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*Suggested Routing: Trading, Legal & Compliance*

## **GUIDELINES ON TRADING SUPERVISION OBLIGATIONS**

This Notice provides guidance to Participants on the application of Policy 7.1 under Universal Market Integrity Rules (“UMIR”) related to Trading Supervision Obligations. Policy 7.1 has been in effect since April 1, 2002. Prior to that time, the Toronto Stock Exchange had a similar policy respecting trading supervision and compliance that required that a supervisory system be in place not later than September 28, 2001.

**Participants are reminded that failure to develop and implement appropriate policies and procedures in accordance with the requirements of Policy 7.1 may result in disciplinary action against the firm, its management and its directors.**

As part of each trade desk review undertaken by staff of Market Regulation Services Inc. (“RS”), RS will review the policies and procedures that have been adopted by a Participant. As a result of this review, RS will comment on whether, in the opinion of RS, such policies and procedures appear to be adequate to prevent and detect violations of Requirements in light of the type and volume of business undertaken by the Participant. The review of the policies and procedures does not constitute an approval of the policies and procedures by RS as RS will not have undertaken a comprehensive analysis of the business of the Participant.

On an ongoing basis, the directors of the Participant must ensure that the principal risks for non-compliance with Requirements have been identified and that appropriate supervision and compliance procedures to manage those risks have been implemented. Management of the Participant is responsible for ensuring that the supervision system is effectively carried out.

Participants are also reminded that management and the board of directors must ensure that the compliance department is adequately funded, staffed and empowered to fulfil its responsibilities. To date, trade desk reviews have not commented on this requirement but may do so in the future. Similarly, inadequate funding of the compliance function may be taken into account in the context of any disciplinary action.

### **Background and Terminology**

UMIR Policy 7.1 requires a Participant “to develop and implement a clearly defined set of policies and procedures that are reasonably designed to prevent and detect violations of Requirements”. Participants are reminded that the “Requirements” include more than UMIR and its policies and that supervision systems must encompass these “Requirements. For the purposes of Policy 7.1, the term “Requirements” is presently defined as including:

- UMIR and its Policies;
- National Instrument 23-101 (the “Trading Rules”)

- Rules, policies and other similar instrument adopted by a recognized exchange or recognized quotation and trade reporting system (“Marketplace Rules”); and
- any direction, order or decision of RS or any other regulation services provider (“Decisions”).

Policy 7.1 sets out requirements for both supervisors and compliance departments and requires that a supervision system include both supervision policies and procedures and compliance policies and procedures. Policy 7.1 uses a number of terms regarding supervision systems that are not specifically defined in UMIR or the Policy. An appreciation of these terms may assist Participants in developing their supervision systems and the following are RS’ administrative interpretations for various terms:

- **“supervision system”** and **“supervisory system”** encompasses the activities of both the supervision procedures and the compliance procedures
- **“supervise”**, **“supervision”**, **“supervisor”**, and **“supervisory”** refer to the responsibilities of the head of trading “and each person who has authority or supervision over or responsibility to the Participant for an employee of the Participant” with respect to the trading activities of the Participant as described in Rule 7.1(4). A Participant may have more than one head of trading and any number of persons who have authority over the trading activity of employees.
- **“supervision procedures”** are the policies and procedures to be followed by supervisors that are aimed at preventing violations from occurring.
- **“compliance department”**, **“compliance”** and **“monitoring”** refer to the responsibilities of the persons responsible for the compliance activities of the Participant.
- **“compliance procedures”** are the policies and procedures to be followed by the compliance department that are aimed at detecting whether violations have occurred.
- **“management”** means those persons who are in either supervisory or monitoring roles.

### **Minimum Elements of a Supervision System**

Trade desk reviews conducted by RS have found that Participants have a number of common misconceptions about the requirements of Policy 7.1 and that there are a number of common deficiencies in the supervision system adopted by Participants. A supervision system must have both compliance procedures and supervision procedures. The nine elements of a supervision system that are listed in Part 2 of Policy 7.1 are primarily conceptual in nature and must be reflected in the overall structure of a Participant’s policies and procedures. A Participant cannot simply list each of these elements in its policies and procedures or affirm that each is being done. When evaluating policies and procedures, RS determines whether these elements have been included. Specific guidance is offered on each of the required nine elements of a supervision system.

