement concluded between the parties.

FOR THESE REASONS TO THE DECISION RENDERED ON JULY 8, 2013;

Montreal, this 30th day of July 2013

Robert Monette, Chair

Guy L. Jolicoeur, Panel Member

Normand Durette, Panel Member

OFFER OF SETTLEMENT

1. On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada and Market Regulation Services Inc. (RS). Pursuant to the *Administrative and Regulatory Services Agreement* between RS and IIROC, effective June 1, 2008, RS has retained IIROC to provide services for RS to carry out its regulatory functions.
2. The Enforcement Department Staff (Staff) of the Investment Industry Regulatory Organization of Canada (IIROC) has conducted an investigation (the Investigation) into the conduct of Interactive Brokers Canada Inc. (the Respondent).
3. 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).
4. 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 the approval by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1 (the Hearing Panel).
5. 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.
6. The Respondent consents to be subject to the jurisdiction of IIROC and its relevant disciplinary process and rules in relation to this matter.

⁴ *Re Questrade & Eydelman* (2013) IIROC 25

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

A. AGREEMENT AS TO REQUIREMENTS CONTRAVENED

8. The Respondent agrees that Between November 2007 and April 2008, it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1

B. ADMITTED FACTS

9. 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.

C. DISPOSITION

10. For the contraventions in paragraph 8 above, Staff and the Respondent have agreed upon disposition as follows:

- (i) a fine of \$50,000.00 payable by the Respondent to IIROC; and
- (ii) Costs of \$10,000.00 payable by the Respondent to IIROC.

11. If this Settlement Agreement is accepted by a Hearing Panel, the Respondent agrees to pay the amounts referred to in paragraph 10 within 30 days of such acceptance.

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

12. The Respondent shall have until the close of business on Friday May 29, 2013 to accept the Offer of Settlement and serve an executed copy thereof on Staff.

13. This Settlement Agreement shall be presented to a Hearing Panel at a public 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.

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

15. 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 Respondent and IIROC will publish a summary of the Requirements contravened, the facts, and the disposition agreed upon in the Settlement Agreement.

16. 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.

17. The Respondent agrees that, in the event he fails to comply with any of the terms of the Settlement Agreement, IIROC may enforce this settlement in any manner it deems appropriate and may, without limiting the generality of the foregoing, suspend the Respondent's access to marketplaces regulated by IIROC until IIROC determines that the Respondent is in full compliance with all terms of the Settlement Agreement.

18. The Respondent agrees that neither he, nor anyone on his 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 Montréal, Québec on the 28th day of May 2013.

(s) Jean-François Bernier

NAME: JEAN-FRANÇOIS BERNIER

TITLE: MANAGING DIRECTOR

FOR: INTERACTIVE BROKERS CANADA INC.

DATED at Montréal, Québec on the May 28th, 2013.

(s) Carmen Crépin

Carmen Crépin

Vice President, Québec

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

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

INTERACTIVE BROKERS CANADA INC.

STATEMENT OF ALLEGATIONS

I. REQUIREMENTS CONTRAVENED

1. It is alleged that Interactive Brokers Canada Inc. (“Interactive Brokers”) has committed the following contravention:

- (i) Between November 2007 and April 2008 (the “Relevant Period”), it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1.

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

II. RELEVANT FACTS AND CONCLUSIONS

Overview

3. During the Relevant Period, Interactive Brokers failed to take adequate steps to prevent and detect manipulative and deceptive trading by a retail client in the shares of Covalon Technologies Inc., listed on the TSX Venture Exchange (“TSXV”) under the trading symbol “COV”. The client frequently entered orders (the majority for 100 shares) at or near the close of trading that up-ticked the prevailing bid.

4. In a settlement agreement with the Ontario Securities Commission, the client admitted that in the period

between November 2007 and April 2008, he engaged in trading in 10 different accounts held at 5 different brokerage firms in which he intended to or did raise or maintain the price for shares of COV to influence the assessment of the COV shares' value for margin purposes.

5. During the Relevant Period, Interactive Brokers lacked adequate policies and procedures for reviewing potentially manipulative late day order entry that could affect the closing bid or offer which led Interactive brokers to fail to prevent and detect the client's pattern of manipulative late day order entry in the shares of COV.
6. A Participant must develop and implement procedures that are adequate, taking into account the business and affairs of the Participant, to ensure compliance with UMIR and each Policy, 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.

