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IIROC NOTICE

**Rules Notice**
**Request for Comments**
UMIR

*Please distribute internally to:*
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*Contact:*

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**14-0077**
**March 27, 2014**

# Proposed Amendments to the Definition of Basis Order

## Executive Summary

The proposed amendments ("Proposed Amendments") would broaden the UMIR definition of Basis Order to specifically include Exempt Exchange-traded Funds[1] ("ETF"). IIROC believes that expanding the definition is appropriate to reflect current ETF trading practices. IIROC has been granting exemptions for these transactions as IIROC believes that the execution of ETFs as Basis Orders is consistent with the principles supporting Basis Orders generally. The Proposed Amendments would expand the current definition by:

- providing that an ETF may be traded as a Basis Order at a price derived from the prices achieved from the executions of the underlying components where the executions represent at least 80% of the component securities weighting of the ETF, and

[1] UMIR defines an Exempt Exchange-traded Fund to mean a mutual fund for the purposes of applicable securities legislation, the units of which:
(a) are a listed security or a quoted security; and
(b) are in continuous distribution in accordance with applicable securities legislation
but does not include a mutual fund that has been designated by the Market Regulator to be excluded from this definition.

To date, IIROC has not designated any mutual funds to be excluded from this definition.

- providing that a basket of listed securities may be traded as a Basis Order where the execution price is derived from the price achieved from the execution on a marketplace of an ETF where the basket of securities comprises at least 80% of the component securities weighting of the ETF.

IIROC does not believe that the adoption of the Proposed Amendments will cause any material impact to Participants, marketplaces or other stakeholders. If the Proposed Amendments are approved, IIROC intends to amend its Internet-based Basis Order reporting form to accommodate the changes to the definition.

IIROC would expect that, if the Proposed Amendments are approved by the Recognizing Regulators, the amendments would be implemented ***within 60 days following the publication of notice of approval of the amendments.***

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## 1. Policy Development Process

The Market Rules Advisory Committee ("MRAC") of IIROC considered this matter. MRAC is an advisory committee comprised of representatives of each of the marketplaces for which IIROC acts as a regulation services provider, Participants, institutional investors and subscribers, and the legal and compliance community.[2]

The Board of Directors of IIROC ("Board") has determined the Proposed Amendments to be in the public interest. On January 29, 2014 the Board approved the publication for comment of the Proposed Amendments.

Comments are requested on all aspects of the Proposed Amendments, including any matter which they do not specifically address. Comments on the Proposed Amendments should be in writing and delivered by ***June 25, 2014*** to:

Kevin McCoy,
Director, Market Regulation Policy,
Investment Industry Regulatory Organization of Canada,
Suite 2000
121 King Street West,
Toronto, Ontario. M5H 3T9
e-mail: kmccoy@iiroc.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Susan Greenglass
Director, Market Regulation
Ontario Securities Commission
Suite 1903, Box 55,
20 Queen Street West
Toronto, Ontario. M5H 3S8

Fax: (416) 595-8940
e-mail: marketregulation@osc.gov.on.ca

***Comment Letters will be made publicly available on the IIROC website at UMIR Request for Comments. A summary of the comments contained in each submission will also be included in a future IIROC Notice.***

[2] Consideration by MRAC should not be construed as approval or endorsement of the Proposed Amendments. Members of MRAC are expected to express their personal advice on topics and that advice may not represent the views of their respective organizations as expressed during the public comment process.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend that revisions be made to the applicable Proposed Amendments. If the revisions are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the Proposed Amendments as revised will be subject to approval by the Recognizing Regulators. If the revisions are material, the Proposed Amendments as revised will be submitted to the Board for approval for republication.

The text of the Proposed Amendments is set out in Appendix "A" and a blackline of the changes is set out in Appendix "B".

