

Market Integrity Notice |

Guidance

October 30, 2006

No. 2006-020

Suggested Routing

- Trading
- Legal and Compliance

Key Topics

- Best Execution Obligation
- Best Price Obligation
- Compliance Testing
- “Day” Orders
- Direct Market Access
- “Good Till Cancelled” Orders
- “Manual” Marketplace
- Market Orders
- Multiple Marketplaces
- Order Markers
- Principal Orders
- Trade Confirmations

UMIR Provisions Referenced

- Rule 1.1 – Interpretation
- Rule 3.1 – Restrictions on Short Sales
- Rule 4.1 – Frontrunning
- Rule 5.1 – Best Execution of Client Orders
- Rule 5.2 – Best Price Obligation
- Rule 5.3 – Client Priority
- Rule 6.3 – Exposure of Client Orders
- Rule 7.1 – Trading Supervision Obligations
- Rule 7.7 – Restrictions on Trading During Certain Securities Transactions
- Rule 8.1 – Client-Principal Trading
- Rule 10.11 – Audit Trail Requirements

COMPLIANCE REQUIREMENTS FOR TRADING ON MULTIPLE MARKETPLACES

Summary

This Market Integrity Notice provides guidance on various compliance requirements of a Participant under the Universal Market Integrity Rules with respect to the handling of orders and trades in a security that trades on more than one marketplace.

Questions / Further Information

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Market Integrity Notices Referenced

- Market Integrity Notice 2005-015 - *Guidance – Complying with “Best Price” Obligations* (May 12, 2005)
- Market Integrity Notice 2006-010 – *Guidance – Short Sale Designations and Restrictions* (April 7, 2006)
- Market Integrity Notice 2005-023 - *Guidance – Securities Trading on Multiple Marketplaces* (July 29, 2006)
- Market Integrity Notice 2006-017 - *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006)
- Market Integrity Notice 2006-019 – *Request for Comments – Provisions Respecting Competitive Marketplaces* (October 6, 2006)

COMPLIANCE REQUIREMENTS FOR TRADING ON MULTIPLE MARKETPLACES

Summary

This Market Integrity Notice provides guidance on various compliance requirements of a Participant under the Universal Market Integrity Rules (“UMIR”) with respect to the handling of orders and trades in a security that trades on more than one marketplace.

Background

On July 14, 2006, the Canadian Securities Administrators (“CSA”) published a Notice of Proposed Amendments to National Instrument 21-101 – *Marketplace Operation* and Companion Policy 21-101CP and National Instrument 23-101 – *Trading Rules* and Companion Policy 23-101CP (the “CSA Notice”). The CSA Notice set out the CSA’s requirements with regard to information on orders and trades that each Participant is to take into account when fulfilling best execution obligations. In particular, the CSA Notice clarified the CSA’s position that in order to meet its best execution obligations, a dealer is expected to take into account order information from all marketplaces where a particular security is traded (not just marketplaces where a dealer is a participant) and take steps to access orders, as appropriate. Market Regulation Services Inc. (“RS”) published Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006) which provides guidance on the obligations of a Participant or Access Person under UMIR with respect to trading activity in a security that trades on more than one marketplace. **Market Integrity Notice 2006-017 repealed and replaced Market Integrity Notice 2005-023 – Guidance – Securities Trading on Multiple Marketplaces (July 29, 2005) and Market Integrity Notice 2005-015 – Guidance – Complying with “Best Price” Obligations (May 12, 2005).**

In the CSA Notice, the CSA indicated that further amendments to the National Instrument 21-101 and National Instrument 23-101 (“ATS Rules”) may be forthcoming on the completion of the study following Concept Paper 23-403 – *Developments in Market Structure and Trade-Through Obligations* published by the CSA on July 22, 2005. The provisions of UMIR and their interpretation and application would be modified to conform to the positions adopted by the CSA. Upon the publication of the proposed amendments to the ATS Rules respecting trade-through obligations, RS will issue additional Market Integrity Notices to request comments on proposed consequential amendments to UMIR and to provide further guidance on trading and compliance practices that may be required as a direct consequence of the final position adopted by the CSA with respect to trade-through obligations.

Questions and Answers

The following is a list of frequently asked questions regarding the compliance requirements of a Participant with respect to trading in a security that trades on more than one marketplace:

1. What records should a Participant maintain for “indications of interest” and orders that are transmitted to a “manual” marketplace for a principal account?