Background

7. Interactive Brokers is registered as an investment dealer and is a Participant under UMIR.
8. Interactive Brokers is a discount broker providing direct access to retail clients for the online trading of securities. Interactive Brokers provides only an order-execution service, as defined in IIROC Dealer Member Rule 3200 (previously IDA Policy 9). It does not provide investment advice or make recommendations to clients.
9. Orders are entered directly by clients and routed to a marketplace through Interactive Brokers' trading system without the involvement of trade desk personnel. However, all Interactive Brokers client orders are pre-trade credit checked to systematically limit the financial exposure of Interactive Brokers to prevent orders exceeding pre-determined credit thresholds for Interactive Brokers and the clients.
10. 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.
11. The client held three accounts at Interactive Brokers: one in his name and two in the name of a company, a sole proprietorship owned by him.
12. Covalon Technologies Inc. is a medical bio-systems company which has a relatively illiquid stock (COV) although it was ranked as a "TSX Venture 50" company and as one of the top 10 technology and life issuers of the TSXV.

Manipulative and deceptive trading in COV

13. During the Relevant Period, the client frequently entered on 73 times out of approximately 110 trading days, multiple orders at or near the close of trading that up-ticked the prevailing bid.
14. The client most often entered multiple orders during the last 15 minutes of trading, the majority of which were entered after 15:59. Nearly all of the orders were for one Standard Trading Unit (100 shares). On the majority of the trading days during this period, the client did not enter any buy orders until at or near the close of trading.
15. The frequency, size and timing of the orders entered by the client in an illiquid security were signs that his intention was not to purchase shares but to create or attempt to create an artificial price.
16. The TSXV daily closing report for March 10, 2008 received by Interactive Brokers showed that the closing trade on an up-tick at 15:59:59 was entered from Interactive Brokers. The client was responsible for this closing trade.
17. Further to this report, Interactive Brokers reviewed the client's executed trades in his personal account and noted on March 12, 2008 that there was "no pattern" of end of day trading activities.
18. Interactive Brokers also reviewed executed trades in the client's personal account and noted that between

February 27 and March 11, 2008, there was daily buying and selling of COV by the client in volumes between 100 and 1,000 shares. Three of the twenty trades (both buys and sells) executed by the client during this period were purchases for one Standard Trading Unit executed within the last five seconds before the close of trading.

19. Between February 27, 2008 and March 11, 2008, the client, through his personal account, set the closing bid on 7 trading days, including March 10, 2008.
20. RS inquired about trading in COV on March 18, 2008, alerting the firm to the possibility that trading in COV through Interactive Brokers could potentially be part of a greater manipulative scheme involving accounts at other Participants.
21. On March 24, 2008, Interactive Brokers sent the client an email warning that the trading in COV was potentially manipulative. The client did not respond to the email, ceased trading in his personal account, and subsequently closed the account. Interactive Brokers did not conduct any further review of orders or trades that had occurred in this account.
22. Between March 18 and April 28, 2008, the client continued to engage in the manipulative trading described above in one of his corporate accounts held at Interactive Brokers, setting the closing bid on 19 trading days.
23. In or about September 2011, the client entered into a settlement agreement with the Ontario Securities Commission (“OSC”) which was later approved by the OSC.
24. In the settlement agreement, the client admitted that between November 2007 and April 2008, he engaged in trading in which he intended to or did raise or maintain the price for shares of COV in 10 different accounts held at 5 different brokerage firms to influence the assessment of the COV shares’ value for margin purposes.
25. The client also admitted that the trading was intended to impact the margin requirements in the client’s own accounts and potentially in the accounts of others held at brokerage firms that based their margin policies on the previous day’s closing bid price.
26. Interactive Brokers had failed to identify these manipulative end of the day trading activities in the client’s accounts namely because it relied on trade exception reports.

Deficiencies in preventing and detecting manipulative and deceptive trading by the client

27. During the Relevant Period, Interactive Brokers’ policies and procedures addressed testing for manipulative and deceptive activities and establishing artificial prices. However, Interactive Brokers’ procedures did not address the post-trade monitoring and testing of orders entered on a marketplace for the creation of an artificial price contrary to UMIR based on its internal analysis of its size, business and affairs.
28. Therefore, Interactive Brokers’ post-trade review for artificial pricing was solely conducted on a monthly and quarterly basis and focused on tick-setting trades occurring in the last three minutes of trading prior to the close.
29. Market Integrity Notice 2007-011 issued on April 20, 2007, provided guidance on the compliance requirements for Participants providing order-execution services for orders of qualified clients. The Notice provided that since such orders would in most circumstances be subject to limited supervision prior to being routed to a marketplace, the Participant’s procedures should at a minimum address the procedures for testing for orders that have been entered and trades that have been executed for the creation of an artificial price contrary to UMIR.
30. Interactive Brokers had inadequate procedures for post-trade monitoring and review of tick-setting trades near the close until December 2007. Before this time, its procedures included only a review of trades executed on the TSX.

