

Market Integrity Notice

Guidance

May 16, 2008

No. 2008-010

Suggested Routing

- Trading
- Legal and Compliance

Key Topics

- Best Execution
- Best Price Obligation
- “Bid Through”
- Client Order
- Crossing Markets
- Just and Equitable Principles of Trade
- Notification of Trade-Through Alerts
- “Offer Through”
- Potential Violation Alert Notice (PVAN)

COMPLYING WITH “BEST PRICE” OBLIGATIONS

Summary

This Market Integrity Notice provides guidance on the expectations of Market Regulation Services Inc. regarding compliance with the “best price” obligations of the Universal Market Integrity Rules in an environment of multiple protected marketplaces. This guidance reflects the adoption of amendments to the Universal Market Integrity Rules as set out in:

- Market Integrity Notice 2008-008 – *Amendment Approval – Provisions Respecting “Off-Marketplace” Trades* (May 16, 2008); and
- Market Integrity Notice 2008-009 – *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008).

This Market Integrity Notice repeals and replaces, effective May 16, 2008, the guidance related to Rule 5.2 from the following notices:

- ***Market Integrity Notice 2007-021 – Guidance – Expectations Regarding “Best Price” Obligations (October 24, 2007).***
- ***Market Integrity Notice 2007-015 – Guidance – Specific Questions Related to Trading on Multiple Marketplaces (August 10, 2007);***
- ***Market Integrity Notice 2006-020 – Guidance – Compliance Requirements For Trading On Multiple Marketplaces (October 30, 2006); and***
- ***Market Integrity Notice 2006-017 – Guidance – Securities Trading on Multiple Marketplaces (September 1, 2006).***

UMIR Provisions Referenced

- Rule 2.1 – Just and Equitable Principles
- Rule 5.1 – Best Execution of Client Orders
- Rule 5.2 – Best Price Obligation
- Rule 7.1 – Trading Supervision Obligation

Market Integrity Notices Referenced

- Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006)
- Market Integrity Notice 2006-020 – *Guidance – Compliance Requirements For Trading On Multiple Marketplaces* (October 30, 2006)
- Market Integrity Notice 2007-015 – *Guidance – Specific Questions Related to Trading on Multiple Marketplaces* (August 10, 2007)
- Market Integrity Notice 2007-021 – *Guidance – Expectations Regarding “Best Price” Obligations* (October 24, 2007)
- Market Integrity Notice 2008-008 - *Amendment Approval – Provisions Respecting “Off-Marketplace” Trades* (May 16, 2008)
- Market Integrity Notice 2008-009 - *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008)

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COMPLYING WITH “BEST PRICE” OBLIGATIONS

Summary

This Market Integrity Notice provides guidance on the expectations of Market Regulation Services Inc. (“RS”) regarding compliance with the “best price” obligations of the Universal Market Integrity Rules (“UMIR”) in an environment of multiple protected marketplaces. This guidance reflects the adoption of amendments to UMIR as set out in:

- Market Integrity Notice 2008-008 – *Amendment Approval – Provisions Respecting “Off-Marketplace” Trades* (May 16, 2008); and
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- ***Market Integrity Notice 2007-021 – Guidance – Expectations Regarding “Best Price” Obligations (October 24, 2007).***
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- ***Market Integrity Notice 2006-020 – Guidance – Compliance Requirements For Trading On Multiple Marketplaces (October 30, 2006); and***
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Revised Guidance

Amendments to the “Best Price” Obligation

Concurrent with this Market Integrity Notice, RS has published notice of certain amendments to UMIR that are effective as of May 16, 2008 that change the “best price” obligation. Reference should be made to the following Market Integrity Notices which contain details of the amendments, together with certain guidance on the interpretation and application of the amendments:

- Market Integrity Notice 2008-008 – *Amendment Approval – Provisions Respecting “Off-Marketplace” Trades* (May 16, 2008) (the “Off-Marketplace” Amendments’); and
- Market Integrity Notice 2008-009 – *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008) (the “Interim Amendments”).