Rule 10.11 of UMIR requires that a Participant comply with the audit trail requirements set out under Part 11 of National Instrument 23-101 (the “CSA Trading Rules”). Under Section 11.2 of the CSA Trading Rules, a dealer must, immediately following the origination of an order for securities, record specific information relating to that order. Subsection 11.2(2) further requires that, immediately following the transmission of such order to a marketplace, the dealer record the identifier of the marketplace and the date and time of transmission of the order.

Until recently, all marketplaces provided for fully automated electronic order entry and recording of information with respect to orders and trades in a manner that facilitated compliance with the audit trail requirements under UMIR and the CSA Trading Rules. For this reason, UMIR did not require a Participant to produce “trade tickets” or the equivalent for principal orders.

Effective August 15, 2006, Shorcan ATS Limited (“Shorcan”) commenced operations as an alternative trading system trading securities that are currently listed on the Toronto Stock Exchange. Shorcan limits access to its marketplace to dealers that have become subscribers and who enter orders as principal (and not as agent on behalf of clients). Shorcan is a “manual” marketplace in which all orders are physically entered on the marketplace by an employee of Shorcan and all “indications of interest” provided by a subscriber by telephone to Shorcan are confirmed by an employee of Shorcan before entry into the Shorcan trading system as an order. To the extent that a Participant transmits an “indication on interest” to Shorcan that is confirmed as an order, a Participant must create and retain a record of such order in compliance with the applicable audit trail requirements. A Participant should also maintain a separate record of “indications of interest” in order for the Participant to be able to demonstrate compliance with various UMIR requirements including:

- Rule 4.1 – Frontrunning; and
- Rule 5.3 – Client Priority.

2. Should a Participant ensure that any sample of orders and trades taken for compliance testing contain orders or trades from each marketplace on which the Participant conducts trading?

Rule 7.1 of UMIR requires that a Participant adopt policies and procedures that are adequate to ensure compliance with the requirements of UMIR. In accordance with Policy 7.1, a Participant must determine the level of testing which is appropriate based on the size and type of business conducted by the Participant. To the extent that a Participant enters orders for a particular security on more than one marketplace, RS

expects that the Participant's compliance testing will be based on a representative sample of the total number of orders entered and trades executed on each marketplace.

In Market Integrity Notice 2006-017 - Guidance – *Trading Securities on Multiple Marketplaces* (September 1, 2006) RS provided additional guidance on the application and interpretation of various UMIR provisions in a multiple marketplace environment. A compliance sample which includes each marketplace on which orders have been entered by a Participant will allow the Participant to assess whether its policies and procedures are adequate to ensure compliance in a environment with multiple marketplaces trading the same securities under:

- Rule 3.1 – Restrictions on Short Sales;
- Rule 5.1 – Best Execution of Client Orders;
- Rule 5.2 – Best Price Obligation;
- Rule 5.3 – Client Priority;
- Rule 7.7 – Restrictions on Trading During Certain Securities Transactions; and
- Rule 8.1 – Client-Principal Trading.

A Participant should consider “sampling” a higher percentage of orders entered or trades executed on a particular marketplace if:

- the Participant has had to develop specific policies and procedures for the handling of orders entered on that marketplace in order to accommodate “unique” aspects of that marketplace;
- the Participant has had no, or limited, previous experience handling orders on that marketplace; or
- the orders entered on that marketplace have not been subjected to the “ordinary filters” contained in the order management system of the Participant.

3. What information must be disclosed on the trade confirmation if a Participant executes a portion of a client order for a particular security on more than one marketplace?

Under section 36 of the *Securities Act* (Ontario) and comparable provisions of the securities legislation of other jurisdictions, a Participant is required to send a trade confirmation to the client. In accordance with Part 3 of the policy adopted under Rule 7.1 of UMIR, a Participant is required to have appropriate policies and procedures to ensure compliance with these requirements.

If a client order for the purchase or sale of a particular security is executed on more than one marketplace, the trade confirmation may disclose that the order has been executed on multiple marketplaces. However, the confirmation must also disclose that details of each trade are available upon request. A Participant must provide the details of each

trade at no charge. This type of confirmation is comparable to the trade confirmation disclosure that a Participant provides when the client order has been filled at multiple prices and an average price is provided on the trade confirmation. If a client order is executed on a single marketplace, the trade confirmation must continue to identify the marketplace on which the order was executed.