## 2. Background to the Proposed Amendments

### *2.1 Basis Trades*

Basis Trades were introduced on the Toronto Stock Exchange ("TSX") in 2003 as a method of trading to reduce exposure by ensuring that a price achieved by one or more derivative transactions is reflected in the prices of the related equity transaction or transactions. The use of Basis Trades allowed a Participant to precisely offset derivative risk. The TSX defined a Basis Trade to mean:

> *A transaction whereby a basket of securities or an index participation unit is transacted at a price calculated in the prescribed manner which represents the average accumulation (or distribution) price of the position, subject to an agreed upon basis spread, achieved through the execution of a related exchange-traded derivative instrument, which may include listed index futures, index options and index participation units in an amount that will correspond to an equivalent market exposure.*

This definition of Basis Trade remains in the TSX Rule Book and is in force today. Policy 4-107 of the TSX Rule Book further requires that a Basis Trade must comprise at least 80% of the component share weighting of the related executions through which the Basis Trade is priced.

### *2.2 Consideration of Index Participation Units*

The TSX definition of Basis Trade provides that the price at which a Basis Trade may be executed on the TSX can be derived from the prices achieved through the execution or executions of a derivative instrument, which for the purpose of the definition, specifically include an index participation unit.

Index participation units were originally listed on the TSX in 1990 in the form of TIPS and HIPS which tracked the exact performance of the TSE 35 Composite Index and the Toronto 100 Index respectively. Effectively, these index participation units were the precursor to today's exchange-traded funds.

### 2.3 Prior IIROC Guidance

In 2003, Market Regulation Services Inc. issued guidance ("Prior Guidance") respecting a Participant's obligations related to TSX specialty crosses.[3] The Prior Guidance respecting basis trading aligned with the TSX rules and provided, among other things that:

- index participation units may be traded as Basis Trades,
- the execution price of a Basis Trade may be outside the prevailing spread at the time of the transaction, and
- details of each Basis Trade must be reported to the Market Regulator on a pre- and post-trade basis.

In 2005, UMIR was amended to add a definition of Basis Order.[4] The definition both incorporated the criteria set out in the Prior Guidance into UMIR and provided that a Basis Order may be executed on a marketplace other than the TSX if offered by other marketplaces. The definition, which remains the current UMIR definition, defines a Basis Order as:

*an order for the purchase or sale of listed securities or quoted securities:*

*(a) where the intention to enter the order has been reported by the Participant or Access Person to a Market Regulator prior to the entry of the order;*

*(b) that will be executed at a price which is determined in a manner acceptable to a Market Regulator based on the price achieved through the execution on that trading day of one or more transactions in a derivative instrument that is listed on an Exchange or quoted on a QTRS; and*

*(c) that comprise at least 80% of the component security weighting of the underlying interest of the derivative instruments subject to the transaction or transactions described in clause (b).*

### 2.4 Riskless Basis Crosses on the Montreal Exchange

The rules of the Montreal Exchange[5] ("MX") provide that Riskless Basis Cross Transactions for futures contracts on both S&P/TSX indices and Canadian shares are permitted to be executed off-exchange.[6] This provision is intended to provide customers with the ability to acquire market exposure in the most efficient way possible. An MX approved participant may use the underlying cash market to take on the equivalent market exposure and replicate that exposure

[3] See MIN 2003-023 – Obligations related to TSX Specialty Crosses – October 28, 2003.

[4] See Market Integrity Notice 2005-010 – Provisions Respecting a "Basis Order" – April 8, 2005.

[5] See Circular no: 009-2010 – Addition of Riskless Basis Cross Transactions on S&P/TSX Index (SXF) and Sectorial Index (SXA,SXB,SXH, and SXY) Futures Contracts – Amendments to Articles 6005 and 6380 of Rule Six of Bourse de Montréal Inc. – January 25, 2010

[6] See Montreal Exchange Procedures Applicable to the Execution of Riskless Basis Cross Transactions on Futures Contracts on S&P/TSX Indices and Futures Contracts on Canadian Shares – February 22, 2012 - http://www.m-x.ca/f_en/procedure_OBSR_en.pdf

through the use of futures contracts. This leaves the MX approved participant with no resulting market exposure.

