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Suggested Routing: Trading, Legal & Compliance

REQUEST FOR COMMENTS

STRATEGIC REVIEW OF THE UNIVERSAL MARKET INTEGRITY RULES

Summary

Market Regulation Services Inc. (“RS”) is undertaking a strategic review of the Universal Market Integrity Rules (“UMIR”). While UMIR has been amended from time to time since coming into effect on April 1, 2002, RS is taking this opportunity to conduct a comprehensive review of UMIR in light of changes in the marketplace and in industry practices, to consider emerging trends in securities regulation, and to explore ways to better contribute to the overall effectiveness of regulation of equity trading in Canada. This initiative will ensure that the rules that govern equities trading in Canada are fair and neutral to all forms of marketplace and continue to enhance market integrity in the Canadian equity markets.

RS is seeking input from the public, including market participants, buy-side firms and their advisors, in connection with this strategic review.

Objectives for the Strategic Review

RS has been recognized as a self-regulatory entity by the Alberta Securities Commission, British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and, in Quebec, the Autorité des marchés financiers (the “Recognizing Regulators”) and, as such, is authorized to be a regulation services provider for the purposes of the National Instrument 21-101 (“Marketplace Operation Instrument”) and National Instrument 23-101 (“CSA Trading Rules”).

RS has adopted, and the Recognizing Regulators have approved, UMIR as the integrity trading rules that will apply in any marketplace that retains RS as its regulation services provider. Presently, RS has been retained to be the regulation services provider for the Toronto Stock Exchange, TSX Venture Exchange and Canadian Trading and Quotation System, each as a recognized exchange and for Bloomberg Tradebook Canada Company and Liquidnet Canada Inc., each as an alternative trading system (“ATS”).

Since marketplaces, Participants and Access Persons have now had two and half years of experience with UMIR, RS is undertaking the strategic review to ensure that UMIR:

- adequately address the risks to market integrity that presently exists in equity trading in Canadian markets in the most effective and efficient manner;
- do not impose requirements that are no longer necessary to ensure market integrity;
- are sufficiently “marketplace neutral” in their requirements so as not to impede the development of competitive marketplaces; and
- requirements that differ from prevailing standards in international markets are justified by differences in Canadian market structure, industry practices and legal requirements.

The strategic review is also an opportunity for persons to make comments or suggestions on any specific Rule or Policy. As a starting point for the strategic review, RS has prepared the Questions set out in Appendix “A”. While RS would appreciate comment on these questions, RS welcomes comments on any aspect of UMIR. Given the importance of this initiative to the Canadian securities industry as well as RS, RS urges the industry and its advisors to participate in the strategic review.

Strategic Review Process

For the purposes of conducting the strategic review of UMIR, a working group has been established comprised of representatives of the Rules Advisory Committee of RS and management of RS. This working group will review each submission made in response to this Request for Comments. All of the submissions received by RS will be available to the public and will be posted on the RS website.

The working group will conduct roundtable meetings in Montréal, Toronto, Calgary and Vancouver with interested parties. Management and staff of RS will prepare a project plan to implement the suggested rule and policy changes that will be submitted to the Board of Directors of RS (the “Board”) for consideration and approval. All proposed changes to UMIR are reviewed by RAC prior to submission to the Board. RAC is an advisory committee comprised of representatives of each of: the marketplaces for which RS acts as a regulation services provider; Participants; institutional investors and subscribers; and the legal and compliance community.

Each proposed amendment to UMIR that has been approved by the Board is published for public comment in the form of a Market Integrity Notice disseminated by RS and posted on its website. Concurrent with this publication, the Ontario Securities Commission (“OSC”), on behalf of the Recognizing Regulators, publishes the text of the Market Integrity Notice in the OSC Bulletin and posts the document on the OSC website. Based on the public comments together with the results of the review conducted by the staff of each of the Recognizing Regulators, each of the Recognizing Regulators will consider approval of the amendment. Generally, amendments only become effective after all of the Recognizing Regulators have approved.

Comments on UMIR should be in writing and delivered by November 30, 2004 to:

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Market Policy and General Counsel's Office,
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A copy should also be provided to Recognizing Regulators by forwarding a copy to:

Cindy Petlock
Manager, Market Regulation
Capital Markets Branch
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20 Queen Street West
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Background

UMIR was adopted by RS effective April 1, 2002 to be the single set of market integrity rules for trading on equity marketplaces in Canada. UMIR is comprised of:

- Rules, the formal requirements which are imposed on persons that are subject to the jurisdiction of RS as a regulation services provider; and
- Policies, the less formal requirements which provide:
 - specific examples of activities covered by a Rule,
 - guidelines for the implementation of a Rule requirement,
 - for the application of a Rule in particular fact situations,
 - guidance on the interpretation of a Rule, and
 - such other matters as permitted by the Rules.

From time to time, RS issues Market Integrity Notices which set out the position of RS with respect to the interpretation or application of a particular Rule or Policy.

