Market Integrity Notice

Amendment Approval

Market Regulation Services Inc.
Services de réglementation du marché inc.

May 26, 2006

No. 2006-012

Suggested Routing
- Trading
- Legal and Compliance

PROVISIONS RESPECTING CLIENT PRIORITY

Key Topics
- Client Consent
- Client Order
- Priority
- Frontrunning
- Principal Order
- Non-client Order
- Special Terms Order

Summary

This Market Integrity Notice provides notice of the approval by the applicable securities regulatory authorities effective May 26, 2006 of amendments to the Universal Market Integrity Rules respecting to client priority such that, subject to certain exceptions, a Participant must give priority to a client order over all principal orders and non-client orders that are entered on a marketplace after the receipt of the client order:

- for the same security;
- at the same or better price;
- on the same side of the market; and
- on the same conditions and settlement terms.

UMIR Provisions Referenced
- Rule 1.1 – Definitions – "Special Terms Order"
- Rule 4.1 – Frontrunning
- Rule 5.3 – Client Priority

Questions / Further Information

For further information or questions concerning this notice contact:

James E. Twiss
Chief Policy Counsel

Telephone: 416.646.7277
Fax: 416.646.7265

e-mail: james.twiss@rs.ca

Market Integrity Notices Referenced
- Market Integrity Notice 2005-017 – Request for Comments - Provisions Respecting Client Priority (June 10, 2005)

PROVISIONS RESPECTING CLIENT PRIORITY

Summary

This Market Integrity Notice provides notice of the approval by the applicable securities regulatory authorities effective May 26, 2006 of amendments (the “Amendments”) to the Universal Market Integrity Rules (“UMIR”) respecting client priority such that, subject to certain exceptions, a Participant must give priority to a client order over all principal orders and non-client orders that are entered on a marketplace after the receipt of the client order:

- for the same security;
- at the same or better price;
- on the same side of the market; and
- on the same conditions and settlement terms.

Background to the Amendments

On June 10, 2005, Market Regulation Services Inc. (“RS”) issued Market Integrity Notice 2005-017 requesting comments on proposed amendment to UMIR respecting client priority (the “Proposal”). The applicable securities regulatory authorities (the “Recognizing Regulators”) approved the Amendments which contain a number of changes from the original Proposal. The Amendments are effective May 26, 2006. The differences between the Amendments and the Proposal are summarized later in this notice under the heading “Summary of Changes from the Proposal”.

Prior to the adoption of the Amendments, Rule 5.3 of UMIR provided that a Participant need not give priority to a client order over a principal order or non-client order if the allocation had been made by the trading system of a marketplace. This approach is acceptable when all marketplaces utilize the same allocation algorithms. However, if there are multiple marketplaces trading the same securities there is a probability that each of the marketplaces will have variations in the priorities for the allocation of orders in respect of trades executed on the marketplace. With the possible introduction of new allocation algorithms, the interests of a client could be affected, intentionally or unintentionally, based on the marketplace on which either the client order or the principal order or non-client order is entered.

Presuming that a Participant has implemented a reasonable system of internal policies and procedures to ensure compliance with the client priority rule and to prevent misuse of information about client orders, nonetheless the Participant under the prior version of Rule 5.3 was not able to rely on the allocation provided by the trading system of a marketplace if:

- any of the client order, principal order or non-client order had been executed on a market other than on a marketplace (e.g. a foreign stock exchange or an organized regulated market outside of Canada);
- the client order was not immediately entered upon receipt; or

- the client order was subsequently changed or cancelled by the Participant (e.g. by the trader in response to market conditions in an attempt to get "best execution" for the client) other than on the instruction of the client.

The Amendment addresses the practical problems associated with the inability of a Participant being in a position to rely on the "trading system exemption" by tying the obligation to provide client priority directly to the time of receipt of the client order.

Summary of the Impact of the Amendments

The following is a summary of the most significant differences between the client priority requirements under the Amendments as compared to the previous provisions of Rule 5.3 and Policy 5.3. Under the Amendments:

- a Participant is required to provide priority for a client order over a principal order or non-client order only if the client order is received prior to the entry of the principal order or non-client order and the client order is at the same or "better" price and is subject to the same conditions and settlement terms as the principal order or non-client order;
- the provisions clarify that a trade permitted by the client priority rule is nonetheless subject to any restrictions imposed by Rule 4.1 dealing with frontrunning;
- a principal order or non-client order is exempted from the client priority requirement if the principal order or non-client order is:
    - automatically generated by the trading system of an exchange or quotation and trade reporting system pursuant to market making obligations, or
    - a Basis Order;
- a client is deemed to have consented to the principal order or non-client order trading in priority if the client has instructed that their order be executed in part at various times during the trading day or at various prices during the trading day;
- a client may provide a "conditional consent" to the principal order or non-client order trading in priority which would require the Participant to "give up" all or part of its fills to the client order if the client's condition is not satisfied;
- if the security trades on more than one marketplace, the Participant would not be able to rely on an allocation made by the trading system of a marketplace unless:
    - the principal order or non-client order is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order, or
    - each of the client order and the principal order or non-client order was entered on the same marketplace; and
- a principal order or non-client order could trade in priority to a client order if a Market Integrity Official requires or permits the trade.

Summary of the Amendments

The following is a summary of the provisions of the Amendments to Rule 5.3 and Policy 5.3:

Same Conditions and Settlement Terms

Rule 5.3 previously provided that a Participant must provide priority to its client orders:

- for the same security;
- at the same or better price; and
- on the same side of the market.