Under the MX rules, the MX approved participant derives the price at which the Riskless Basis Cross Transaction will execute from executions in the cash market used to acquire the equivalent market exposure. Transactions on the cash market may include securities, baskets of securities, index participation units or exchange-traded funds. For Riskless Basis Cross Transactions respecting index futures, the executions on the cash market must be comprised of at least 80% of the components constituting the underlying index. The Riskless Basis Cross is executed at a price that is based on the average price of the executions of the underlying constituents plus a pre-negotiated basis.

## 3. Discussion of the Proposed Amendments

Following is a summary of the principal components of the Proposed Amendments.

### *3.1 Limitations of Current Definition*

The current UMIR definition limits the use of Basis Orders to the purchase and sale of listed securities at a price derived from the prices achieved though the execution or executions of a derivative instrument that is listed on an Exchange or quoted on a QTRS. This definition does not clearly encompass the execution of units of an ETF as a Basis Order at a price derived from the prices achieved through the execution of the component securities.[7] This fails to reflect current ETF trading practices and accordingly, IIROC has been granting exemptions for these transactions as IIROC believes that the execution of ETFs as Basis Orders is consistent with the principles supporting Basis Orders generally. During the period of October 1, 2013 to December 31, 2013, IIROC's market regulation policy staff granted approximately 20 exemptions.

### *3.2 Exempt Exchange-traded Funds*

Exchange-traded funds are regulated by the Canadian Securities Administrators as mutual funds under securities law and not as derivative instruments. As such, references to "derivative instruments" in the UMIR definition of Basis Order could be interpreted to exclude ETFs. Both the TSX definition of Basis Trade and the Prior Guidance provide that an index participation unit may be traded as a Basis Order. IIROC believes that it is appropriate to specifically include ETFs in the definition of Basis Order as the structure of an ETF is similar to that of an index participation unit, as both are designed to track the performance of the underlying component securities. The Proposed Amendments would incorporate ETFs into the definition.

7 ETFs are regulated as mutual funds under securities law and not as derivative instruments.

The Proposed Amendments would provide that:

- a basket of listed securities may be traded as a Basis Order at a price derived from the prices achieved from the execution of units of an ETF where the basket of listed securities comprises at least 80% of the component securities weighting of the underlying interest of the ETF,
- units of an ETF may be traded as a Basis Order at a price derived from the executions of the underlying components (that are not derivative instruments traded on an exchange or a QTRS) where the executions of the underlying component securities comprise at least 80% of the component securities weighting of the ETF, and
- units of an ETF may be executed as a Basis Order at a price derived from the prices achieved on the execution or executions of a derivative instrument traded on an exchange or a QTRS.

### *3.3 Relevance of Underlying Component Securities*

IIROC staff believes that it is appropriate to allow ETFs to be traded as Basis Orders where there is confidence in the relationship between the calculated price for the ETF execution and the actual prices achieved through the execution of the underlying components.

The current UMIR definition of Basis Order requires that at least 80% of the component securities weighting of the derivative instrument traded is comprised of listed securities. Listed securities for the purposes of UMIR are those securities which are listed on an Exchange.[8] Accordingly, any derivative instruments where the underlying component securities are not primarily listed securities are excluded from the definition.

In considering the complexity of ETFs currently listed on the Exchanges, IIROC believes it is appropriate to permit Basis Orders in ETF units when the underlying component securities may not be listed securities.

The underlying components of many ETFs do not trade on a marketplace and are therefore not listed securities for the purposes of UMIR. The underlying components of many ETFs trade on foreign markets and may include non-equity products, such as debt, foreign exchange or commodities. In such cases, the execution of the underlying components could not occur on a marketplace.

IIROC staff acknowledges that pricing on some markets, such as OTC markets, is more opaque than trades that occur on a marketplace which may result in executions with lower confidence that the price achieved represents that actual value of the security. However, given the varying complexities of ETFs currently listed in Canada, IIROC believes it is

[8] Exchange is defined in UMIR to mean a person recognized by the applicable securities regulatory authority under securities legislation to carry on business as an exchange.

inappropriate to exclude those ETFs from the definition of Basis Order where the underlying constituents are not principally listed securities.