31. In late August 2007, Interactive Brokers was advised by RS to review samples of unfilled orders entered late in the day for artificial pricing, pre-open cancellations for potential spoofing, and trades executed for high and low closing but the required changes to address the issue of post-trade monitoring and testing of orders were implemented only after the relevant period.
32. In addition, the client hold at Interactive Broker two corporate accounts for a company, sole proprietorship of the client but Interactive Brokers failed to connect the manipulative activities by the client in his personal and his corporate accounts, which also contributed to the failure to detect the client's manipulative and deceptive trading, specifically during the period of March and April 2008.

Mitigating Factors

33. Interactive Brokers' margin policies and procedures have at all times provided for real-time margining of client positions as opposed to margining based on the previous trading session's closing bid or closing price. Interactive Brokers' margin policies and procedures did not (and still do not) provide or allow for margin on any TSXV securities, including COV shares.
34. Interactive Brokers' credit policies have at all times provided that all client orders are credit checked on a pre-trade basis to systematically limit the financial exposure of Interactive Brokers and to prevent orders exceeding pre-determined credit thresholds for Interactive Brokers and its clients.
35. During the Relevant Period, when the client was submitting improving bids from his account at Interactive Brokers, Interactive Brokers did not know the details of the trading activity conducted by the client through other dealers where the client tried to influence the price of the COV shares for margin purposes.
36. Interactive Brokers proceeded to revise and implement new policies and procedures with respect to late day order entry.
37. Interactive Brokers was cooperative and responsive during the course of the investigation.
38. Interactive Brokers has retained a consultant to review its policies and procedures pursuant to UMIR 7.1 and Policy 7.1 and UMIR 2.2 with respect to artificial pricing, wash sales, spoofing and order layering. Interactive Brokers has provided the consultant's report to IIROC. IIROC is satisfied with the review conducted by the consultant. Interactive Brokers is in the process of implementing the recommendations and will be amending its policies and procedures accordingly.

CONCLUSION

39. A Participant must have policies and procedures that are adequate in light of its business and affairs 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.
40. During the Relevant Period, Interactive Brokers lacked procedures to address the post-trade monitoring and testing of orders entered on a marketplace for the creation of an artificial price and to monitor the late day order entry activity of clients with multiple accounts.
41. As a result of this lack of adequate procedures, Interactive Brokers failed to prevent and detect a pattern of manipulative late day order entry in the shares of COV by one of its retail clients.

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 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 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 provisions of UMIR 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 provision of UMIR. 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

UMIR and Policies	Compliance Review Procedures	Potential Information Sources	Frequency and Sample Size
<p><i>Synchronization of Clocks</i></p> <p><i>Rule 10.14</i></p>	<ul style="list-style-type: none"> • confirm accuracy of clocks and computer network times • remove unused or non-functional machines 	<ul style="list-style-type: none"> • time clocks • Trading Terminal system time • OMS system time 	<ul style="list-style-type: none"> • Daily
<p><i>Audit Trail Requirements</i></p> <p><i>Rule 10.11</i></p>	<ul style="list-style-type: none"> • ensure the presence of: <ul style="list-style-type: none"> -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 	<ul style="list-style-type: none"> • order tickets • the Diary List 	<ul style="list-style-type: none"> • quarterly • check 25 original client tickets selected randomly over the quarter
<p><i>Electronic Records</i></p> <p><i>Rule 10.11</i></p>	<ul style="list-style-type: none"> • verify that electronic order information is: <ul style="list-style-type: none"> -being stored -retrievable -accurate 	<ul style="list-style-type: none"> • firm and service bureau systems 	<ul style="list-style-type: none"> • annually
<p><i>Manipulative and Deceptive Trading</i></p> <p><i>Rule 2.2(1), (2)</i></p> <p><i>Policy 2.2</i></p>	<ul style="list-style-type: none"> • review trading activity for: <ul style="list-style-type: none"> -wash trading -unrelated accounts that may display a pattern of crossing securities -off-market transactions which require execution on a Marketplace 	<ul style="list-style-type: none"> • order tickets • the diary list • new client application forms • monthly statements 	<ul style="list-style-type: none"> • quarterly • review sampling period should extend over several days
<p><i>Establishing Artificial Prices</i></p> <p><i>Rule 2.2(1), (3)</i></p> <p><i>Policy 2.2</i></p>	<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • order tickets • the diary list • Equity History Report (available on TSE market data website for TSE-listed securities) 	<ul style="list-style-type: none"> • monthly • emphasis on trades at the end of month, quarter or year (for trades not on MOC or index related) • for MOC or index