The Amendments varied these requirements such that priority would be provided only if the client order was on the same conditions and settlement terms as the principal or non-client order. The Amendments recognize that unless the conditions and settlement terms are the same, the principal order or non-client order has not effectively taken away a trading opportunity from the client.

In order to prevent abuse, the Policy specifically states that it is unacceptable for a Participant to:

- add terms or conditions to a client order (other than on the instructions of the client) so that the client order ranks behind principal or non-client orders at that price; or
- put terms or conditions on a principal or non-client order for the purpose of differentiating the principal or non-client order from a client order that would otherwise have priority at that price.

Anonymous Orders

A Participant does not have to provide priority for a client order that has been entered directly by the client of the Participant on a marketplace that does not require the disclosure of the identifier of the Participant in a consolidated market display and the person who enters the principal order or non-client order has no knowledge that the "anonymous" order is from a client of the Participant until the execution of the client order.

With the introduction of "attribution choice" on the TSX in March of 2002, an intentional cross with an unattributed order on both the buy and sell side was exempt from interference. To the extent that a principal order or non-client order may be entered without the disclosure of the relevant identifier of the Participant, it may be possible for a principal account or non-client account to obtain an execution in priority to a previously entered client order where the identifier of the Participant has been disclosed on the entry of the client order. Under the previous client priority rule, the Participant may not have had to reallocate any fill obtained by the "unattributed" principal or non-client order to the previously entered client order as the allocation had been made by a trading system of a marketplace. However, RS took the position as set out in Market Integrity Notice 2003-024 dated October 31, 2003 that a Participant would be expected to provide priority to any "disclosed" client order. With the adoption of the Amendments, this position has been incorporated directly into the Policies and a Participant is under an obligation to provide priority to any previous client order on the same terms.

Exemptions for Trades Pursuant to Market Maker Obligations

Previously, the requirement to provide priority to a client order had been interpreted not to apply in the event the principal order or non-client order had been automatically generated by the trading system of a marketplace in order to fulfil Market Maker Obligations imposed by that marketplace on the Participant or an employee of the Participant in accordance with the applicable Marketplace Rules. In executing these trades, the market maker is not attempting to bypass client orders but to meet its obligations as a market maker. The Amendments incorporate this interpretation into the language of the rule.

Exemptions for a "Basis Order"

Effective April 8, 2005, UMIR was amended to provide recognition to a "Basis Order". A Basis Order is subject to a number of conditions including that the price of the resulting trade is determined in a manner acceptable to a Market Regulator based on the price achieved through the execution on that trading day of one or more transactions in a derivative instrument that is listed on a recognized exchange or quoted on a recognized quotation and trade reporting system. Under these circumstances, a Participant that executes a principal order as a Basis Order is not attempting to bypass client orders at the same or a better price but merely completing a trade at a price which is determined by derivative transactions. The Amendments to the client priority rule provide an exemption for a principal order or non-client order entered as a Basis Order.

Reliance on Trading System Allocation

Previously Rule 5.3 allowed a Participant to rely on trading allocations made by a trading system of a marketplace provided:

- the client order was entered on a marketplace immediately upon receipt;
- the client order was not varied except on the instruction of the client; and
- the Participant has a reasonable system of internal policies and procedures to prevent misuse of information about client orders.

This provision was based on a previous requirement of the TSX which had adopted "time priority" as the basis for trade allocations. However, if there are multiple marketplaces trading the same securities and each marketplace has distinct allocation algorithms, the interests of a client could be affected intentionally or unintentionally based on the marketplace on which either the client order or the principal order or non-client order is entered.

With the adoption of the Amendments, a Participant will only be able to rely on the trading system exemption if:

- the security which is the subject of the orders trades on a single marketplace;
- the principal order or non-client is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order; or
- each of the client order and the principal order or non-client order was entered on the same marketplace.

The exception for the Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order recognizes that the price at which these orders will execute is generally not known at the time of the entry of the order. Provided the client order has been entered on receipt and not varied without the consent of the client, any allocation by the trading system of the marketplace for these "specialty orders" is not an attempt to bypass client orders. Similarly, if the client order has been entered on receipt and not varied without the consent of the client, any allocation by the trading system of the marketplace between a client order and a principal order or non-client is not an attempt to bypass client orders.

Client Consent

Specific Consent

A Participant does not have to provide priority to a client order if the client specifically consents to the Participant trading alongside or ahead of the client. The consent of the client must be specific to a particular order and details of the agreement with the client must be noted on the order ticket. A client cannot give a blanket form of consent to permit the Participant to trade alongside or ahead of any future orders the client may give the Participant.

If the client order is part of a pre-arranged trade that is to be completed at a price below the best bid price or above the best ask price as indicated on a consolidated market display, the Participant will be under an obligation to ensure that "better-priced" orders on a marketplace are filled prior to the execution of the client order. Prior to executing the client order, the Participant must ensure that the client is aware of the better-priced orders and has consented to the Participant executing as against them in priority to the client. The consent of the client must be noted on the order ticket.

Deemed Consent

Under the Amendments, a client is deemed to have consented to the principal order or non-client order trading in priority if the client has instructed that their order is to be executed in part at various times during the trading day or at various prices during the trading day. Unless the client has provided standing written instructions that all orders are to be executed at various times during the trading day or a various prices during the trading day, the client instructions should be treated as specific to a particular order and the details of the instructions by the client must be noted on the order ticket. This Amendment incorporates the existing administrative interpretation provided by RS with respect to client consent.