While the Proposed Amendments also provide that a basket of listed securities may be executed at a price derived through the executions of an ETF, IIROC staff believes that it is appropriate to require that the basket of listed securities is comprised of at least 80% of the component securities weighting of the underlying interest of the ETF. This is consistent with the current definition in respect to a Basis Order where a basket of listed securities is executed at a price based on the prices achieved through the executions of a derivative instrument that is listed on an Exchange or quoted in a QTRS.

In all cases, a Basis Order must be executed at a price which is determined in a manner acceptable to a Market Regulator. When a Basis Order has been used inappropriately, such as when the execution of the underlying component securities represents less than 80% of the securities weighting of the ETF, a Market Integrity Official may require that the trade be printed as a regular trade and that the Participant or Access Person displace any better priced orders. IIROC will also review a Participant's use of Basis Orders during its trade desk review.

### *3.4 Reporting Requirements*

The current Basis Order definition requires that the intention to enter the Basis Order must be reported to IIROC prior to the Basis Order being entered on a marketplace. The Proposed Amendments do not introduce any additional reporting requirements. The Proposed Amendments would clarify that the report to IIROC must be in the form and manner acceptable to IIROC. The reporting requirements applicable to Basis Orders provide IIROC with the opportunity to review and monitor the use of Basis Orders on an ongoing basis. IIROC intends to modify the current Basis Order reporting form to reflect the Proposed Amendments. IIROC expects that a Participant or Access Person would continue its current practice of submitting the Basis Order reporting form after all hedging activity is completed and prior to the entry of the Basis Order.

## 4. Summary of the Impact of the Proposed Amendments

The following is a summary of the most significant impacts of the adoption of the Proposed Amendments.

### *4.1 Addition of ETFs to the Definition of Basis Orders*

The Proposed Amendments would provide that:

- an ETF may be printed as a Basis Order at a price determined by the actual prices received through the execution of the underlying components where the executions of the underlying component securities represent at least 80% of the ETF, and
- a basket of listed securities that comprise at least 80% of the component securities weighting of an ETF may be printed as a Basis Order at a price determined by the actual prices received though the execution of an ETF on a marketplace.

### *4.2 Component Securities of an ETF Expanded to Include Securities Other Than Listed Securities*

The Proposed Amendments would allow for the execution of a Basis Order involving units of an ETF where the underlying component securities are:

- not listed securities, or
- a combination of both listed securities and securities that are not listed securities.

## 5. Technological Implications and Implementation Plan

IIROC staff does not believe that the adoption of the Proposed Amendments will have any technological or resource implication for Participants, marketplaces or other stakeholders. IIROC intends to modify its Basis Order reporting form to accommodate the changes to the definition.

IIROC would expect that, if the Proposed Amendments are approved by the Recognizing Regulators, the amendments would be implemented ***within 60 days following the publication of notice of approval of the amendments.***

## 6. Questions

While comment is requested on all aspects of the Proposed Amendments, comment is also specifically requested on the following questions:

1. The current definition of Basis Order requires that the component securities weighting of the executed derivative are comprised of at least 80% listed securities. Is it appropriate that the Proposed Amendments consider component securities other than listed securities (e.g. securities traded on foreign markets and OTC markets)?
2. Similar to the existing definition, the Proposed Amendments require that the executions of the component securities represent at least 80% of the component securities weighting of the underlying interest of the derivative instrument or the ETF. Is 80% an appropriate measure?
3. Should Basis Orders for units of ETFs which are actively managed be excluded from the definition of Basis Order?
4. Should Basis Orders for units of ETFs be limited to include only ETFs that track the performance of a particular index?