<i>UMIR and Policies</i>	<i>Compliance Review Procedures</i>	<i>Potential Information Sources</i>	<i>Frequency and Sample Size</i>
	<i>Market on Close (MOC) or index related orders</i>	<ul style="list-style-type: none"> • <i>closing report from Market Regulator (delivered to Participants)</i> • <i>new client application forms</i> 	<i>related orders, check for reasonable price movement</i>
<i>Grey or Watch List</i> <i>Rule 2.2</i>	<ul style="list-style-type: none"> • <i>review for any trading of Grey or Watch List issues done by proprietary or employee accounts</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>the diary list</i> • <i>trading blotters</i> • <i>firm Grey List or Watch List</i> • <i>monthly statements</i> 	<ul style="list-style-type: none"> • <i>daily</i>
<i>Restricted List</i> <i>Rule 2.2</i> <i>Rule 7.8</i> <i>Rule 7.9</i>	<ul style="list-style-type: none"> • <i>review for any trading of restricted list issues done by proprietary or employee accounts</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>the diary list</i> • <i>trading blotters</i> • <i>firm Restricted List</i> • <i>monthly statements</i> 	<ul style="list-style-type: none"> • <i>daily</i>
<i>Frontrunning</i> <i>Rule 4.1</i>	<ul style="list-style-type: none"> • <i>review trading activity of proprietary and employee accounts prior to:</i> <li style="padding-left: 20px;"><i>-large client orders</i> <li style="padding-left: 20px;"><i>-transactions that would impact the market</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>the diary list</i> • <i>equity history report</i> 	<ul style="list-style-type: none"> • <i>quarterly</i> • <i>sample period should extend over several days</i>
<i>Sales from Control Blocks</i> <i>Securities legislation incorporated by Rule 10.1</i>	<ul style="list-style-type: none"> • <i>review all known sales from control blocks to ensure regulatory requirements have been met</i> • <i>review large trades to determine if they are undisclosed sales from control block</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>trading blotter</i> • <i>new client application form</i> • <i>OSC bulletin</i> • <i>Exchange company bulletins</i> 	<ul style="list-style-type: none"> • <i>as required</i> • <i>sample trades over 250,000 shares</i>
<i>Order Handling Rules</i> <i>Rule 5.1</i> <i>Rule 5.3</i> <i>Rule 6.3</i> <i>Rule 8.1</i>	<ul style="list-style-type: none"> • <i>review client-principal trades of 50 standard trading units or less for compliance with order exposure and client principal transactions rules</i> • <i>verify that orders of 50 standard trading units or less are not arbitrarily withheld from the market</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>equity history report</i> • <i>trading blotters</i> • <i>the diary list</i> 	<ul style="list-style-type: none"> • <i>quarterly</i> • <i>sample, specifically:</i> <li style="padding-left: 20px;"><i>-trader managed orders of 50 standard trading units</i>
<i>Order Markers</i> <i>Rule 6.2</i>	<ul style="list-style-type: none"> • <i>verify that appropriate client, employee, and proprietary trade markers are being employed</i> 	<ul style="list-style-type: none"> • <i>order tickets</i> • <i>trading blotters</i> • <i>the diary list</i> 	<ul style="list-style-type: none"> • <i>quarterly</i> • <i>samples should include one full</i>

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. A Participant must have policies and procedures in place to “diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under the circumstances”. The policies and procedures must:

- *outline a process designed to achieve best execution;*
- *require the Participant, subject to compliance by the Participant with any Requirement, to follow the instructions of the client and to consider the investment objectives of the client;*
- *include the process for taking into account order and trade information from all appropriate marketplaces and foreign organized regulated markets; and*
- *describe how the Participant evaluates whether “best execution” was obtained.*

In order to demonstrate that a Participant has “diligently pursued” the best execution of a particular client order, the Participant must be able to demonstrate that it has abided by the policies and procedures. 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”.

Part 6 – Specific Provisions Respecting the Best Price Obligation

Each Participant must adopt written policies and procedures that are adequate, taking into account the business and affairs of the Participant, to ensure compliance with the “best price obligation”. The policies and procedures must set out the steps or process to be followed by the Participant that constitute the “reasonable efforts” that the Participant will take to ensure that orders receive the “best price” when executed on a marketplace. These policies and procedures must address the factors which the Participant will take into account:

- initially in determining whether order on a protected marketplace need to be considered; and*
- on an on-going basis once the Participant has determined that orders on a particular protected marketplace should be considered.*

The policies and procedures adopted by the Participant:

- must take into account the factors and other requirements enumerated in Policy 5.2; and*
- may take into account other additional factors which are reasonable and of particular importance to the type of business conducted by the Participant provided any additional factors identified by a Participant must not be inconsistent with the requirements set out in Policy 5.2 or the provisions of the Marketplace Operation Instrument.*

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