Conditional Consent

Under the Amendments to the Policies, a client may provide a “conditional consent” to the principal order or non-client order trading in priority which would require the Participant to “give up” all or part of its fills to the client order if the client’s condition is not satisfied. For example, a client may consent to a principal order of Participant sharing fills with the client order provided the client order is fully executed by the end of the trading day. If the client's order is not fully executed, the client may expect that the Participant "give up" its fills to the extent necessary to complete the client order. In this situation, the Participant should mark its orders as "principal" throughout the day. Any part of the execution which is given up to the client should not be re-crossed on a marketplace but should simply be journalled to the client (since the condition of the consent has not been met, the fills in question could be viewed as properly belonging to the client rather than the principal order). To the extent that a Participant "gives up" part of a fill of a principal order to a client based on the conditional consent, the Participant shall report the particulars of the "give up" to the Market Regulator not later than the opening of trading on marketplaces on the next trading day.

The conditional consent of the client must be specific to a particular order. The details of the agreement with the client must be noted on the order ticket.

Application of the Frontrunning Rule

The Amendments clarify that a trade that is permitted by Rule 5.3 dealing with client priority would nonetheless be subject to any restriction imposed by Rule 4.1 dealing with frontrunning. In particular, if a Participant has knowledge of a client order that has not been entered on a marketplace that could, on entry on a marketplace, reasonably be expected to affect the market price of the security, the Participant is precluded from:

- entering a principal or non-client order with respect to that security or a related security;
- soliciting an order from any other person for the purchase or sale of that security or any related security; or
- informing any other person, other than in the necessary course of business, of the client order.

If that part of a client order that has not been entered on a marketplace could “reasonably be expected to affect the market price of the security”, the frontrunning rule would preclude the entry of a principal or non-client order even if the client had given consent for the Participant to trade alongside or ahead of the client order for the purposes of the client priority rule. A Participant must determine the extent to which a client order, including a limit order, that is to be entered in part at various times during the trading day (e.g. an “over-the-day” order) or at various prices throughout the day (e.g. to approximate a volume-weighted average price) would, upon entry on a marketplace, reasonably be expected to affect the market price of the security. If the client has provided specific consent, deemed consent or conditional consent to the Participant trading alongside or ahead of the client order that could reasonably be expected to affect the market price of the security, a Participant would be able to rely on the exemptions from the frontrunning rule that would permit the entry of a principal or non-client order if:

- no director, officer, partner, employee or agent of the Participant who made or participated in making the decision to enter a principal order or non-client order or to solicit an order had actual knowledge of the client order;
- an order is entered or trade made for the benefit of the client for whose account the order is to be made;
- an order is solicited to facilitate the trade of the client order;
- a principal order is entered to hedge a position that the Participant had assumed or agreed to assume before having actual knowledge of the client order provided the hedge is:
  - o commensurate with the risk assumed by the Participant, and
  - o entered into in accordance with the ordinary practice of the Participant when assuming or agreeing to assume a position in the security;
- a principal order is made to fulfil a legally binding obligation entered into by the Participant before having actual knowledge of the client order; or
- the order is entered for an arbitrage account.

Summary of Changes from the Proposal

Based on comments received in response to the Request for Comments contained in Market Integrity Notice 2005-017 and based on comments received from the Recognizing Regulators, RS made a number of changes to the Proposal. The text of the Amendments is set out in Appendix "A" and the revisions made to the Proposal are highlighted in Appendix "B". The following is a summary of the significant changes made to the Proposal on the adoption of the Amendments:

"Same Terms and Conditions"

Under the Proposal, a Participant would have to provide client priority for a prior client order that had the same "terms and conditions". In order to clarify the ambit of this provision, the Amendments were varied to make specific reference to a "Special Terms Order". Under Rule 1.1 of UMIR, a "Special Terms Order" means an order for the purchase or sale of a security:

- for less than a standard trading unit;
- the execution of which is subject to a condition other than as to price or date of settlement; or
- that on execution would be settled on a date other than:
  - o the third business day following the date of the trade, or
  - o any settlement date specified in a special rule or direction referred to in subsection (2) of Rule 6.1 that is issued by an Exchange or a QTRS.

If either the client order or the principal order or non-client order is a Special Terms Order, a Participant would only have to provide priority to the client order if the client order would have executed in the transaction or transactions involving the principal order or non-client order. In the view of RS, this change is a clarification only and does not change the substance of the Proposal.

Trading System Allocation

The Amendments extended the circumstances under which a Participant may rely on an allocation made by the trading system of a marketplace in order to satisfy the requirements of the client priority rule. Under the Amendments, if the client order has been entered on receipt by the Participant and not varied without the consent of the client, any allocation by the trading system of the marketplace between a client order and a principal order or non-client entered on the same marketplace is not an attempt to bypass client orders and the Participant may rely on the allocation made by the trading system of the marketplace.

Appendices

- Appendix "A" sets out the text of the Amendments; and
- Appendix "B" contains a summary of the comments received by RS on the Proposal together with the response of RS to each of the comments. Appendix "B" also highlights the changes made to the Proposal that were incorporated upon the approval of the Amendments.

Questions / Further Information

For further information or questions concerning this notice contact:

James E. Twiss,
Chief Policy Counsel,
Market Policy and General Counsel's Office,
Market Regulation Services Inc.,
Suite 900,
145 King Street West,
Toronto, Ontario. M5H 1J8

Telephone: 416.646.7277
Fax: 416.646.7265
e-mail: james.twiss@rs.ca

ROSEMARY CHAN,
VICE PRESIDENT, MARKET POLICY AND GENERAL COUNSEL

Appendix “A”

Amendments Respecting Client Priority

The Universal Market Integrity Rules are amended by repealing Rule 5.3 and substituting the following:

5.3 Client Priority

(1) A Participant shall give priority to a client order of the Participant over all principal orders and non-client orders of the Participant that are entered on a marketplace or an organized regulated market after the receipt of the client order for the same security that is:

(a) at the same price or a higher price in the case of a purchase or the same or a lower price in the case of a sale; and

(b) on the same side of the market.