RS considers these to be “interim” amendments because the Canadian Securities Administrators (“CSA”) are developing a trade-through proposal.¹ Depending upon the final

¹ See Market Integrity Notice 2007-007 – *Request for Comments – Joint Canadian Securities Administrators/Market Regulation Services Inc. Notice on Trade-Through Protection, Best Execution and Access to Marketplaces* (April 20, 2007).

form of this trade-through regime, conforming changes may be required to UMIR, in particular the “best price” obligation under Rule 5.2 as modified by the Interim Amendments. RS expects that the Interim Amendments will be in effect from May 16, 2008 until changes implementing the final form of the CSA’s trade-through regime become effective.

All of Market Integrity Notice 2007-021 – Guidance – Expectations Regarding “Best Price” Obligations (October 24, 2007) is repealed and replaced with the following:

Questions and Answers

The following is a list of questions dealing with the expectations of RS regarding the compliance by a Participant with the “best price” obligations under Rule 5.2 of UMIR as a result of the launch of new protected marketplaces:

1. Will a Participant have satisfied its “best price” obligation if the trading decision is based on information as seen by the Participant?

RS recognizes that there will be different latencies in the delivery of information between the various data vendors, service providers and the internal systems of the Participant. The standard of conduct for compliance with the best price obligation is “particular” for each Participant.

For a discussion of the obligation of a Participant to consider information from a particular protected marketplace, reference should be made to Market Integrity Notice 2008-009 – *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008)

2. Does RS consider a “trade-through” to have occurred if the displayed market changes after the entry of an order by a Participant?

No. The “best price” obligation under Rule 5.2 is based on a Participant taking “reasonable efforts”. In “race conditions”, a Participant that enters an order based on the available information at the time of the entry of the order will be in compliance with Rule 5.2.

3. What communications will I receive from RS regarding trade-through alerts after May 16, 2008?

On a regular basis since the launch of continuous auction trading on Pure Trading in September of 2007, RS has been distributing “Notifications of Trade-Through Alerts” to Participants to assist firms in their efforts to ensure compliance with the “best price” obligation. As of May 16, 2008, RS will no longer be providing the Notifications of Trade-Through Alerts. However, RS will continue to monitor for trade-throughs and may issue a Potential Violation Alert Notifications (“PVAN”) if the facts of the “trade-through” of better-priced orders warrant.

4. What is RS's expectation with respect to the monitoring and testing to be undertaken by a Participant for compliance with the "best price" obligation?

With the launch of continuous auction market trading in same securities on multiple protected marketplaces, each Participant must review and update the policies and procedures adopted pursuant to Rule 7.1 of UMIR to ensure compliance with the "best price" obligation. RS also expects that the compliance procedures adopted by a Participant will be reviewed to ensure that there is adequate testing for compliance with "best price" obligations, particularly with respect to any portion of the order flow of the Participant that has not been handled by a smart order router or other automated solution.

RS expects that each Participant will periodically test any automated solution to verify that the "solution" remains effective for the type of businesses being conducted by the Participant. RS expects that such tests will be conducted whether the automated solution has been developed by the Participant or provided by a third party service provider. The results of these tests must be retained by the Participant and RS expects to be in a position to review the results of these tests during regularly scheduled trade desk reviews conducted by RS.

5. What are the obligations of a Participant that "bids through" or "offers through" an order contained in a consolidated market display?

If a Participant actively "bids through" or "offers through" on a particular marketplace the prices indicated in a consolidated market display on another marketplace, this action will result in "crossed markets" where the bid on one marketplace is higher than the offer on another marketplace. A "bid through" occurs when an order to purchase is booked on a marketplace at a price which is higher than an offer to sell that security displayed on another protected marketplace. A "offer through" occurs when an order to sell is booked on a marketplace at a price which is lower than a bid to purchase that security displayed on another protected marketplace.

In the view of RS, a Participant that intentionally "bids through" or "offers through" orders on another marketplace is in breach of the requirements of UMIR, including under Rule 2.1 to transact business openly and fairly and in accordance with just and equitable principles of trade. In addition, if the Participant is entering a client order when "bidding through" or "offering through", the Participant may be in violation of the "best execution" requirements under Rule 5.1 to diligently pursue the execution of the client order on the most advantageous terms for the client as expeditiously as practicable.

6. Can a Participant that executes a “trade-through” when handling a client order rectify the problem by improving the price payable to or by the client?

