

Market Integrity Notice |

Guidance

March 10, 2006

No. 2006-008

Suggested Routing

- Trading
- Legal and Compliance

USE OF THE MARKET-ON-CLOSE FACILITY

Key Topics

- Index Rebalancing
- Last Sale Price
- Manipulative Trading
- Market-on-Close
- Off-Setting Orders
- Wash Trading

Summary

This Market Integrity Notice provides guidance relating to the entry of a “market order” in the Market-on-Close Facility of the Toronto Stock Exchange and the circumstances under which the subsequent entry of a limit order on the other side of the market may be considered a manipulative and deceptive activity by Market Regulation Services Inc. for the purposes of the Universal Market Integrity Rules.

UMIR Provisions Referenced

- Rule 1.1 – Definitions – “Exchange-traded Fund”
- Rule 2.2 – Manipulative and Deceptive Activities
- Rule 6.2 – Designations and Identifiers
- Rule 7.7 – Trading During Certain Securities Transactions

Questions / Further Information

For further information or questions concerning this notice contact:

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Market Integrity Notices Referenced

- Market Integrity Notice 2004-021 – Entry of Off-Setting Market-on-Close Orders (August 26, 2004)
- Market Integrity Notice 2005-029 – Entry of Orders on Both Sides of the Market (September 1, 2005)

USE OF THE MARKET-ON-CLOSE FACILITY

Summary

This Market Integrity Notice provides guidance relating to the entry of a “market order” in the Market-on-Close Facility (“MOC Facility”) of the Toronto Stock Exchange (“TSX”) and the circumstances under which the subsequent entry of a limit order on the other side of the market may be considered a manipulative and deceptive activity by Market Regulation Services Inc. (“RS”) for the purposes of the Universal Market Integrity Rules (“UMIR”).

Background

The Market-on-Close Facility of the TSX permits the entry of market orders to trade at the closing price (“Market MOC Order”) from 7:00 a.m. to 3:40 p.m. At 3:40 p.m., the TSX calculates and broadcasts the order imbalance for each of the securities participating in the MOC Facility indicating whether the imbalance is on the buy or sell side and the size of the imbalance. After 3:40 p.m., only limit orders on the opposite side of the market as the imbalance (“Limit MOC Order”) may be entered into the MOC Facility. The MOC Facility is “blind” as there is no transparency with respect to particular orders entered as Market MOC Orders or Limit MOC Orders. A Market MOC Order entered prior to 3:40 p.m. may not be amended or cancelled at any time after 3:40 p.m. and any Limit MOC Order entered prior to 4:00 p.m. may not be amended or cancelled at any time after 4:00 p.m. At 4:00 p.m. the orders in the MOC Facility are combined with outstanding orders in the central limit order book of the TSX Regular Session to calculate the Closing Price.

It is expected that a Market MOC Order is essentially “price insensitive” and that the person entering such an order is prepared to trade at any price that may be as much as 10% higher or lower than the price of the last sale in the Regular Session of the TSX prior to 4:00 p.m. The primary consideration of the person entering such an order is the guarantee of being able to trade at the closing price. For example, in the case of a person who maintains a portfolio of securities that tracks the performance of an index, orders to buy and sell securities to reflect an index rebalancing need to be filled at the closing price so that the performance of the portfolio continues to match the performance of the index. Similarly, if a person will be entering into a swap contract that is based on the closing price that person is essentially “neutral” on the level of the closing price provided they are able to obtain that price. Persons who are essentially “price insensitive” for these or similar reasons should properly be the investors who determine the order imbalance in the MOC Facility that is broadcast at 3:40 p.m. Persons who are “sensitive” to the closing price would respond to the imbalance and have the opportunity to provide liquidity through the entry of Limit MOC Orders following the broadcast of the imbalance till 4:00 p.m. A person who had entered a Market MOC Order but is “price sensitive” may be restricted or prohibited from entering an “off-setting” Limit MOC Order if the broadcast of the imbalance indicates that the closing price may move in the opposite direction to that which the person anticipated.

General Prohibition on Wash Trades in the MOC Facility

Rule 2.2(1) of UMIR prohibits any manipulative or deceptive method, act or practice in connection with any order or trade on a marketplace. A Participant or Access Person is prohibited from entering an order on a marketplace if the Participant or Access Person knows or ought reasonably to know that any resulting trade will be either fictitious or involve no change in beneficial or economic ownership (a “wash trade”).

Similarly, a Participant or Access Person will have contravened Rule 2.2(2) if the Participant or Access Person knows or ought reasonably to know that the entry of the order or the execution of the trade will create or could reasonably be expected to create:

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

A Participant or an Access Person will be considered to have engaged in “wash trading”, a type of manipulative and deceptive activity, if the Participant or Access Person knows or ought reasonably to know that:

- orders for the purchase and for the sale of the same security are being entered on a marketplace;
- the orders are for the benefit of an account or accounts which have the same economic and beneficial owner or are under the direction or control of the same person; and
- the orders have the potential of trading with each other.

Market Integrity Notice 2004-021 – *Entry of Off-Setting Market-on-Close Orders* issued on August 26, 2004 sets out the position of RS that the entry by a Participant or Access Person into the MOC Facility of a Limit MOC Order to “off-set” a Market MOC Order entered by that Participant or Access Person constitutes a “wash trade”.

Exceptions from the General Prohibition

RS recognizes that a particular trader can be trading multiple strategies at the same time. For example, the trader may have orders that are benchmarked to the closing price (such as for the purpose of the index rebalancing or swap contract described above) while trading an inventory for “fundamental” reasons (e.g. buy low/sell high). In these circumstances, the trader could enter Market MOC Orders prior to 3:40 p.m. and then enter Limit MOC Orders in reaction to the broadcast of a large imbalance. However, the entry of the Limit MOC Order would prompt RS to contact the trader who would have to demonstrate that the Limit MOC Order was not entered simply to “off-set” a Market MOC Order (that might otherwise trade at a “bad” price) but to achieve a valid investment strategy. If time permits, a trader who wishes to enter a Limit MOC Order in these circumstances is urged to contact the Market Supervision Section of RS (at

416.646.7220 in Toronto) to confirm that the entry of such an order would be viewed as acceptable by RS.

On the other hand, a fundamental trader would have a hard time demonstrating that a Market MOC Order was, in fact, price insensitive. If a fundamental trader entered a Market MOC Order then off-set the order following the broadcast of the MOC imbalance with the entry of a Limit MOC Order, that trader would not be able to claim to be working two different strategies. Instead, RS would take the position that the order pattern would create inaccurate or misleading MOC imbalance messages in a manner which is manipulative and deceptive for the purposes of UMIR.

Market Integrity Notice 2005-029 set out a number of circumstances in which RS will not consider a Participant or Access Person to be engaging in a manipulative or deceptive activity if a “wash trade” occurs. With particular reference to the MOC Facility, Market Supervision may in some cases specifically authorize the entry of an off-setting Limit MOC Order for a Market MOC Order to correct an erroneous Market MOC Order that would not otherwise be capable of amendment or cancellation after 3:40 p.m. In determining whether to permit the entry of an off-setting order for the amount of an error or a lesser amount, Market Supervision will consider:

- the possible impact of the erroneous Market MOC Order on the closing price;
- the extent to which trading activity may have already occurred in the affected security based on the MOC imbalance report; and
- whether there is sufficient time to issue a notice to the market of the adjustment to the imbalance report.

Questions / Further Information

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