

| Market Integrity Notice |

Guidance

April 20, 2007

No. 2007-011

Suggested Routing

- Trading
- Legal and Compliance

Key Topics

- Gatekeeper Obligation
- Order-Execution Services
- Trading Supervision Obligations

UMIR Provisions Referenced

- Rule 2.2 - Manipulative and Deceptive Activities
- Rule 6.2 – Designations and Identifiers
- Policy 7.1 – Trading Supervision Obligations

Market Integrity Notices Referenced

- Market Integrity Notice 2002-012 – *Regulation ID Order Markers and Order Inhibition During Regulatory Halts & Suspensions* (July 9, 2002)
- Market Integrity Notice 2005-011 – *Notice of Amendment Approval – Provisions Respecting Manipulative and Deceptive Activities* (April 1, 2005)
- Market Integrity Notice 2007-009 - *Request for Comments – Provisions Respecting Access to Marketplaces* (April 20, 2007)
- Market Integrity Notice 2007-010 - *Guidance - Compliance Requirements for Dealer-Sponsored Access Trading* (April 20, 2007)

COMPLIANCE REQUIREMENTS FOR ORDER-EXECUTION SERVICES

Summary

This Market Integrity Notice provides guidance on the compliance requirements under the Universal Market Integrity Rules for a Participant providing order-execution services for orders of qualified clients.

Questions / Further Information

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COMPLIANCE REQUIREMENTS FOR ORDER-EXECUTION SERVICES

Summary

This Market Integrity Notice provides guidance on the compliance requirements under the Universal Market Integrity Rules (“UMIR”) for a Participant providing order-execution services for orders of qualified clients.

Background

Market Regulation Services Inc. (“RS”) published Market Integrity Notice 2005-011 – *Notice of Amendment Approval - Provisions Respecting Manipulative and Deceptive Activities* (April 1, 2005), which made effective a number of amendments to UMIR, including an amendment to Policy 7.1 to clarify that Participants have supervisory and compliance responsibility for all client orders irrespective of the source of the order or the means by which the order is transmitted to a marketplace. The amendment to Policy 7.1 highlighted the need for a Participant to adopt supervisory policies and compliance procedures that take into account the additional risk exposure experienced by the Participant for orders that may not be directly handled by staff of the Participant.

Concurrent with the issuance of this Market Integrity Notice, RS has issued Market Integrity Notice 2007-009 – *Request for Comments – Provisions Respecting Access to Marketplaces*, (April 20, 2007) which requests comments on proposed amendments to UMIR respecting “Dealer-Sponsored Access” and various other aspects of access to marketplaces (“Proposed Amendments”). Under the Proposed Amendments, the term “Dealer-Sponsored Access” would be defined as the right to access to the trading system of a marketplace either directly or by means of an electronic connection to the order routing system of a Participant that has been granted by the Participant to a client that is an “institutional customer” for the purposes of Policy 4 – *Minimum Standards for Institutional Account Opening, Operation and Supervision* of the Investment Dealers Association (“IDA”)¹.

In the view of RS, the definition of “Dealer-Sponsored Access” excludes the handling of an order by a Participant in respect of which:

- the client is not an “institutional customer” for the purposes of IDA Policy 4; and

¹ IDA Policy 4 – *Minimum Standards for Institutional Account Opening, Operation and Supervision* provides five broad categories of persons that would be considered “institutional customers” including:

- acceptable counterparties as defined in IDA Form 1 - Joint Regulatory Financial Questionnaire and Report (“JRFQ”);
- acceptable institutions as defined in the JRFQ;
- regulated entities as defined in the JRFQ;
- registrants (other than individual registrants) under securities legislation; and
- a non-individual with total securities under administration or management exceeding \$10 million.

- the Participant provides only an “order-execution service”², which for this purpose is considered as the handling, in accordance with the requirements of a securities regulatory authority or a self-regulatory entity, of a client order which:
 - the Participant has not recommended, and
 - the Participant has no responsibility as to the appropriateness or suitability of the order to the financial situation, investment knowledge, investment objectives and risk tolerance of the client.