4. *What is a Participant expected to do with “Day” or “Good Till Cancelled” client orders that have been entered on a marketplace that has closed for trading on a particular day if trading in the security continues on other marketplaces?*

Part 6 of the CSA Trading Rules provides that each marketplace may establish its own trading hours. A number of marketplaces have established or are expected to establish, hours of operation which are outside historic trading hours. As a result, RS expects that a Participant will establish appropriate policies and procedures with respect to the handling of a “Day” and “Good Till Cancelled” orders and communicate such policy to its clients. For example, a Participant might consider a “Day” order to expire at a number of different times, including at the close of:

- the marketplace on which the order is entered;
- the “principal market” on which such security trades (for an interpretation of the term “principal market” reference should be made to Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006));
- the last of the marketplaces on which the security trades and which provides pre-trade transparency; or
- any other marketplace or marketplaces on which the security trades.

Similarly, in the case of a “Good Till Cancelled” order, a Participant may adopt policies and procedures that would consider such an order “active” only when certain marketplaces are open for trading.

If a Participant has adopted a policy on the expiration of “Day” orders and “inactivity” of “Good Till Cancelled” orders and has informed its clients of its policy, the Participant would not be expected to continue to monitor trading opportunities on marketplaces that continue to operate after a “Day” order is considered to have expired or while a “Good Till Cancelled” order is inactive.

To the extent that a Participant has not informed clients of the Participant’s policy on the handling of “Day” and “Good Till Cancelled” orders, RS would expect that the Participant, in compliance with its “best execution” obligations under Rule 5.1 of UMIR, would continue to monitor trading opportunities on those marketplaces open for trading. For example, if a Participant in handling various “Day” and “Good Till Cancelled” orders on behalf of clients has entered the orders on a marketplace that has closed for trading on a particular day, RS would not expect that the Participant would move the orders “en masse” to a marketplace that continues to trade those securities. In considering best

execution of the client orders, the Participant must weigh the possible loss of priority against the likelihood of execution opportunities. In such circumstances, a Participant must ensure that it has appropriate policies and procedures in place to monitor trading opportunities on marketplaces that operate outside of the historic trading hours of 9:30 a.m. to 4:00 p.m. It would also be expected that the Participant would periodically sample unfilled “Day” and “Good Till Cancelled” orders to ensure that the policies and procedures are being adhered to and are effective in ensuring “best execution” of such client orders.

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

Upon receipt of a “market” order from a client, a Participant would be expected to enter the order on the marketplace that would provide the best price for the client based on orders displayed in the consolidated market display. In certain cases, this may involve the Participant splitting the order for entry on more than one marketplace. If the order is executed on one marketplace at a time when a better-priced order existed on a transparent marketplace, the Participant would owe an obligation to fill that better-priced order in accordance with Rule 5.2 of UMIR. The obligation of the Participant to fill the better-priced order would apply even if the client had instructed the Participant to enter the “market” order on a specific marketplace.

The historic 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 historic trading hours. Unless a Participant has adopted a policy for the handling of “market” orders outside of the historic trading hours that has been communicated to its clients, a Participant that receives a market order after 4:00 p.m. and before 9:30 a.m. the next trading day would be expected to consider trading opportunities on any visible marketplace that is then open for trading.

In accordance with Rule 6.3 on the exposure of client orders, 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”. (See question 12 for a discussion of “standard trading units”.) 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.

RS expects that a Participant will adopt policies and procedures with respect to the handling of “market” 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” order may trade.

6. If a client order for a security that trades on more than one marketplace is not immediately tradable on any marketplace, on which marketplace may the order be “booked”?

Rule 5.1 of UMIR requires a Participant to diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions. If a client order is not immediately tradable, a Participant may enter or “book” the order on any marketplace that trades the security subject to any instructions provided by the client with respect to the entry of the order. If the client order is immediately tradable based on orders displayed in a consolidated market display, Rule 5.1 would require the Participant to honour such better-priced displayed orders whether or not the client has instructed that its order be executed on another marketplace.

RS expects that a Participant will adopt policies and procedures with respect to the marketplace or marketplaces on which client orders are entered in the absence of specific client instruction. It is also expected that a Participant will inform its clients of such policy and the implications for the entry of orders on a particular marketplace. (For example, see the response to question 4 above.) If a client instructs a Participant to enter the order on a specific marketplace, the Participant is not required to monitor trading opportunities for the client order on other marketplaces that continue to trade the security.

RS has proposed amendments to Rule 6.3 of UMIR to require that client orders for 50 standard trading units or less must be immediately entered on a marketplace that provides pre-trade transparency. Reference is made to Market Integrity Notice 2006-019 – *Request for Comments – Provisions Respecting Competitive Marketplaces* (October 6, 2006). Orders which are routed to a non-transparent marketplace to determine if liquidity is available on that marketplace at prices that are the same or better than displayed in a consolidated market display would comply with the proposed rule if any unexecuted portion of the client order was then immediately entered on a marketplace that did provide order transparency.

