IIROC OCRCVM
Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Request for Comments
UMIR and Dealer Member Rules

Please distribute internally to:
Institutional
Legal and Compliance
Retail
Operations
Senior Management
Trading Desk
Training

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13-0256
October 15, 2013

Proposed Guidance Respecting Order Execution Services as a Form of Third-Party Electronic Access to Marketplaces

IIROC is requesting comments on proposed guidance related to the supervision of Order Execution Service ("OES")[1] account activity (the "Proposed Guidance"). Concurrent with the publication of this notice, IIROC also published a Rules Notice for comment which sets out proposed provisions (the "Proposed Amendments") respecting, among other things, the supervision of OES account activity.[2] The Proposed Guidance is related to the Proposed Amendments and sets out IIROC's expectations respecting:

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[1] The term "order-execution service" is defined in Rule 3200 – Minimum Requirements for *Dealer Members Seeking Approval Under Rule 1300.1(T) For Suitability Relief For Trades Not Recommended by the Member* to mean "the acceptance and execution of orders from customers for trades that the Dealer Member has not recommended and for which the Dealer 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".

[2] See IIROC Notice 13-0255

- the inclusion of a client identifier ("ID") on each order entered for or on behalf of any client whose OES account activity exceeds the thresholds set out in the Proposed Amendments or is not an individual and registered as a dealer or adviser under applicable securities legislation;
- reporting of OES client identities and client IDs to IIROC;
- supervision requirements relating to Manipulative and Deceptive Activities; and
- supervision requirements to address the risks associated with the lack of intermediation by staff of a Dealer Member that provides OES ("OES Dealer").

Policy Development Process

The Market Rules Advisory Committee ("MRAC") of IIROC considered this matter as proposed in concept by IIROC staff. 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. IIROC's Order Execution Sub-Committee ("OES Committee") was consulted during the formation of this proposed guidance. The OES Committee is comprised of representatives of Dealer Members that provide order execution-only services. [3]

The text of the Proposed Guidance is set out in Appendix "A". Comments are requested on all aspects of the Proposed Guidance, including any matter not addressed in the Proposed Guidance and any specific questions asked on the following page. Comments should be in writing and delivered by ***January 14, 2014*** to:

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and

Jamie Bulnes
Director, Member Regulation Policy

[3] Consideration by MRAC or consultation with the OES Committee should not be construed as approval or endorsement of the Proposed Guidance. Members of MRAC are expected to provide their personal advice on topics and that advice may not represent the views of their respective organizations as expressed during the public comment process.

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Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "Notices" and sub-heading "Rules – Request for Comments") upon receipt. A summary of the comments contained in each submission will also be included in a future IIROC Notice.

After considering the comments on the Proposed Guidance received in response to this Request for Comments and after considering comments received on the Proposed Amendments, IIROC may make revisions to the Proposed Guidance prior to the issuance of the final Guidance Note.

Questions

While comment is sought on all aspects of the Proposed Guidance, IIROC would specifically request responses to the following question:

1. Should the method for applying an identifier to certain OES order flow be different than the method used for identifying order flow from direct electronic access and routing arrangements?

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13-0***
*, 2013

Guidance Respecting Order Execution Services as a Form of Third-Party Electronic Access to Marketplaces

Executive Summary

This Rules Notice provides guidance to Dealer Members on the supervision of order execution service ("OES")[4] account activity given the additional risks associated with third-party electronic access to marketplaces when orders may not be directly handled by staff of the Dealer Member. The Guidance repeals and replaces previous guidance issued respecting

[4] The term "order-execution service" is defined in Rule 3200 – Minimum Requirements for Dealer Members Seeking Approval Under Rule 1300.1(T) For Suitability Relief For Trades Not Recommended by the Member to mean "the acceptance and execution of orders from customers for trades that the Dealer Member has not recommended and for which the Dealer 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".

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compliance requirements for OES ("Prior Guidance")[5] and specifically addresses provisions established under amendments to UMIR and the Dealer Member Rules ("DMR") ("Amendments").[6] The Prior Guidance addressed compliance requirements under UMIR, and as such was only directly relevant to those Dealer Members who are also Participants for the purposes of UMIR. The Guidance addresses the requirements under the DMR and therefore applies to all Dealer Members. The Guidance also provides instruction on the manner in which to apply client identifiers ("IDs") that are required under the Amendments. Additional guidance is also provided on the types of activities that may be considered manipulative and deceptive, and what a Dealer Member needs to consider when developing its policies and procedures and systems of supervision and control.