- **Element 1 - Identification of Relevant Requirements**

A Participant's policies and procedures must address all of the "Requirements" that apply to its business and trading. Participants are reminded that "Requirements" include not only the rules under UMIR but also the Trading Rules, Marketplace Rules and Decisions.

At a **minimum**, RS will review supervisory and compliance policies and procedures for inclusion of:

- the rules set out in Part 3 of Policy 7.1 (Minimum Compliance Procedures for Trading on a Marketplace); and
- any practice or procedure to be followed by a Participant as described in a Market Integrity Notice issued by RS.

RS issues a Market Integrity Notice upon a new or amended provision coming into effect. The following table identifies the changes to UMIR and its Policies that have become effective since April 1, 2002.

Market Integrity Notice	Date	Title	Related UMIR Provision
2002-012	July 9, 2002	Regulation ID Order Markers	6.2
2003-012	June 11, 2003	Definition of "Employee"	1.1
2003-024	October 31, 2003	Accommodation of Anonymous Orders	5.3, 8.1

From time to time, RS will publish a Market Integrity Notice to provide guidance on the interpretation of a particular provision of UMIR. The following table identifies Market Integrity Notices published since April 1, 2002 which have provided guidance on the interpretation of UMIR provisions.

Market Integrity Notice	Date	Title	Related UMIR Provision
2002-005	April 10, 2002	Evidence of Beneficial Ownership of Accounts	10.12
2002-007	May 6, 2002	Time Synchronization	10.14
2002-010	June 26, 2002	Changes in Beneficial and Economic Ownership	2.2, 6.4
2002-021	December 16, 2002	Prohibition Against Establishing Artificial Prices	2.2
2003-002	January 13, 2003	Prohibition on Double Printing	2.2
2003-007	March 27, 2003	Order Marking	6.2
2003-009	April 29, 2003	Trades on an "Organized Regulated Market"	6.4
2003-010	May 5, 2003	Trades in Debt Securities	6.4
2003-011	May 27, 2003	Short Position Reports	10.10
2003-016	August 13, 2003	Short Position Reports	10.10
2003-017	August 19, 2003	Trades in Listed Securities or Quoted Securities	6.4
2003-023	October 28, 2003	Obligations Related to TSX Specialty Crosses	5.3, 10.1

- ***Element 2 - Documentation of the Supervision System***

A Participant must have written policies and procedures for both supervision and compliance. The written policies and procedures must be sufficiently detailed such that a reasonably knowledgeable person can understand when a policy or procedure would apply and how to comply with the policy or procedure. For compliance procedures, a testing method must be described in a manner that a reasonably knowledgeable person would be able to duplicate the testing method.

Preferably, the policies and procedures would be in narrative form. Compliance procedures would contain a step-by-step description of the testing methodologies together with any definitions that would be necessary to explain the logic of the procedures.

Participants should be aware that a copy, photocopy or slightly augmented version of Policy 7.1 does not satisfy the requirement for either compliance procedures or supervisory procedures. The procedures adopted by a Participant must be appropriate for the size and type of business and trading conducted by the Participant and must specifically address the "Requirements" that apply to that type of business or trading.

- ***Element 3 - Training and Proficiency***

Supervisors must have policies and procedures that ensure employees are educated and trained on all of:

- the applicable Requirements;
- the procedures adopted by the Participant; and
- the electronic systems used by the Participant, such as trade stations.

Supervisors must also ensure that there is adequate education and training with respect to:

- changes in Requirements, procedures or systems;
- rectifying any problems found by compliance monitoring.

A Participant should not assume that a new employee has been adequately trained by another firm or by taking an industry course. The existence of multiple or inconsistent procedures may indicate that a firm has not adequately trained its employees. Each Participant must document the education and training that is provided to employees.

To date, trade desk reviews generally have not commented on the education and training provided by supervisors. In the future, the trade desk reviews may comment on the adequacy of the education and training programme adopted by a Participant.

- ***Element 4 - Designation of Supervisory and Compliance Personnel***

RS recognizes that duties can be delegated. However, compliance duties must not be delegated to any person who would be in a conflict of interest. For example, it is not appropriate to delegate the compliance function to an employee that reports to a trading supervisor.

Participants should also be aware that any employee or officer that has supervisory or compliance responsibility and who delegates the duties to another person retains the responsibility for the performance of those functions.