As background material for the strategic review, RS has prepared a chart which identifies the specific market integrity risks that have been addressed in the current provisions of UMIR and

identifies comparable provisions in other jurisdictions, principally the United States. This chart is available through the RS website at www.rs.ca under the heading “Market Policy”.

In their original conception, UMIR were to be “universal” in that the rules should:

- apply to trading in all marketplaces;
- apply equally to all dealers or persons who access a marketplace;
- not be capable of being circumvented by directing trading activity to another marketplace or market;
- apply, to the greatest extent possible, to trading in all forms of securities; and
- incorporate, to the greatest extent possible, any exceptions to the rules that are required to accommodate the workings of an individual marketplace.

As outlined in the Market Integrity Notice which accompanied the introduction of UMIR, RS recognized that amendments to UMIR would, or could, be required in a number of circumstances including:

- changes in the Marketplace Operation Instrument and the CSA Trading Rules;
- changes in applicable securities legislation and regulations;
- recognition of additional marketplaces (whether or not such marketplaces retain RS as their regulation services provider);
- introduction of new products and facilities by marketplaces; and
- developments in securities trading regulation in jurisdictions and markets outside of Canada.

Requirements Under the Recognition Orders

The orders issued by each of the Recognizing Regulators recognizing RS as a self-regulatory entity (“Recognition Orders”) require that each of the provisions of UMIR:

- not be contrary to the public interest; and
- be necessary or appropriate to govern and regulate all aspects of the business and affairs.

More specifically, the Recognition Orders requires that RS ensure that the provisions of UMIR are designed to:

- ensure compliance with securities legislation;
- prevent fraudulent and manipulative acts and practices;
- promote just and equitable principles of trade;

- foster cooperation and coordination with entities engaged in regulating, clearing, settling, processing information about, and facilitating transactions in, securities;
- provide for appropriate discipline; and
- ensure that the business of RS is conducted in an orderly manner so as to afford protection to investors.

RS must also ensure that the provisions of UMIR do not:

- permit unreasonable discrimination between those granted access to the regulation services of RS; or
- impose any burden on competition that is not necessary or appropriate in furtherance of securities legislation.

When UMIR was approved by the Recognizing Regulators as the rules for RS effective April 1, 2002, the Recognizing Regulators accepted that UMIR as drafted met the standards required by the Recognition Orders. Any changes to UMIR which may be recommended as a result of the strategic review must satisfy the requirements of the Recognition Orders.

Proposed Amendments to UMIR

Since UMIR became effective on April 1, 2002, RS has pursued a number of amendments to UMIR. Each of these amendments was reviewed by RAC, adopted by the Board and circulated for public comment prior to approval by the Recognizing Regulators.

The following is a list of proposed amendments to UMIR which have been released for public comment but which have not yet been approved of by the Recognizing Regulators. These Market Integrity Notices are available through the RS website at www.rs.ca under the heading “Market Policy”. Commentators may wish to take these proposed amendments into account in any submission. Commentators are invited to submit comments on these outstanding amendments even though the formal public comment period provided for in the Market Integrity Notice may have expired.

Market Integrity Notice	Title	Summary of Proposed Amendment
2004-013 April 30, 2004	Practice and Procedure	Make a number of amendments to the Policies governing the practice and procedure to be followed in a disciplinary proceeding which are generally of an administrative, editorial or technical nature.
2004-017 August 13, 2004	Provisions Respecting Manipulative and Deceptive Activities	Vary the requirements related to manipulative and deceptive activities by: <ul style="list-style-type: none"> • modifying the language to achieve greater clarity and consistency; • providing for consistency with the requirements related to manipulative and deceptive activities under the CSA Trading Rules and applicable securities legislation; • confirming the “gatekeeper” obligations of Participants and Access Persons; • introducing a specific requirement to report to RS significant violations of

Market Integrity Notice	Title	Summary of Proposed Amendment
		UMIR; and <ul style="list-style-type: none"> eliminating potential gaps that may be caused by the current rule which combines both manipulative “effects” and “methods” in a single requirement.
2004-018 August 20, 2004	Provisions Respecting “Off-Marketplace” Trades	Vary the requirements respecting the ability of Participants and Access Persons to conduct trades of listed or quoted securities other than by the entry of orders on a marketplace. In particular, the amendments would require a Participant, when handling a principal or non-client order, to make reasonable efforts to fill better-priced orders on marketplaces prior to executing a trade at an inferior price in a transaction undertaken other than on a Canadian marketplace. The amendments would impose a similar obligation on an Access Person when that person is trading directly and the order is not being handled by a registered dealer. In the case of large block trades, the amendments would provide a mechanism to cap the obligation to fill better-priced orders to the disclosed volume of better-priced orders indicated on a consolidated market display. The amendments also make a number of additional consequential changes to UMIR including the provision of definitions for the terms “organized regulated market”, “Canadian account”, “non-Canadian account” and “trading increment”.
2004-019 August 13, 2004	Impeding or Obstructing a Market Regulator	Introduce provisions to: <ul style="list-style-type: none"> specifically provide that it is an offence to impede or obstruct a Market Regulator in an investigation, proceeding or the exercise of a power; provide that a person who is subject to the jurisdiction of UMIR (“Regulated Person”) shall respond to a request by a Market Regulator forthwith or not later than the date permitted by the Market Regulator as specified in its written request; and adopt a definition of “document” and clarify that records which must be provided by a Regulated Person during an investigation are not limited to “records” as contemplated by the audit trail and retention requirements.
2004-024 September 10, 2004	Amendments Respecting Trading During Certain Securities Transactions	Change the provisions of UMIR to: <ul style="list-style-type: none"> combine prohibitions and restrictions relating to market stabilization and market balancing activities into a single rule; introduce exemptions from the prohibitions and restrictions relating to market stabilization and market balancing for trading in “highly-liquid” securities and exchange-traded funds; and harmonize the UMIR provisions governing restrictions and prohibitions on trading activities by Participants with the proposed rule of the Ontario Securities Commission (“OSC”) governing the trading activities of dealers and parties connected to the issuer.