(2) Despite subsection (1) but subject to Rule 4.1, a Participant is not required to give priority to a client order if:

(a) the client specifically has consented to the Participant entering principal orders and non-client orders for the same security at the same price on the same side of the market on the same settlement terms;

(b) the client order has not been entered on a marketplace as a result of:

(i) the client specifically instructing the Participant to deal otherwise with the particular order,

(ii) the client specifically granting discretion to the Participant with respect to entry of the order, or

(iii) the Participant determining in accordance with Rule 6.3(1)(e) that, based on market conditions, entering the order would not be in the best interests of the client,

and no director, officer, partner, employee or agent of the Participant with knowledge that the client order has not been entered on a marketplace enters a principal order or a non-client order for the same security on the same side of the market on the same conditions and settlement terms;

(c) the principal order or non-client order is:

(i) automatically generated by the trading system of an Exchange or QTRS in accordance with the Marketplace Rules in respect of the applicable Market Maker Obligations, or

(ii) a Basis Order;

(d) the client order has been entered directly by the client of the Participant on a marketplace that does not require the disclosure of the identifier of the Participant in a consolidated market display and the director, officer, partner, employee or agent of the Participant who enters a principal order or a non-client order does not have knowledge that the client order is from a client of the Participant until the execution of the client order;

(e) the principal order or non-client order is executed pursuant to an allocation by the trading system of a marketplace and:

(i) either:

(A) the security which is the subject of the order trades on no marketplace other than that marketplace,

(B) the principal order or non-client order is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order, or

(C) each of the client order and the principal order or non-client order was entered on the same marketplace,

(ii) the client order was entered by the Participant on that marketplace immediately upon receipt by the Participant, and

(iii) if the client order was varied or changed by the Participant at any time after entry, the variation or change was on the specific instructions of the client;

(f) either the client order or the principal order or non-client order is a Special Terms Order and the client order would not have executed in the transaction or transactions involving the principal order or non-client order due to the terms and conditions of at least one Special Terms Order; or

(g) a Market Integrity Official requires or permits the principal order or non-client order to be executed in priority to a client order.

(3) For the purposes of clause (2)(a), a client shall be deemed to have consented to the Participant entering principal orders and non-client orders for the same security at the same price on the same side of the market on the same conditions and settlement terms if the client order, in accordance with the specific instructions of the client, is to be executed in part at various times during the trading day or at various prices during the trading day.

The Policies under the Universal Market Integrity Rules are amended by repealing Policy 5.3 and substituting the following:

POLICY 5.3 – CLIENT PRIORITY

Part 1 – Background

Rule 5.3 restricts a Participant and its employees from trading in the same securities as a client of the Participant. The restriction is designed to minimize the conflict of interest that occurs when a Participant or its employee compete with the firm's clients for execution of orders. The Rule governs:

- *trading ahead* of a client order, which is taking out a bid or offering that the client could have obtained had the client order been entered first. By trading ahead, the pro order obtains a better price at the expense of the client order.
- *trading along* with a client, or competing for fills at the same price.

The application of the rule can be quite complex given the diversity of professional trading operations in many firms, which can include such activities as block facilitation, market making, derivative and arbitrage trading. In addition, firms may withhold particular client orders in order to obtain for the client a better execution than the client would have received if the order had been entered directly on a marketplace. Each firm must analyze its own operations, identify risk areas and adopt compliance procedures tailored to its particular situation.

A Participant has overriding agency responsibilities to its clients and cannot use technical compliance with the rule to establish fulfillment of its obligations if the Participant has not otherwise acted reasonably and diligently to obtain best execution of its client orders.

Part 2 – Prohibition on Intentional Trading Ahead

Rule 5.3 provides that a Participant must give priority of the execution to client orders over all principal orders and non-client orders of the Participant that are entered on a marketplace or an organized regulated market after the receipt of the client order for the same security at the same price on the same side of the market on the same conditions and settlement terms. The requirement is subject to certain exceptions necessary to ensure overall efficiency of order handling.

In particular, exceptions to the client priority rule are provided if the principal order or non-client order that is entered after the receipt of the client order is:

- automatically generated by the trading system of an Exchange or QTRS in accordance with the Market Maker Obligations of that marketplace;
- a Basis Order; or

- required or permitted to be executed by a Market Integrity Official in priority to the client order.

A principal order which is automatically generated by the trading system of an Exchange or QTRS in accordance with that marketplace's rules on market-making activities is not an intentional attempt by a Participant to trade ahead of or along with a client order. An exemption from the client priority rule is therefore provided in order to ensure overall market liquidity in accordance with established Market Making Obligations.

A Basis Order is undertaken at a price that is determined by prices achieved in related trades made in the derivatives markets. As such, the execution of a Basis Order is not an intentional attempt by a Participant to trade ahead of or along with a client order.

An exception to the client priority rule is also provided where the trading system of a marketplace allocates the fill to a principal order or non-client order. In order to be able to rely on this exception the following three conditions must be met:

- either:
  - the security does not trade on any marketplace other than the one on which the client order and the principal order or non-client order is entered,
  - the principal order or non-client order is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order, or
  - each of the client order and the principal order or non-client order was entered on the same marketplace;
- the client order was entered immediately upon receipt by the Participant; and
- after entry, the client is not varied or changed except on the specific instructions of the client.