No. The “best price” obligation is an obligation which each Participant owes to the market generally rather than to the client. While a Participant that executes a trade-through in the handling of a client order may not have obtained “best execution” for that client order and may therefore need to adjust the price of the trade for the benefit of the client, the “best price” obligation requires that the Participant concurrent with, or immediately following, the execution of the trade-through to enter orders on another marketplace of sufficient volume and at a price that will fill the volume of better-priced orders on that other marketplace that are visible at the time of the execution of the trade-through.

7. How will a Participant know if a particular security is traded on more than one marketplace?

It is the obligation of each Participant to monitor the marketplaces to determine which securities are eligible to trade on each marketplace. RS has noted that many of the potential trade-throughs have been executed during the period immediately following the security becoming eligible for trading on an additional protected marketplace.

Questions 5, 8, 9 and 12 in Market Integrity Notice 2007-015 – Guidance – Specific Questions Related to Trading on Multiple Marketplaces are repealed and replaced with the following:

5. When entering a short sale order on a marketplace what obligation does a Participant have to “better-priced” orders on another marketplace?

Under Rule 5.2, a Participant has an obligation to make reasonable efforts to fill better-priced orders on a protected marketplace at the time the Participant executes at an inferior price on another marketplace or foreign organized regulated market. A Participant will be considered to have undertaken “reasonable efforts” if the Participant enters orders on a protected marketplace concurrent with, or immediately following, the trade on a particular marketplace and such orders have a sufficient volume and are at a price that will fill the volume of the better-priced orders on that other protected marketplace that are visible at the time of the trade on the particular marketplace.

The following assumption and chart provides the basis for the two examples below:

*Assume that a particular security is listed on an Exchange that is the “principal market” and on two ATs and that each of the marketplaces qualify as a “protected marketplace”.*²

² For a discussion of the definition of a “protected marketplace”, see “Definition of Protected Marketplace” on pages 9 and 10 of Market Integrity Notice 2008-008 - Amendment Approval – Provisions Respecting “Off-Marketplace” Trades (May 16, 2009).

Marketplace	Undisclosed Bid Size	Disclosed Bid Size	Bid Price	Ask Price	Disclosed Ask Price	Last Sale	Time of Last Sale
Principal Market	10,000	1,000	\$10.00	\$10.10	3,000	\$10.10	11:15 a.m.
ATS 1		5,000	\$9.90	\$10.20	4,000	\$9.90	11:20 a.m.
ATS 2		1,000	\$9.89	\$10.05	4,000	\$10.05	10:15 a.m.

Example 3: A Participant wishes to enter a market order to sell 7,000 shares “short”.

A Participant or Access Person would be able to enter the short sale on:

- *the Principal Market at \$10.10 (being the “last sale price” on that marketplace);*
- *ATS 1 at \$9.90 (as the last sale on ATS 1 was established subsequent to the last sale on the Principal Market); and*
- *ATS 2 at \$10.10 (as the \$10.05 last sale on ATS 2 was prior to the \$10.10 last sale on the Principal Market).*

However, if a Participant executed the short sale on ATS 1, the Participant would owe an obligation to the “better-priced” orders disclosed in the consolidated market display. Rule 5.2 of UMIR would require a Participant to immediately enter an order on the Principal Market to execute against the better-priced visible order (\$10.00 for 1,000 shares).

Since the order entered on the Principal Market by the Participant to satisfy its displacement obligation would be a “short sale”, the Participant may have to enter the order as “short exempt” in order to ensure that it trades (as the trading system of the Principal Market may be programmed not to permit a short sale below the last sale price on that market). Since the short sale was properly executed on ATS 1, orders entered by the Participant on the Principal Market to meet “best price” obligations under Rule 5.2 will not be considered to be a violation of price restrictions on short sales for the purposes of Rule 3.1. While there was another 10,000 shares at a better price on the Principal Market, that volume was not “visible” in the consolidated market display and, as such, the Participant would not have a “best price” obligation to such undisclosed volume.

Example 4: Same scenario as above, however the better-priced bid on the Principal Market is fully disclosed (\$10.00 for 10,000 shares).