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[5] See Notice 2007-011 – Market Integrity Notice – Guidance – Compliance Requirements for Order-Execution Services (April 20, 2007). http://www.iiroc.ca/Documents/2007/DFE6DC42-02A0-46AF-AAD6-C98CB77CFE50_en.pdf

[6] See IIROC Notice (xx-xxxx) - Rules Notice – Notice of Approval – Provisions Respecting Order Execution Services as a Form of Third-Party Electronic Access to Marketplaces (####).

1. Background

On #####, IIROC published notice of the approval of the Amendments respecting OES as a form of third-party electronic access to marketplaces. These Amendments introduced a more comprehensive regulatory framework for OES, including:

- a requirement to assign client IDs to certain "active" OES clients and clients that are not individuals and registered as a dealer or adviser under applicable securities legislation,
- a requirement to advise IIROC of the client IDs and the clients associated with them,
- a requirement that the policies and procedures and systems of control of a Dealer Member offering OES ("OES Dealer") consider the added risk of order entry with limited order handling by staff of the OES Dealer, and
- a definition of Manipulative and Deceptive Activities.

2. Supervision of Order Execution Service Accounts

An OES Dealer, while exempted from suitability obligations, must comply with all other provision of DMR 2500 – *Minimum Standards for Retail Customer Account Supervision* as well as DMR 38.1 - *Compliance and Supervision*. An OES Dealer is required to have written policies and procedures and systems of supervision and control in place to review client trading for all aspects of DMR 2500 other than those related to customer suitability. The standards set out in DMR 2500 are the minimum requirements to supervise account activity and a Dealer Member is not precluded from establishing policies, procedures and systems of supervision and control that exceed the minimum standard where warranted by the business activities or offerings of the Dealer Member. Dealer Members that maintain accounts for clients who meet the definition of "Institutional Customer"[7] must comply with the requirements set out in DMR 38.1 and 2700 – *Minimum Standards for Institutional Customer Accounts Opening, Operation and Supervision*.

IIROC believes that orders entered by OES clients may pose additional risks to the integrity of the markets and to the Dealer Member itself as a result of the direct nature of order entry by the client. In an OES account, the limited ability for staff of the Dealer Member to directly

[7] Institutional Customer is defined in the Dealer Member Rules to mean
(1) An Acceptable Counterparty (as defined in Form 1);
(2) An Acceptable Institution (as defined in Form 1);
(3) A Regulated Entity (as defined in Form 1);
(4) A Registrant (other than an individual registrant) under securities legislation; or
(5) A non-individual with total securities under administration or management exceeding $10 million.

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handle orders eliminates a significant opportunity to identify potentially problematic orders or patterns prior to the entry of the order to a marketplace. Rule 3200 requires an OES Dealer to take into account the additional risks associated with the method of order entry and the absence of order handling by staff of the OES Dealer. IIROC expects that an OES Dealer's policies and procedures and systems of supervision and control address these added risks.

The policies and procedures developed and implemented by the Dealer Member must be reasonably designed to ensure that the Dealer Member's regulatory obligations are continually being met, including its client obligations and its obligations to the marketplace generally.

In terms of a Dealer Member's obligations to the marketplace, its policies and procedures must address its gatekeeping obligations, such as monitoring client account activity for orders and trades that may be harmful to the integrity of the markets. This includes activity that is or may be considered manipulative and deceptive. Effective gatekeeping also includes reviewing for problematic account activities that cannot be easily detected by a single order or trade, but through the identification of patterns that may emerge over a period of time.

A Dealer Member's policies, procedures and systems of supervision and control should be appropriate to the size and scope of the Dealer Member and the types of businesses conducted.

3. Manipulative and Deceptive Activities

As part of its supervision obligation, a Dealer Member is expected to have policies and procedures in place that are reasonably designed to identify account activity that is or may be considered manipulative and deceptive. Manipulative and Deceptive Activities is defined in the Dealer Member Rules to mean:

"the entry of an order or the execution of a trade that would create or could reasonably be expected to create:

a) a false or misleading appearance of trading activity in or interest in the purchase or sale of a security; or
b) an artificial ask price, bid price or sale price for the security or a related security".