The exception that is provided for a principal or non-client order which is a Call Market Order, Opening Order, Market-on Close Order or a Volume-Weighted Average Price Order recognizes that the price at which such an order may execute will not generally be known at the time the principal or non-client order is entered on a marketplace. Provided the client order has been entered on receipt and not varied without the consent of the client, any allocation by the trading system of the marketplace for these particular types of orders is not an attempt to bypass client orders.

A Participant can never intentionally trade ahead of a client market or tradeable limit order received prior to the entry of the principal order or non-client order without the specific consent of the client. Examples of "intentional trades" include, but are not limited to:

- withholding a client order from entry on a marketplace (or removing an order already entered on a marketplace) to permit the entry of a competing principal or non-client order ahead of the client order;

- entering a client order in a relatively illiquid market and entering a principal or non-client order in a more liquid marketplace where the principal or non-client order is likely to obtain faster execution;
- adding terms or conditions to a client order (other than on the instructions of the client) so that the client order ranks behind principal or non-client orders at that price;
- putting terms or conditions on a principal or non-client order for the purpose of differentiating the principal or non-client order from a client order that would otherwise have priority at that price; and
- entering a principal order or non-client order as an "anonymous order" (without the identifier of the Participant) which results in an execution in priority to a previously entered client order where the identifier of the Participant has been disclosed on the entry of the client order.

Part 3 – No Knowledge of Client Order

Rule 5.3 also contains four exceptions to client priority that require the director, officer, partner, employee or agent of the Participant who enters the principal order or the non-client order to be unaware that the client order has not been entered. The exceptions are:

- the client specifically instructs the Participant to withhold entry of the order;
- the client specifically grants discretion to the Participant with respect to the entry of the order;
- the Participant withholds the client order from entry in accordance with Rule 6.3 in a *bona fide* attempt to get better execution for the client; and
- the client enters the order directly on a marketplace that does not require the disclosure of the identifier of the Participant in a consolidated market display.

In these circumstances, the Participant must have reasonable procedures in place to ensure that information concerning client orders is not used improperly within the firm. These procedures will vary from firm to firm and no one procedure will work for all firms. If a firm does not have reasonable procedures in place, it cannot rely on the exceptions. Reference should be made to Policy 7.1 – Policy on Trading Supervision Obligations, and in particular Part 4 – Specific Procedures Respecting Client Priority and Best Execution.

If a client has instructed a Participant to withhold an order or has granted a Participant discretion with respect to the entry of an order, details of the instruction or grant of discretion must be retained for a period of seven years from the date of the instruction or grant of discretion and, for the first two years, the consent must be kept in a readily accessible location.

Part 4 – Client Consent

A Participant does not have to provide priority to a client order if the client specifically consents to the Participant trading alongside or ahead of the client. The consent of the client must be specific to a particular order and details of the agreement with the client must be noted on the order ticket. A client cannot give a blanket form of consent to permit the Participant to trade alongside or ahead of any future orders the client may give the Participant.

If the client order is part of a pre-arranged trade that is to be completed at a price below the best bid price or above the best ask price as indicated on a consolidated market display, the Participant will be under an obligation to ensure that "better-priced" orders on a marketplace are filled prior to the execution of the client order. Prior to executing the client order, the Participant must ensure that the client is aware of the better-priced orders and has consented to the Participant executing as against them in priority to the client order. The consent of the client must be noted on the order ticket.

If the client has given the Participant an order that is to be executed at various times during a trading day (e.g. an "over-the-day" order) or at various prices (e.g. at various prices in order to approximate a volume-weighted average price), the client is deemed to have consented to the entry of principal and non-client orders that may trade ahead of the balance of the client order. Unless the client has provided standing written instructions that all orders are to be executed at various times during the trading day or a various prices during the trading day, the client instructions should be treated as specific to a particular order and the details of the instructions by the client must be noted on the order ticket. However, if the un-entered portion of the client order would reasonably be expected to affect the market price of the security, the Participant may be precluded from entering principal or non-client orders as a result of the application of the frontrunning rule.

In certain circumstances, a client may provide a conditional consent for the Participant to trade alongside or ahead of the client order. For example, a client may consent to a principal order of Participant sharing fills with the client order provided the client order is fully executed by the end of the trading day. If the client's order is not fully executed, the client may expect that the Participant "give up" its fills to the extent necessary to complete the client order. In this situation, the Participant should mark its orders as "principal" throughout the day. Any part of the execution which is given up to the client should not be re-crossed on a marketplace but should simply be journalled to the client (since the condition of the consent has not been met, the fills in question could be viewed as properly belonging to the client rather than the principal order). To the extent that a Participant "gives up" part of a fill of a principal order to a client based on the conditional consent, the Participant shall report the particulars of the "give up" to the Market Regulator not later than the opening of trading on marketplaces on the next trading day. The conditional consent of the client must be specific to a particular order. The details of the agreement with the client must be noted on the order ticket.

Appendix "B"

Comments Received on Proposed Amendments Respecting Client Priority

On June 10, 2005, RS issued Market Integrity Notice 2005-017 requesting comments on proposed amendments to UMIR respecting client priority (the "Proposal"). In response to that Market Integrity Notice, RS received comments from the following persons:

BMO Nesbitt Burns Inc. ("BMO")
Scotia Capital Inc. ("Scotia")
Shorcan Brokers Limited ("Shorcan")
TD Securities Inc. ("TD")

The following table presents a summary of the comments received together with the response of RS to those comments. Column 1 of the table also indicates the revisions to the Proposal as published on June 10, 2005 that have been made in the Amendments as approved.