The guidance contained in this Market Integrity Notice sets out RS’s expectations regarding compliance procedures to be adopted by a Participant providing an order-execution service to a client that is not an “institutional customer” (“Execution Client”) and is applicable whether or not the Proposed Amendments are approved. A Participant who provides “Dealer-Sponsored Access” to clients that are “institutional customers” should refer to Market Integrity Notice 2007-010 - Guidance – *Compliance Requirements for Dealer-Sponsored Access Trading* (April 20, 2007), which sets out RS’s expectations with respect to trading supervision and compliance procedures of a Participant that provides Dealer-Sponsored Access.

Supervisory Obligations of Participants

Part 1 of Policy 7.1 provides that a Participant has an obligation to supervise orders which are entered on a marketplace:

- by traders 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 a Participant; or
- by any other means.

In the view of RS, the means by which an order is entered on a marketplace does not relieve a Participant of responsibility for the supervision of such orders. RS is also of the view that orders entered by an Execution Client which are routed to the order management system of a Participant without the involvement of staff of the Participant present heightened risks to both the integrity of the markets and the Participant through whom the order is routed. The lack of involvement by staff of the Participant (i.e. an investment advisor or trader “handling” an order) eliminates a significant opportunity for a Participant’s personnel to identify and detect unusual trading patterns or anomalies prior to the offending order being entered on a marketplace. To the extent that orders entered by an Execution Client are not directly handled by staff of the

² The term “order-execution service” is defined in IDA Policy 9 – *Minimum Requirements for Members Seeking Approval Under Regulation 1300.1(E) for Suitability Relief for Trades not Recommended by the Member* as “the acceptance and execution of orders from customers for trades that the Member has not recommended and for which the Member takes no responsibility as to the appropriateness or suitability of the trades to the customers’ financial situation, investment knowledge, investment objectives and risk tolerance.”

Participant, RS expects that a Participant will have supervision policies and procedures and compliance testing which addresses the additional risk exposure posed by Execution Client trading.

Questions and Answers

The following is a list of frequently asked questions regarding the compliance requirements of a Participant that provides order-execution services to its clients and the response of RS to each question:

1. *Is there an obligation to monitor on a “real-time basis” the orders entered by an Execution Client?*

RS expects a Participant to have supervision policies and procedures and compliance testing which are appropriate for its size and business and which are reasonably designed to prevent and detect violations of requirements. To this end, Participants are expected to employ appropriate supervisory policies and procedures that have the ability to detect an offending order prior to such order being entered on a marketplace. To the extent that it is not feasible to employ on-going monitoring of specific elements of an order on a “real-time basis”, RS expects that a Participant will have sufficient “pre-“ and “post-trade” compliance testing to address the risks associated with orders entered by Execution Clients. However, it is important that the compliance department of the Participant have the capacity to monitor orders entered by Execution Clients on a real-time basis should such monitoring become necessary as a result of a request by RS, an applicable securities regulatory authority or the marketplace on which the orders are entered. Similarly, if compliance has determined that trading by a particular Execution Client needs additional “monitoring” the Participant should have the capacity to do so on a “real-time basis”.

2. *Why does RS believe that there is greater “risk” to market integrity associated with an order entered by an Execution Client?*

RS understands that Participants generally rely on automated “filters” to identify potentially offending orders. It is RS’s further understanding that the implementation of such “filters” varies broadly in nature and scope amongst Participants, and that the majority of such filters, are primarily “credit-based”, that is, they are designed to “flag” orders that exceed a client’s credit or cash position or other pre-established “credit based” parameters set by a Participant. As such, to the extent that a potentially offending order is not otherwise “off-side” any credit-based parameters, such order would not be “flagged” for review by staff of the Participant and would be routed directly to the marketplace without involvement of staff of the Participant. It is RS’s view that this lack of involvement eliminates a significant opportunity for a Participant to perform its “gatekeeper” function and to act on “red flags”.

This lack of involvement by staff of a Participant is particularly significant given the varied knowledge and experience of Execution Clients. Unlike Dealer-Sponsored Access trading that is available specifically to “eligible clients”, namely institutional clients that employ experienced traders and conduct trading in accordance with internal policies and procedures and in certain cases bound by fiduciary obligations, there are no eligibility requirements for a client accessing the order-execution services of a Participant. In RS’s view, the lack of eligibility requirements may give rise to a higher proportion of unintentional offending orders being entered by Execution Clients with limited knowledge of the trading rules. Similarly, the anonymous nature of trading conducted by means of an order-execution account may equally lend itself to unscrupulous trading by sophisticated Execution Clients that is meant to circumvent trading rules and may also result in a higher proportion of offending orders being entered by Execution Clients.