IIROC is of the view that the policies and procedures developed by the Dealer Member should take into account higher risk activities and consider orders and trades that may pose heightened risks to market integrity. For example, an OES Dealer must consider the heightened risks associated with the entry of orders that are not directly handled by staff of the Dealer Member. UMIR Policy 2.2 sets out a list of activities that may be considered manipulative and deceptive. These activities would similarly be considered Manipulative and Deceptive Activities under the DMR definition. These activities include:

- effecting a trade in a security that involves no change in beneficial or economic ownership,
- making purchases of, or offers to purchase a security at successively higher prices or in a pattern generally of successively higher prices,
- making sales of, or offers to sell a security at successively lower prices or in a pattern generally of successively lower prices,
- entering an order or a series of orders for a security that are not intended to be executed,
- entering an order or orders for the purchase of sale of a security to:
    - establish a predetermined sale price, ask price or bid price,
    - effect a high or low closing sale price, ask price or bid price, or
    - maintain the sale price, ask price, or bid price within a predetermined range,
- entering an order for the purchase of a security without, at the time of entering the order, having the ability or the reasonable expectation to make the payment that would be required to settle any trade that would result from the execution of the order,
- entering an order for the sale of a security without, at the time of entering the order, having the reasonable expectation of settling any trade that would result from the execution of the order,
- effecting a trade in a security between accounts under the direction or control of the same person,
- entering an order or orders for the purchase of a security with the knowledge that an order of substantially the same size, at substantially the same time and at substantially the same price for the sale of that security, has been or will be entered by or for the same or different persons, and
- entering an order or orders for the sale of a security with the knowledge that an order or orders of substantially the same size, at substantially the same time at substantially the same price for the purchase of that security, has been or will be entered by the same or different persons.

IIROC previously issued guidance confirming IIROC's position that certain trading strategies may be considered manipulative and deceptive for the purposes of UMIR.[8] These strategies

[8] See IIROC Notice 13-0053 Rules Notice – Guidance – UMIR – Guidance on Certain Manipulative and Deceptive Trading Practices (February 14, 2013)

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may similarly be considered manipulative and deceptive under the definition of Manipulative and Deceptive Activities in the DMR. These activities include:

- "Quote Stuffing",
- "Quote Manipulation",
- "Spoofing", and
- "Abusive Liquidity Detection".

4. Client Identifier

To assist IIROC in providing a consistent level of market surveillance of trading activity that may pose similar risks to market integrity, DMR 3200 A.V(a) requires that each order originated by or on behalf of certain "active" OES clients and any OES client that is not an individual and is registered as a dealer or adviser under applicable securities legislation be assigned a client ID. The client ID must be included on each order entered by or on behalf of any client that requires its use. An "active" client is any OES client whose trading activity:

- exceeds a daily average of 100 trades per trading day in any calendar month, or
- exceeds a daily average of 500 orders per trading day in any calendar month.

IIROC expects that an OES Dealer will, on a monthly basis, review orders and trades from the prior month to identify any clients that met the prescribed threshold in that month. Once a client has been identified, the OES Dealer is expected to take immediate steps to assign or obtain a client ID and to advise IIROC of the client ID and the name of the client associated with it.

IIROC requires that a client ID also be applied to orders for any OES client that is not an individual and registered as a dealer or adviser under applicable securities legislation. IIROC expects that OES dealers will identify any such current clients and take the appropriate steps to obtain a client ID for each such client. New clients that are registered as a dealer or advisor must be assigned a client ID upon the account being opened.

The practice relating to the obtaining and use of client IDs is the same as the existing practice used for clients accessing the marketplace through DEA and routing arrangements. Once the client ID has been obtained and assigned to a particular client, the OES Dealer must immediately advise IIROC of the client ID and the identity of the client associated with it.

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5. Questions and Answers

The following is a list of questions regarding OES as a form of third-party electronic access to marketplaces:

1. ***What form of client ID is IIROC requiring and how is it assigned?***

   The practice relating to the obtaining and use of client IDs is the same as the existing practice used for clients accessing the marketplace through DEA and routing arrangements. Client IDs will be included in the "User ID" field (as designated by the marketplace on which the order is entered) for DEA clients, investment dealers and foreign dealers under routing arrangements and OES clients that require the use of a client ID. OES Dealers are required to request client IDs through the Participant responsible for their order flow to the marketplace.[9] Once the OES Dealer has been advised of the client ID, it must immediately advise IIROC of the client ID and the identity of the client associated to it. Any OES Dealers with clients that require the use of a client ID must ensure that their order management systems have the capacity to carry the particular client ID in the "User ID" field on each order entered by or on behalf of the client associated with the ID.