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
5.3 Client Priority (1) A Participant shall give priority to a client order of the Participant over all principal orders and non-client orders of the Participant that are entered on a marketplace or an organized regulated market after the receipt of the client order for the same security that is: (a) at the same price or a higher price in the case of a purchase or the same or a lower price in the case of a sale; and ~~(b)~~ on the same side of the market~~; and~~ ~~(c) on the same conditions and settlement terms~~.	**BMO –** Problem is not really a mismatch of allocation algorithms but rather how a Participant can guarantee time priority to a client order. Believes that National Instrument 23-101 should be amended to require an electronic connection between marketplaces in order to satisfy client priority and trade-through obligations.	National Instrument 21-101 was amended to remove the requirement that marketplaces connect to every other marketplace trading the same security. As such, the proposed amendment is a response in part to that change in the marketplace structure.
	Scotia – Believes that there should be an electronic inter-connection between marketplaces and a single, or compatible, allocation algorithm. An inter-connection between marketplaces would relieve Participants on the obligation to monitor orders on several marketplaces and provide a cleaner audit trail, greater consistency and efficiency in execution and facilitate the introduction of TREATS.	See response to BMO comment above.
	TD – Concerned that proposal may require Participants to build sophisticated, centralized order management systems with connections to other markets.	The amendment will not require connections to all marketplaces. Rather it is the ability of the Participant to connect to multiple marketplaces that gives rise to the need for a Participant to discharge its fiduciary obligation to its client by providing priority to client orders. RS is proposing to expand the ability of a Participant to rely on a marketplace allocation to circumstances where both the client order and the principal or non-client order have been entered on the same marketplace (and the client order was entered immediately upon receipt by the Participant.)

<table>
<tr><th>Text of the Amendments (Changes from the Proposal Highlighted)</th><th>Commentator and Summary of Comment</th><th>Response to Comment</th></tr>
<tr><td rowspan="4">(2) Despite subsection (1) but subject to Rule 4.1, a Participant is not required to give priority to a client order if:

(a) the client specifically has consented to the Participant entering principal orders and non-client orders for the same security at the same price on the same side of the market on the same settlement terms;

(b) the client order has not been entered on a marketplace as a result of:

(i) the client specifically instructing the Participant to deal otherwise with the particular order,

(ii) the client specifically granting discretion to the Participant with respect to entry of the order, or

(iii) the Participant determining in accordance with Rule 6.3(1)(e) that, based on market conditions, entering the order would not be in the best interests of the client,

and no director, officer, partner, employee or agent of the Participant with knowledge that the client order has not been entered on a marketplace enters a principal order or a non-client order for the same security on the same side of the market on the same conditions and settlement terms;

(c) the principal order or non-client order is:

(i) automatically generated by the trading system of an Exchange or QTRS in accordance with the Marketplace Rules in respect of the applicable Market Maker Obligations, or

(ii) a Basis Order;

(d) the client order has been entered directly by the client of the Participant on a marketplace that</td><td>BMO – Believes that an exemption should be provided where the principal order is a “contingent order” or a “basket order” as the Participant is not attempting to bypass the client order.</td><td>The amendment originally proposed that priority is to be given to client orders “on the same conditions and settlement terms”. In order to clarify the ambit of that phrase, RS is proposing to replace the language in subsection (1) with a new exemption under subsection (2) related to “Special Terms Orders”. In the view of RS, this provision would permit a Participant to execute a “contingent order” or a “basket order” without reallocation to a client order unless the client order had the same contingencies or was for the same basket of securities (and each order comprising the “basket” is contingent on the execution of all of the other orders in the basket). Nonetheless, there is a general anti-avoidance provision which would preclude a Participant from adding a condition or an additional security to a basket for the purpose of avoiding the application of the client priority rule.</td></tr>
<tr><td>Scotia – Concerned with the application of the frontrunning rule and believes that a Participant who is legitimately trading along side a client order with the client’s consent should not be prohibited from doing so by regulation.</td><td>The frontrunning rule is not premised on the quantification of harm to the client. Rather the rule prohibits a Participant from taking advantage of client information which is reasonably expected to have an effect on the market price of a security and which is not available to other market participants</td></tr>
<tr><td>Shorcan – Believes that the repeal of the existing trading system exemption has the effect of reducing competition among marketplaces that trade but do not list TSX securities. Believes that the change is unnecessary since a client’s interest is already well protected under the current rules. RS is simply assuming adverse customer outcomes on marketplaces that have a different trading allocation algorithm than the TSX.</td><td>Rule 5.3 sets out how a Participant can discharge its fiduciary obligations to a client. The Market Integrity Notice indicates that a Participant is in a conflict situation when they can determine the marketplace on which their order is entered. The requirement is marketplace neutral in that the Participant will be obliged to give priority to client orders that were received by the Participant prior to the entry of the principal or non-client order.</td></tr>
<tr><td>TD – Concerned that the application of the frontrunning rule may impede the ability of the firm to provide liquidity to clients in respect of large orders. Believes that a client should always be able to consent to a Participant trading alongside or ahead of a client order, particularly where the Participant has facilitated a trade with the client.</td><td>See response to Scotia comment above.