- ***Element 5 - Tailor Procedures to Fit the Participant's Business***

Policy 7.1 applies to all the trading done by a Participant. The Policy is not limited in its application to the head office or to institutional trading. Supervision procedures must encompass all employees involved in the trading process and ensure that they are appropriately educated and trained. These employees may include investment advisors and operations staff. Compliance monitoring must encompass all business units and locations to evaluate the complete trading process.

- ***Element 6 – Procedures for Dealing with Violations***

The compliance department must report problems to the trading supervisors or their delegates. It does not satisfy the Policy to simply monitor trading but not take appropriate steps to correct any problems that are detected. Supervisors are responsible for ensuring that adequate steps are taken to address problems. If the supervisors do not adequately address problems, the person responsible for compliance must ensure that the problem is escalated within the Participant to a higher management level or even the board of directors. These steps and corrective actions must be documented and maintained in an easily retrievable format.

In the view of RS, compliance testing showing that the same or similar problems continue to occur over a period of time may indicate that supervisors have not taken adequate steps to supervise activities or to provide training and education. The continuation of a problem over a period of time may also indicate that the compliance department has not adequately reported the deficiencies in the supervision system to the appropriate management level.

- ***Element 7 - Reviewing the Supervision System***

The Participant must ensure that its supervision and compliance policies and procedures are effective and relevant by reviewing them at least annually. Policy 7.1 has been in effect since April 1, 2002. Prior to that time, the Toronto Stock Exchange had a similar policy respecting trading supervision and compliance that required that a supervisory system be in place not later than September 28, 2001. As such, each Participant that has been in business since September of 2001 should have completed at least two annual reviews of their policies and procedures.

Management must ensure that the compliance procedures and supervisory procedures are updated to reflect new rules, procedures, systems, business lines, offices and employees. Compliance procedures must be reviewed to ensure the testing is effective and address any changes in the Participant.

- ***Element 8 - Retaining Results of Compliance Reviews***

Compliance reviews are to be used to determine a Participant's level of compliance generally and to identify particular areas or rules that in respect of which problems have occurred. The compliance reviews will show if there is a compliance problem and, over time, whether the problem is increasing or decreasing. The compliance reviews will also show if the steps taken by supervisors to address previously identified problems have been effective. For these reasons, tracking trends and patterns over several compliance reviews can be very useful.

RS requires that the results of the compliance reviews be summarized, quantified and retained in an easily retrievable format. Test results must be verifiable. In undertaking a trade desk review, RS will evaluate all summary documents of the required testing and may request the underlying sources for review.

- ***Element 9 - Reports to the Board of Directors***

A summary of the compliance reviews and the results of the supervision system review must be provided at least annually to the board of directors of the Participant. As of this date, each Participant should have reported at least once to its board of directors on these matters. As part of the trade desk review, RS will request a copy of that section of the minutes of the meeting of the board of directors dealing with these reviews together with a copy of the material provided to the board of directors for their consideration.

### **Minimum Compliance Procedures for Trading on a Marketplace**

Part 3 of Policy 7.1 sets out a framework for the **minimum** compliance procedures to be used to monitor trading on a marketplace. Participants are reminded that their compliance procedures should be modified to take account of:

- new or amended Rules or Policies as made from time to time;
- interpretations of UMIR as published by RS as a Market Integrity Notice.

Each Participant must monitor the publication of Market Integrity Notices and the compliance department should determine if the compliance procedures need to be modified to reflect any development described in a Market Integrity Notice. Lists of the relevant Market Integrity Notices which have been issued in the period April 1, 2002 to October 31, 2003 are set out on page 3 of this Notice under the heading "Identification of Relevant Requirements".

Each Participant must determine the level of testing which is appropriate for their firm based on size and type of business conducted by that firm. Each Participant must determine and document its testing methodologies, including the reports and systems that are used by their firm. The table in Part 3 of Policy 7.1 contains columns headed "Compliance Review Procedures" and "Potential Information Sources". The information in the table under these headings is intended to only be suggestions and should not be interpreted as an exhaustive list of requirements.

Similarly, each Participant must determine the appropriate standards for their firm. In many cases, larger sample sizes and more frequent testing may be required. Each Participant must develop reasonable sample sizes and review frequencies and must document the rationale supporting these decisions. The information in the table under the heading "Frequency and Sample Size" only sets out minimum standards for sample size and frequency of tests.

As part of a trade desk review, RS will evaluate the appropriateness of the testing methodologies adopted by a Participant.

## **Questions**

Questions concerning this notice may be directed to:

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