3. *Can a Participant use the same compliance sampling and testing standards to monitor trading conducted by Execution Clients as it does for other trading activity?*

Under Policy 7.1 of UMIR, if an order is entered on a marketplace without the involvement of a trader a Participant’s 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. To the extent that a Participant does not conduct separate testing of trading by Execution Clients, it may be appropriate for a Participant to sample for compliance testing a higher percentage of orders entered by Execution Clients that have not been handled by staff of the Participant (i.e. orders that were not “flagged” or otherwise handled by staff of the Participant) than the percentage of orders sampled in other circumstances.

4. *Are there any particular “risks” that need to be addressed in compliance procedures for trading by Execution Clients?*

Part 3 of Policy 7.1 under UMIR sets out the minimum compliance procedures for trading on a marketplace. However, Policy 7.1 also stipulates that the compliance procedures must be appropriate for the lines of business conducted by a Participant. Given that orders entered by an Execution Client will in most circumstances be subject to limited supervision prior to being sent to the order routing system of the Participant, the compliance procedures for Execution Clients should, at a minimum, address the procedures for testing:

- orders that have been entered for order markers as required by Rule 6.2 of UMIR, and in particular:
 - the “short sale” marker unless the trading system of the Participant automatically codes as “short” any sale of a security not then held in the account of the Execution Client, and

- the insider or significant shareholder order markers unless the trading system of the Participant automatically codes the order appropriately or restricts trading activities in affected securities; (As set out in Market Integrity Notice - 2002-012 - *Regulation ID Order Markers and Order Inhibition During Regulatory Halts & Suspensions* (July 9, 2002), a Participant may rely on the “know your client” information collected from the account holder provided that such information is “current” and the Participant does not have actual knowledge that a client is an insider or significant shareholder.)
- orders that have been entered for “spoofing” contrary to Rule 2.2 of UMIR (the entry of an order or orders which are not intended to be executed and are entered for the purpose of determining the depth of the market, checking for the presence of an “iceberg” order, affecting a calculated opening price or other similar improper purpose);
- orders that have been entered on a marketplace and trades that have executed for the creation of an “artificial price” contrary to Rule 2.2 of UMIR;
- orders that have been entered which seek to abuse the minimum guaranteed fill facility of a Market Maker;
- orders that have entered at unreasonable prices;
- trades for “wash trading” (particularly if the Execution Client has more than one account with the Participant); and
- trades for failure in settlement.

As required by Rule 7.1, any special compliance procedures employed for trading by Execution Clients must be in writing and must contain detailed guidance on how testing of Execution Client orders and trades is to be conducted.

A Participant should also be aware that Part 5 of Policy 7.1 requires that the procedures adopted by a Participant address 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. Similarly, the procedures should address trading activity by a particular client through an Order-Execution Service account and through other accounts at the Participant.

5. Does IDA Policy 9 affect supervisory or compliance obligations under UMIR?

IDA Policy 9 - *Minimum Requirements for Members Seeking Approval Under Regulation 1300.1(E) for Suitability Relief for Trades not Recommended by the Member* details the minimum supervisory and compliance requirements of a Participant in circumstances where the Participant is offering Order-Execution Services exclusively (generally considered to be discount brokerage services) and circumstances in which the Participant offers both advisory and Order-Execution Services to clients. In both instances, IDA Policy 9 requires a Participant to have supervisory and compliance

procedures and systems in place that are at least equal to and address the concerns listed in IDA Policy 2 - *Minimum Standards for Retail Account Supervision*.

IDA Policy 2 establishes minimum industry standards for retail account supervision. That policy does not preclude a Participant from establishing a higher standard of supervision and in certain situations deems a higher standard to be necessary to ensure proper supervision. In particular, IDA Policy 2 provides that a Participant is required to know and comply with the by-laws, rules, regulations and policies of other self-regulatory organizations and applicable securities legislation. As such, IDA Policy 9 does not alter or relieve a Participant from any obligation under Policy 7.1 of UMIR.

Questions / Further Information

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