## Appendix A – Proposed UMIR Amendments

The Universal Market Integrity Rules are hereby amended as follows:

1. The definition of **Basis Order** in 1.1 is amended by:

   (a) Deleting "...listed securities or quoted securities"

   (b) Deleting clause (a) and replacing with:

   > (a) listed securities or quoted securities that comprise at least 80% of the component securities weighting of the underlying interest of:
   >
   > (i) a derivative instrument that is listed on an Exchange or quoted on a QTRS; or
   >
   > (ii) an Exempt Exchange-traded Fund,
   >
   > which will be executed at prices determined in a manner acceptable to a Market Regulator that are based on the price achieved through the execution on that trading day of one or more transactions in the derivative instrument or Exempt Exchange-traded Fund; or

   (c) Deleting clause (b) and replacing with:

   > (b) a derivative instrument that is a listed or quoted security or an Exempt Exchange-traded Fund, which will be executed at a price determined in a manner acceptable to a Market Regulator that is based on the prices achieved through the execution on that trading day of transactions in the securities that comprise at least 80% of the component security weighting of the underlying interest of the derivative instrument or Exempt Exchange-traded Fund,

   (d) Inserting following clause (b) "provided that prior to the entry of the order the Participant or Access Person reports to a Market Regulator its intention to enter the order and the details of the related transactions, in the form and manner required by the Market Regulator."

   (e) Deleting clause (c).

## Appendix B – Text of UMIR to Reflect Proposed UMIR Amendments to the Definition of Basis Order

| Text of Provision Following Adoption of the Proposed UMIR Amendments | Text of Current Provisions Marked to Reflect Adoption of the Proposed UMIR Amendments |
|---|---|
| **1.1 Definitions**<br>**"Basis Order"** means an order for the purchase or sale of:<br>(a) listed securities or quoted securities that comprise at least 80% of the component securities weighting of the underlying interest of:<br>(i) a derivative instrument that is listed on an Exchange or quoted on a QTRS; or<br>(ii) an Exempt Exchange-traded Fund,<br>which will be executed at prices determined in a manner acceptable to a Market Regulator that are based on the price achieved through the execution on that trading day of one or more transactions in the derivative instrument or Exempt Exchange-traded Fund; or<br>(b) a derivative instrument that is a listed or quoted security or an Exempt Exchange-traded Fund, which will be executed at a price determined in a manner acceptable to a Market Regulator that is based on the prices achieved through the execution on that trading day of transactions in the securities that comprise at least 80% of the component security weighting of the underlying interest of the derivative instrument or Exempt Exchange-traded Fund,<br>provided that prior to the entry of the order the Participant or Access Person reports to a Market Regulator its intention to enter the order and the details of the related transactions, in the form and manner required by the Market Regulator. | **1.1 Definitions**<br>**"Basis Order"** means an order for the purchase or sale of ~~listed securities or quoted securities~~:<br>~~(a) where the intention to enter the order has been reported by the Participant or Access Person to a Market Regulator prior to the entry of the order;~~<br>~~(b) that will be executed at a price which is determined in a manner acceptable to a Market Regulator based on the price achieved through the execution on that trading day of one or more transactions in a derivative instrument that is listed on an Exchange or quoted on a QTRS; and~~<br>~~(c) that comprise at least 80% of the component security weighting of the underlying interest of the derivative instruments subject to the transaction or transactions described in clause (b).~~<br>(a) listed securities or quoted securities that comprise at least 80% of the component securities weighting of the underlying interest of:<br>(i) a derivative instrument that is listed on an Exchange or quoted on a QTRS; or<br>(ii) an Exempt Exchange-traded Fund,<br>which will be executed at prices determined in a manner acceptable to a Market Regulator that are based on the price achieved through the execution on that trading day of one or more transactions in the derivative instrument or Exempt Exchange-traded Fund; or<br>(b) a derivative instrument that is a listed or quoted security or an Exempt Exchange-traded Fund, which will be executed at a price determined in a manner acceptable to a Market Regulator that is based on the prices achieved through the execution on that trading day of transactions in the securities that comprise at least 80% of the component security weighting of the underlying interest of the derivative instrument or Exempt Exchange-traded Fund,<br>provided that prior to the entry of the order the Participant or Access Person reports to a Market Regulator its intention to enter the order and the details of the related transactions, in the form and manner required by the Market Regulator. |