The frontrunning rule has always been interpreted as permitting a Participant to cover any position the Participant has taken on by executing as principal part of the client order. Such trading by the Participant requires the specific consent of the client under Rule 5.3. What would be offensive to the frontrunning rule would be transactions by a Participant with knowledge of an unentered client order that would affect the market ahead of or alongside a client (even with the consent of the client) in circumstances where the Participant has not taken on a position for the benefit of the client or undertakes transactions in excess of that position. RS would propose to clarify the interplay</td></tr>
</table>

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
does not require the disclosure of the identifier of the Participant in a consolidated market display and the director, officer, partner, employee or agent of the Participant who enters a principal order or a non-client order does not have knowledge that the client order is from a client of the Participant until the execution of the client order; (e) the principal order or non-client order is executed pursuant to an allocation by the trading system of a marketplace and: (i) either: (A) the security which is the subject of the order trades on no marketplace other than that marketplace, ~~or~~ (B) the principal order or non-client order is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order, <u>or</u> <u>(C) each of the client order and the principal order or non-client order was entered on the same marketplace,</u> (ii) the client order was entered by the Participant on that marketplace immediately upon receipt by the Participant, and (iii) if the client order was varied or changed by the Participant at any time after entry, the variation or change was on the specific instructions of the client; ~~or~~ <u>(f) either the client order or the principal order or non-client order is a Special Terms Order and the client order would not have executed in the transaction or transactions involving the principal order or non-client order due to the terms and conditions of at least one Special Terms Order; or</u>		between the client priority and frontrunning rules in the Market Integrity Notice issued on the approval of the amendments.

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
(g) a Market Integrity Official requires or permits the principal order or non-client order to be executed in priority to a client order.		
(3) For the purposes of clause (2)(a), a client shall be deemed to have consented to the Participant entering principal orders and non-client orders for the same security at the same price on the same side of the market on the same conditions and settlement terms if the client order, in accordance with the specific instructions of the client, is to be executed in part at various times during the trading day or at various prices during the trading day.		
POLICY 5.3 – CLIENT PRIORITY **Part 1 – Background** Rule 5.3 restricts a Participant and its employees from trading in the same securities as a client of the Participant. The restriction is designed to minimize the conflict of interest that occurs when a Participant or its employee compete with the firm's clients for execution of orders. The Rule governs: • *trading ahead* of a client order, which is taking out a bid or offering that the client could have obtained had the client order been entered first. By trading ahead, the pro order obtains a better price at the expense of the client order. • *trading along* with a client, or competing for fills at the same price. The application of the rule can be quite complex given the diversity of professional trading operations in many firms, which can include such activities as block facilitation, market making, derivative and arbitrage trading. In addition, firms may withhold particular client orders in order to obtain for the client a better execution than the client would have received if the order had been entered directly on a marketplace. Each firm must analyze its own operations, identify risk areas and adopt compliance procedures tailored to its particular situation. **A Participant has overriding agency responsibilities to its clients and cannot use technical compliance with the rule to establish fulfillment of its obligations if the Participant has**		

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
not otherwise acted reasonably and diligently to obtain best execution of its client orders.		
Part 2 – Prohibition on Intentional Trading Ahead Rule 5.3 provides that a Participant must give priority of the execution to client orders over all principal orders and non-client orders of the Participant that are entered on a marketplace or an organized regulated market after the receipt of the client order for the same security at the same price on the same side of the market on the same conditions and settlement terms. The requirement is subject to certain exceptions necessary to ensure overall efficiency of order handling. In particular, exceptions to the client priority rule are provided if the principal order or non-client order that is entered after the receipt of the client order is: • automatically generated by the trading system of an Exchange or QTRS in accordance with the Market Maker Obligations of that marketplace; • a Basis Order; or • required or permitted to be executed by a Market Integrity Official in priority to the client order. A principal order which is automatically generated by the trading system of an Exchange or QTRS in accordance with that marketplace's rules on market-making activities is not an intentional attempt by a Participant to trade ahead of or along with a client order. An exemption from the client priority rule is therefore provided in order to ensure overall market liquidity in accordance with established Market Making Obligations. A Basis Order is undertaken at a price that is determined by prices achieved in related trades made in the derivatives markets. As such, the execution of a Basis Order is not an intentional attempt by a Participant to trade ahead of or along with a client order. An exception to the client priority rule is also provided where the trading system of a marketplace allocates the fill to a principal order or non-client order. In order to be able to rely on this exception the following three conditions must be met:		

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
• either: o the security does not trade on any marketplace other than the one on which the client order and the principal order or non-client order is entered, ~~or~~ o the principal order or non-client order is a Call Market Order, an Opening Order, a Market-on-Close Order or a Volume-Weighted Average Price Order, or o each of the client order and the principal order or non-client order was entered on the same marketplace; • the client order was entered immediately upon receipt by the Participant; and • after entry, the client order is not varied or changed except on the specific instructions of the client. The exception that is provided for a principal or non-client order which is a Call Market Order, Opening Order, Market-on Close Order or a Volume-Weighted Average Price Order recognizes that the price at which such an order may execute will not generally be known at the time the principal or non-client order is entered on a marketplace. Provided the client order has been entered on receipt and not varied without the consent of the client, any allocation by the trading system of the marketplace for these particular types of orders is not an attempt to bypass client orders. A Participant can never intentionally trade ahead of a client market or tradeable limit order received prior to the entry of the principal order or non-client order without the specific consent of the client. Examples of "intentional trades" include, but are not limited to: • withholding a client order from entry on a marketplace (or removing an order already entered on a marketplace) to permit the entry of a competing principal or non-client order ahead of the client order; • entering a client order in a relatively illiquid market and entering a principal or non-client order in a more liquid marketplace where the principal or non-client order is likely to obtain faster execution;		