A Participant would be able to enter the short sale on:

- *the Principal Market at \$10.10 (being the “last sale price” on that marketplace);*
- *ATS 1 at \$10.00 (to avoid trading-through the better-priced order on the Principal Market); and*

- *ATS 2 at \$10.10 (as the \$10.05 last sale on ATS 2 was prior to the \$10.10 last sale on the Principal Market).*

As set out in example 3 above, a Participant will be considered to have made “reasonable efforts” to comply with its best price obligations if a Participant enters orders on a protected marketplace concurrent with, or immediately following, the trade on a particular marketplace and such order(s) have a sufficient volume and are at price that will fill the volume of better-priced orders in the consolidated market display at the time of the trade. In this example, while the last sale of the security on ATS 1 was subsequent to the last sale on the principal market, because the volume of the proposed short sale (7,000 shares) if executed, is not of sufficient volume to fill the volume of better-priced orders in the consolidated market display (10,000 shares) a Participant may not enter a short sale on ATS 1.

8. *Is a Participant required to consider orders in a special terms book of a marketplace as part of its “best price” obligation?*

Under UMIR, the determination of the “best ask price” and “best bid price” excludes the price of any order that is a Special Terms Order and a number of “specialty” orders such as Basis Order, Call Market Order, Closing Price Order, Market-on-Close Order, Opening Order and Volume-Weighted Average Price Order. While a Participant is not required to consider Special Terms Orders in determining best price, a Participant may be required to consider execution opportunities in the special terms book of a marketplace in accordance with its best execution obligation under Rule 5.1 of UMIR.

9. *If a Participant executes a trade on a marketplace at an inferior price, and immediately thereafter attempts to displace a specific better-priced order on another marketplace that is cancelled before the Participant is able to enter the order, is a Participant obligated to displace other orders at that same price and volume?*

RS is of the opinion that a Participant will be considered to have undertaken reasonable efforts if the Participant enters orders on another protected marketplace concurrent with, or immediately following, the trade on a particular marketplace and such orders have a sufficient volume and are at a price that will fill the volume of the better-priced orders on that other protected marketplace that are visible at the time of the trade on the particular marketplace. To the extent that the better-priced orders visible at the time of the trade are “immediately” replaced with another order or orders, the Participant has an obligation to enter an order even though it may trade with a different order(s) than intended or not trade at all. The volume of the order to be entered is determined solely by the visible volume of the better-priced order(s) at the time of the trade on the particular marketplace.

In the view of RS, an order entered by a Participant on a protected marketplace to satisfy its displacement obligation must be entered concurrently with, or immediately following the trade on another marketplace, regardless of whether the order(s) that gave rise to the displacement obligation continue to be “available”. As such, a Participant may wish to enter an order to satisfy its displacement obligation in a manner that ensures that the order trades only with the volume of better-priced orders that are then “available”, and that any unfilled portion of the order may be “killed” to prevent the unfilled portion of the order from being “booked” on the other marketplace.

The “Off-Marketplace” Amendments introduced a requirement for a “bypass order” marker to facilitate compliance with obligations owed to order comprising part of the disclosed volume. This marker will be implemented on a future date to be determined by the Board of Directors of RS. When implemented, the “bypass order” marker will allow orders entered on a protected marketplace for the purpose of meeting “best price” obligations to “bypass” certain types of orders including undisclosed volume of iceberg order, Special Terms Orders and other specialty types of orders.³

12. Can a Participant factor in connectivity costs or other fees related to accessing a marketplace in determining “best price”?

Rule 5.2 of UMIR requires that a Participant make reasonable efforts at the time of the execution of an order to ensure that the order is executed at the best available price. As a result of the Interim Amendments, transaction costs and other costs (including access fees, trade processing fees and settlement charges) associated with executing a trade on a marketplace was repealed as one of the factors to be considered in complying with the “best price” obligation. Transaction costs may **no** longer be considered in determining whether a Participant has made “reasonable efforts”.

Presently, a marketplace is allowed to establish fees to access its marketplace without limitation. While differences in access fees charged by marketplaces is allowed, the regulation of access fees is currently the subject of a proposal by the Canadian Securities Administrators (“CSA”), which among other things, proposes to establish a maximum amount that a visible marketplace can charge for access to a quote. Reference should be made to Market Integrity Notice 2007-007 – *Request for Comments - Joint Canadian Securities Administrators / Market Regulation Services Inc. Notice on Trade-Through Protection, Best Execution and Access to Marketplaces* (April 20, 2007) for a discussion of CSA “trade-through” proposal. The provisions of UMIR and their interpretation and application would be modified to conform to the position adopted by the CSA. Under the proposals with respect to “best execution”, the overall cost of the transaction will be one of the factors that a

³ See “Definition of Disclosed Volume” on pages 7 and 8 of Market Integrity Notice 2008-008 - *Amendment Approval – Provisions Respecting “Off-Marketplace” Trades* (May 16, 2008).