7. Is a Participant required to consider visible orders on a 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 a client 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 marketplaces that are then open for trading. The “best price” obligation will apply to visible orders entered on special trading facilities of a marketplace which conducts trading before or after its “regular” trading hours.

8. If a marketplace does not support a marker required under UMIR is a Participant permitted to execute the trade on that marketplace without the required marker?

No. As a general rule, the orders and trades that require a UMIR marker may only be entered or executed on a marketplace that supports that marker. For example, if a marketplace did not support a “short sale” marker, a Participant would not be permitted to enter “short sale” orders on that marketplace.

Currently, certain marketplaces do not support the “short exempt” marker. Generally, if a Participant wishes to place a “short exempt” order on a marketplace that does not support that marker, RS is generally of the view that the Participant may do so if the Participant instead marks the order “short”. RS will accept that a Participant may enter a “short exempt” order as a “long” order on a marketplace that does not support the “short exempt” marker **only** where an order is a bundled long/short order. For further information on this exemption, reference should be made to Market Integrity Notice - 2006-010 – *Guidance – Short Sale Designations and Restrictions* (April 7, 2006).

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 transparent 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 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006).

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.

10. Is a Participant required to monitor a marketplace for trading opportunities that has historically not provided liquidity for a particular security in order to meet its “best execution” obligation?

With the publication of the CSA Notice, the CSA has confirmed their requirement that each Participant will take into account order and trade information from all marketplaces that trade the same securities when discharging their best execution obligations. While neither the UMIR nor the CSA Trading Rules requires a Participant to maintain trading access to every Canadian marketplace on which a security may trade, the CSA expects that a Participant will make arrangements with another dealer who is a participant of a particular marketplace or will route an order to a particular marketplace, where appropriate. In the view of RS, a Participant would be expected to make such arrangements if the particular marketplace had demonstrated that there is a reasonable

likelihood that the marketplace will have liquidity for a specific security relative to the size of the client order. In order to determine whether a particular marketplace has demonstrated a reasonable likelihood of liquidity, RS expects that a Participant will have appropriate procedures in place to monitor all marketplaces in order to determine whether a particular marketplace has, on a historical basis, demonstrated a reasonable likelihood of liquidity for the particular security. The test is measured on a security by security basis and is not dependent upon the marketplace meeting a threshold level a trading in securities generally. The obligation to consider a marketplace when obtaining “best execution” of a client order extends to those marketplaces that do not provide pre-trade transparency but have demonstrated a reasonable likelihood of liquidity for the particular security.

11. When are the compliance requirements with respect to the handling of orders in a security that trades on more than one marketplace effective?

With the publication of the CSA Notice on July 14, 2006, the CSA confirmed their requirements that a dealer take into account information on orders and trades from all marketplaces trading a particular security, as appropriate. RS published Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006) to provide guidance on when it was appropriate to consider order and trade information from a particular marketplace given the differences amongst marketplaces with respect to the dissemination of order and trade data, marketplace access and automation of order entry and execution. In addition, RS has published a number of proposed amendments to UMIR to accommodate the introduction of competitive marketplaces that will become effective following public comment and approval by the applicable securities regulatory authorities. Reference should be made to Market Integrity Notice 2006-019 – *Request for Comments – Provisions Respecting Competitive Marketplaces* (October 6, 2006).

12. What last sale price should be used for determining “standard trading units”?

UMIR defines a “standard trading unit” of any equity of similar security as:

- 1,000 units of a security trading at less than \$0.10 per unit;
- 500 units of a security trading at \$0.10 or more per unit and less than \$1.00 per unit; and
- 100 units of a security trading at \$1.00 or more per unit.

For the purposes of this calculation, the “last sale price” on the preceding trading day is to be used. In the absence of an information processor, trade information disseminated by certain marketplaces is not readily incorporated into data feeds provided by other information vendors. RS is of the view that the “last sale price” of a particular security should be the price from the “principal market” for the trading of that security. As at the date of this Market Integrity Notice, the “principal market” for any listed security is

generally the Exchange on which the security is listed.¹ Reference should be made to Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006) for more information on the determination of the “principal market” for a particular security.

Questions / Further Information

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¹ As at the date of this Market Integrity Notice, the “principal market” for any listed security is the Exchange on which the security is listed subject to the following exceptions:

- XPEL Technologies Corp. which trades on the TSX Venture Exchange under the symbol “DAP.U” while also listed on CNQ under the symbol “XPEL” and for which the “principal market” is CNQ; and
- United Reef Limited which trades on CNQ under the symbol “URPL” while also listed on the TSXV under the symbol “URP” and for which the “principal market” is TSX Venture Exchange.