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
• adding terms or conditions to a client order (other than on the instructions of the client) so that the client order ranks behind principal or non-client orders at that price; • putting terms or conditions on a principal or non-client order for the purpose of differentiating the principal or non-client order from a client order that would otherwise have priority at that price; and • entering a principal order or non-client order as an "anonymous order" (without the identifier of the Participant) which results in an execution in priority to a previously entered client order where the identifier of the Participant has been disclosed on the entry of the client order.		
Part 3 – No Knowledge of Client Order Rule 5.3 also contains four exceptions to client priority that require the director, officer, partner, employee or agent of the Participant who enters the principal order or the non-client order to be unaware that the client order has not been entered. The exceptions are: • the client specifically instructs the Participant to withhold entry of the order; • the client specifically grants discretion to the Participant with respect to the entry of the order; • the Participant withholds the client order from entry in accordance with Rule 6.3 in a *bona fide* attempt to get better execution for the client; and • the client enters the order directly on a marketplace that does not require the disclosure of the identifier of the Participant in a consolidated market display. In these circumstances, the Participant must have reasonable procedures in place to ensure that information concerning client orders is not used improperly within the firm. These procedures will vary from firm to firm and no one procedure will work for all firms. If a firm does not have reasonable procedures in place, it cannot rely on the exceptions. Reference should be made to Policy 7.1 – Policy on Trading Supervision Obligations, and in particular Part 4 – Specific Procedures Respecting Client Priority and Best Execution.		

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
If a client has instructed a Participant to withhold an order or has granted a Participant discretion with respect to the entry of an order, details of the instruction or grant of discretion must be retained for a period of seven years from the date of the instruction or grant of discretion and, for the first two years, the consent must be kept in a readily accessible location.		
Part 4 – Client Consent A Participant does not have to provide priority to a client order if the client specifically consents to the Participant trading alongside or ahead of the client. The consent of the client must be specific to a particular order and details of the agreement with the client must be noted on the order ticket. A client cannot give a blanket form of consent to permit the Participant to trade alongside or ahead of any future orders the client may give the Participant. If the client order is part of a pre-arranged trade that is to be completed at a price below the best bid price or above the best ask price as indicated on a consolidated market display, the Participant will be under an obligation to ensure that "better-priced" orders on a marketplace are filled prior to the execution of the client order. Prior to executing the client order, the Participant must ensure that the client is aware of the better-priced orders and has consented to the Participant executing as against them in priority to the client order. The consent of the client must be noted on the order ticket. If the client has given the Participant an order that is to be executed at various times during a trading day (e.g. an "over-the-day" order) or at various prices (e.g. at various prices in order to approximate a volume-weighted average price), the client is deemed to have consented to the entry of principal and non-client orders that may trade ahead of the balance of the client order. Unless the client has provided standing written instructions that all orders are to be executed at various times during the trading day or a various prices during the trading day, the client instructions should be treated as specific to a particular order and the details of the instructions by the client must be noted on the order ticket. However, if the un-entered portion of the client order would reasonably be expected to affect the market price of the security, the Participant may be precluded	**Scotia –** Believes that client consent is implicit for the Participant to trade against better-priced orders when the Participant has to move the market to execute a pre-arranged trade or cross. Believes that it is impractical to obtain consent to trade ahead of or along side a retail client order and that this will effectively prohibit a Participant from trading a security that trades on more than one marketplace. States "a Participant's traders have no knowledge or access to information regarding retail, discount and other client orders entered on a trading system of a marketplace via straight-through processing". Opposes the introduction of "conditional consent" as they are of the view that such arrangements should be a "private matter to be negotiated as between the client and Participant prior to executing the trade and not a matter requiring regulatory intervention."	If a client agrees to a prearranged trade or cross at a particular price, it can not be assumed that the client is aware of the depth of the market at a better price. The rule does not preclude the Participant from executing against these better-priced orders when moving the market, rather it simply ensures that the client has provided an "informed consent". Unless the order has been entered "anonymously", traders are able to see orders from clients of their firm in the consolidated market display. In the absence of the amendment, a trader would be able to direct a pre-arranged trade or cross involving a principal or non-client order to another marketplace in order to avoid interference from the pre-existing order of a client of the firm. While RS acknowledges that it would be impractical to obtain the consent of retail clients, it is the position of RS that the retail client order is entitled to be filled in priority. In the absence of a provision to cover a conditional consent, the Participant would have to "recross" to the client in an on-marketplace transaction. This would require the Participant to move the market to the price at which the Participant would trade with the client the position which the Participant had accumulated when trading along or ahead of the client. The introduction of the concept of conditional consent is therefore a "relief provision" for the benefit of the Participant. A Participant who is unwilling to assume the risk would not enter into a conditional consent arrangement.
	TD – Supports the introduction of the concepts of "deemed consent" and "conditional consent".	

Text of the Amendments (Changes from the Proposal Highlighted)	Commentator and Summary of Comment	Response to Comment
from entering principal or non-client orders as a result of the application of the frontrunning rule. In certain circumstances, a client may provide a conditional consent for the Participant to trade alongside or ahead of the client order. For example, a client may consent to a principal order of Participant sharing fills with the client order provided the client order is fully executed by the end of the trading day. If the client's order is not fully executed, the client may expect that the Participant "give up" its fills to the extent necessary to complete the client order. In this situation, the Participant should mark its orders as "principal" throughout the day. Any part of the execution which is given up to the client should not be re-crossed on a marketplace but should simply be journalled to the client (since the condition of the consent has not been met, the fills in question could be viewed as properly belonging to the client rather than the principal order). To the extent that a Participant "gives up" part of a fill of a principal order to a client based on the conditional consent, the Participant shall report the particulars of the "give up" to the Market Regulator not later than the opening of trading on marketplaces on the next trading day. The conditional consent of the client must be specific to a particular order. The details of the agreement with the client must be noted on the order ticket.		