Annotated Version of UMIR

To assist persons who may wish to make a submission as part of the strategic review, RS would remind commentators that an annotated version of UMIR is available through the RS website at www.rs.ca under the heading “Market Policy”. The annotated version of UMIR is current as of September 30, 2004 and is organized into parts with a part for each subject matter covered by UMIR. Each part contains:

- the relevant Rule and Policy;
- reference to any defined term contained in the Rule or Policy;

- Market Integrity Notices related to the Rule or Policy;
- the history of any amendment to the Rule or Policy; and
- reference to any Market Integrity Notice containing proposed amendments to the Rule or Policy.

Inquiries

Inquiries concerning this notice may be directed to:

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ROSEMARY CHAN,
VICE PRESIDENT, MARKET POLICY AND GENERAL COUNSEL

Appendix “A”

LIST OF QUESTIONS TO BE CONSIDERED

The following is a list of questions which RS will consider as part of the strategic review of UMIR. The list is not exhaustive and is intended only as a catalyst for discussion. As responses from commentators will be publicly available on the RS website, RS would ask that responses to the questions or other comments are accompanied by sufficient detail or examples that will allow other participants in the strategic view to appreciate the position taken by the commentator.

- **Addressing Market Integrity Risks**

- In April, 2004, RS delivered an online questionnaire to the investment community to ascertain their opinions on the risks to market integrity. In particular, respondents were asked for their views on what they perceive are the highest risks to market integrity and the trend of these risks. The results were quite consistent and there were many areas of convergence of views amongst Participants and non-participants. Both Participants and non-participants ranked manipulative/deceptive trading, insider trading, front running and client priority as the top four market integrity risks in terms of likelihood, impact and trend. The most significant divergence in views was in connection with best execution/best price/client priority where Participants were of the view that this risk was unlikely to occur and non-participants were of the view that it was the second highest risk in terms of likelihood.
- *Does UMIR adequately address the risks to market integrity that presently exists in equity trading in Canadian markets? In particular, are the Rules and Policies comprehensive? Are the Rules and Policies clear and understandable?*
- *Does UMIR impose requirements that are no longer necessary to ensure market integrity?*

- **Neutrality of Rules**

- The Recognition Orders require that UMIR not impose any burden on competition that is not necessary or appropriate in furtherance of securities legislation. While UMIR was drafted in contemplation of multiple competitive marketplaces trading the same securities, UMIR also reflected the structure of the Canadian equity marketplaces as they existed in early 2002.
- *Is UMIR sufficiently “marketplace neutral” in its requirements so as not to impede the development of competitive marketplaces?*

- **Harmonization**

- UMIR was drafted in the context of trading rules which existed in Canada in 2002. While UMIR and regulatory requirements in other jurisdictions “deal” with many of the same market integrity concerns, UMIR often addresses the concern in a manner which is different from the practice in other jurisdictions. For example, the rules governing short sales permit sales at prices not less than the last sale price (rather than requiring the price to be above the last sale price as is the case in the United States) and dealers are not required to make a “positive affirmation” before entering the short sale that securities have been borrowed to permit the settlement of any short sale (as is now required in the United States). The question arises whether there would be any implications for dealers or marketplaces in Canada if UMIR were to parallel the requirements in the United States that short sales must be made above the last sale price and only after the dealer had made a positive affirmation that the securities were available for settlement of any trade. A summary of the differences in approach between UMIR and requirements in other jurisdictions, principally the United States, is set out in a paper entitled “Background Chart for the Strategic Review of UMIR” available on the RS website.
- *Are the requirements of UMIR that differ from prevailing standards in international markets justified by differences in Canadian market structure, industry practices and legal requirements?*
- *Are there any UMIR requirements that can be “harmonized” without significant impact on marketplaces or marketplace participants?*

- **Specific Comments**

- While RS would appreciate comment on the questions asked above, RS welcomes comments on any aspect of UMIR, including comments on any specific provision contained in UMIR. Commentators should bear in mind that the submission will be considered as part of a strategic review of UMIR and, as such, comments on a specific provision should be ones which will have application generally to other Participants, Access Persons or marketplaces.