Participant will be able to take into account in complying with the “best execution” obligation.

Questions 5, 7 and 9 in Market Integrity Notice 2006-020 – Guidance – Compliance Requirements For Trading On Multiple Marketplaces (October 30, 2006) are repealed and replaced with the following:

5. How should an “immediately tradeable” order from a client be handled if not all of the marketplaces are open at the time the order is received?

The traditional continuous auction trading hours of exchanges in Canada have been between 9:30 a.m. and 4:00 p.m. Certain of the marketplaces open earlier or close later than these traditional trading hours. RS expects that a Participant will adopt policies and procedures with respect to the handling of “market” and other “immediately tradeable” orders that are received outside of historic trading hours. RS also expects that a Participant will inform its clients of such policy and its implications. It is the view of RS that the adoption of such a policy will reduce the likelihood of confusion on the part of clients with respect to when and where a “market” or other immediately tradeable orders may trade. Any policy adopted by a Participant must be consistent with the “best execution” obligations owed to the client under Rule 5.1.

How an immediately tradeable client order received outside of traditional trading hours is handled by a Participant will depend on the policy adopted by the Participant as communicated to its clients. For example, the policy may provide that a Participant that receives a market order after 4:00 p.m. and before 9:30 a.m. the next trading day may consider trading opportunities on any visible marketplace that is then open for trading or the Participant may “hold” the order until all marketplaces or the principal market is open for trading.

Notwithstanding any policy adopted by a Participant, Rule 6.3 dealing with the exposure of client orders provides that a Participant is able to withhold entry of a client order to purchase or sell 50 standard trading units or less if the Participant “determines based on market conditions that entering the order would not be in the best interests of the client”. If the Participant withholds the orders in these circumstances, the Participant guarantees that the client will receive a price at least as good as the price the client would have received if the client order had been executed on receipt by the Participant or a better price if the client order executes against a principal or non-client order.

7. Is a Participant required to consider visible orders on a protected marketplace that is not then open for trading in order to meet its “best price” obligation in the handling of a client order?

Under Rule 5.2, a Participant must make reasonable efforts to ensure that an order is executed at the “best price”. If a marketplace displays orders in a consolidated

market display but that marketplace is not open for trading at that particular time, a Participant does not need to consider such orders in evaluating its “best price” obligation. A Participant need only consider visible orders on protected marketplaces that are then open for trading. A Participant will have to consider as part of its “best price” obligation visible orders entered on special trading facilities of a protected marketplace which conducts trading before or after its “regular” trading hours.

Reference should be made to Market Integrity Notice 2008-009 – *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008) for a discussion of other circumstances when a Participant is not required to take account of visible orders on a protected marketplace.

9. What “best price” obligation does a Participant have with respect to orders entered on a particular marketplace by a client with “direct market access”?

If a Participant has provided direct market access to a client with respect to the entry of orders on a particular marketplace, the Participant has the obligation to fill any better-priced orders on a protected marketplace in respect of which an obligation under Rule 5.2 is owed. For a discussion of the orders of marketplaces for which an obligation is owed under Rule 5.2, reference should be made to Market Integrity Notice 2008-009 – *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008).

If the Participant routes orders from a client with direct market access through a “smart order router”, the Participant must ensure that the client is entitled to have direct market access to any marketplace to which the smart order router may direct the order.

That part of Market Integrity Notice 2006-017 – Guidance – Securities Trading on Multiple Marketplaces (September 1, 2006) under the heading “Rule 5.2 – Best Price Obligation” is repealed. For a discussion of the application of the “best price” obligation for securities trading on multiple marketplaces, reference should be made to the “Background to the Interim Amendments” and “Description of the Interim Amendments” in Market Integrity Notice 2008-009 - *Request for Comments – Provisions Respecting the “Best Price” Obligation* (May 16, 2008).

Questions / Further Information

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