2. ***How often does a firm need to confirm whether any of its clients exceed the threshold at which a client ID is required?***

   IIROC expects that a firm should, on a monthly basis, review the previous month for client activity that meets the threshold at which the use of a client ID is required. The calculation of order and trade activity is based on the average order and trade activity per trading day in the previous calendar month. Once a client is identified, the OES Dealer must take steps to assign or obtain a client ID for that client. Once a client meets the threshold where the use of a client ID is required, the requirement to include the client ID on all subsequent orders will continue to apply regardless of the future activity of that particular client.

3. ***In the case of a client with multiple accounts at an OES Dealer, does the OES Dealer need to take all the accounts into consideration when determining whether the client has met the threshold at which a client ID is required?***

   Where a client operates more than one account with the same OES Dealer, IIROC expects the OES Dealer to consider the client's aggregated activity for the purposes of determining whether the threshold has been met. If the use of a client ID is required

[9] OES Dealers that are themselves Participants can assign the client IDs directly. OES Dealers that are not Participants must obtain the client IDs through the Participant responsible for the execution of their order flow.

for a particular client, the same identifier may be applied to all orders entered for or on behalf of that client across all accounts belonging to that client.

4. ***Is there an obligation to monitor on a "real-time" basis orders entered by an OES client?***

Each Dealer Member's supervision policies and procedures and systems of control should be appropriate for its size and business and be reasonably designed to prevent and detect violations of any requirement applicable to the Dealer Member's business. An OES Dealer should consider employing supervisory controls that have the ability to detect an offending order prior to such order being completed for entry to a marketplace. To the extent that this is not possible, the OES Dealer should, at a minimum, have sufficient pre- and post-trade compliance testing to address the added risks associated with orders entered by OES clients.

The ability to monitor trading on a "real-time" basis would be particularly helpful if additional monitoring of a specific client's activity becomes necessary as a result of a regulatory request, or if the OES Dealer itself determines that trading by a particular client requires additional monitoring.

IIROC published provisions respecting electronic trading which became effective March 1, 2013 that are applicable to all Dealer Members that are also Participants for the purposes of UMIR.[10] These provisions outline certain elements of the risk management and supervisory controls, policies and procedures which must be employed by Participants. These include:

- automated controls to examine each order before entry on a marketplace to prevent the entry of an order which would result in:
  - the Participant exceeding pre-determined credit or capital thresholds,
  - a client of the Participant exceeding pre-determined credit or other limits assigned by the Participant to that client, or
  - the Participant or client of the Participant exceeding pre-determined limits on the value or volume of unexecuted order for a particular security or class of securities; and
- provisions to prevent the entry of an order that is not in compliance with applicable Requirements.[11]

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[10] See IIROC Notice 12-0363 Rules Notice – Notice of Approval – UMIR – Provisions Respecting Electronic Trading (December 7, 2012).

[11] "Requirements" include UMIR, applicable securities regulation, requirements of any self-regulatory organization applicable to the activity of the account and the rules and policies of any marketplace on which the account activity takes place.

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5. ***Can a Dealer Member use the same compliance testing and review standards to monitor trading activity by OES clients as it does for full service brokerage?***

   Under DMR 2500, 2700 and 38.1, a Dealer Member's policies and procedures and systems of control should be designed to address the risks relevant to its business. Orders entered through OES may introduce additional risks to the Dealer Member and to the marketplace generally given the limited involvement of staff in the handling of client orders. To the extent that a Dealer Member does not have separate compliance testing and review standards for its OES business, it must ensure that the overall standards of compliance and supervision sufficiently address the heightened risks associated with OES order entry.

6. ***Are there any particular risks that need to be addressed in compliance procedures for trading by OES clients?***

   DMR 2500 and 2700 require that policies and procedures and systems of supervision and control must be appropriate for the lines of business conducted by the Dealer Member. Given that the entry of orders through OES is subject to limited intermediation by staff of the OES Dealer, compliance procedures, at a minimum, should address:

   - orders that have been entered which are not intended to be executed, such as orders entered for the purpose of determining the depth of the market, affecting a calculated opening price, checking for the presence of hidden liquidity or other similar improper purpose;
   - orders that have been entered on a marketplace and trades that have executed for the purpose of creating a high or low closing price in the case of a trade, or a high or low bid or offer in the case of an order;
   - orders that have been entered at unreasonable prices; and
   - trades that involve no beneficial change in ownership (i.e. wash trading) particularly where a client has multiple accounts.

6. Impact on Existing Guidance

This Rules Notice repeals and replaces, effective ####, the guidance set out in Market Integrity Notice 2007-011 – *Guidance – Compliance Requirements for Order-Execution Services* (April 20, 2007)

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