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IIROC NOTICE

Rules Notice
Request for Comments
UMIR

Please distribute internally to:
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July 17, 2012

Proposed Guidance on Certain Manipulative and Deceptive Trading Practices

Executive Summary

IIROC is publishing for comment draft guidance regarding the obligations of a Participant or Access Person in relation to manipulative and deceptive trading practices, particularly trading strategies using automated order systems[1] or direct electronic access[2] (the "Proposed Guidance"). The Proposed Guidance would confirm IIROC's position that employing certain trading strategies commonly known as:

- "Layering";

1 An automated order system is a "system used to automatically generate or electronically transmit orders that are made on a pre-determined basis. As set out in section 1.2(1) of National Instrument 23-103 CP, an automated order system would encompass "both hardware and software used to generate or electronically transmit orders on a pre-determined basis and would include smart order routers and trading algorithms that are used by marketplace participants, offered by marketplace participants to clients or developed or used by clients."

2 For this purpose, "direct electronic access" means an arrangement between a Participant and a client that permits the client to electronically transmit an order containing the identifier of the Participant:

(a) through the systems of the Participant for automatic onward transmission to a marketplace; or

(b) directly to a marketplace without being electronically transmitted through the systems of the Participant.

- "Quote Stuffing";
- "Quote Manipulation";
- "Spoofing"; or
- "Abusive Liquidity Detection"

on a marketplace would be considered a manipulative and deceptive trading practice for the purposes of UMIR. While these strategies are often associated with the use of automated order systems, including "algorithmic" and "high frequency" trading, IIROC would remind Participants and Access Persons that these strategies are prohibited whether conducted manually or electronically.

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1. Policy Development Process

IIROC has been recognized as a self-regulatory organization by each of the Canadian provincial securities regulatory authorities (the "Recognizing Regulators") and, as such, is authorized to be a regulation services provider for the purposes of National Instrument 21-101 ("Marketplace Operations Instrument") and National instrument 23-101 ("CSA Trading Rules").

As a regulation services provider, IIROC administers and enforces trading rules for the marketplaces that retain the services of IIROC.[3] IIROC has adopted, and the Recognizing Regulators have approved, UMIR as the integrity trading rules that will apply in any marketplace that retains IIROC as its regulation services provider.

The Market Rules Advisory Committee ("MRAC") of IIROC reviewed the Proposed Guidance. MRAC is an advisory committee comprised of representatives of each of: the marketplaces for which IIROC acts as a regulation services provider; Participants; institutional investors and subscribers, and the legal and compliance community.[4]

The text of the Proposed Guidance is set out in Appendix "A". Comments are requested on all aspects of the Proposed Guidance, including any matter not addressed specifically in the Proposed Guidance. Comments should be in writing and delivered by ***October 15, 2012*** **to:**

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Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "Policy" and

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3 Presently, IIROC has been retained to be the regulation services provider for: the Toronto Stock Exchange ("TSX"), TSX Venture Exchange ("TSXV"), Canadian National Stock Exchange ("CNSX") and Alpha Exchange ("Alpha"), each as an "exchange" for the purposes of the Marketplace Operation Instrument ("Exchange"); and for Bloomberg Tradebook Canada Company, Chi-X Canada ATS Limited, Instinet Canada Cross Ltd., Liquidnet Canada Inc., Omega ATS Limited, TMX Select and TriAct Canada Marketplace LP (the operator of "MATCH Now"), each as an alternative trading system ("ATS"). CNSX presently operates an "alternative market" known as "Pure Trading" that is entitled to trade securities that are listed on Exchanges and that presently trades securities listed on the TSX and TSXV.

4 The review by MRAC of the Proposed Guidance should not be construed as approval or endorsement of the Proposed Guidance. Members of MRAC may express their personal views on topics and that advice may not represent the views of their respective organizations as expressed during the public comment process.

sub-heading "Market Proposals/Comments") upon receipt. A summary of the comments contained in each submission will also be included in a future IIROC Notice.

After considering the comments on the Proposed Guidance received in response to this Request for Comments, IIROC may make revisions to the Proposed Guidance prior to the issuance of the final Guidance Note.

2. Background to the Proposed Guidance

2.1 Developments in Market Structure and Trading Strategies

Market structure in Canada, as in other jurisdictions, has been transformed in recent years in a number of ways resulting in a more complex trading environment with new trading dynamics. Notably, the operation of marketplaces and trading of securities have evolved from primarily using manual processes to predominantly employing high-speed automated systems for trading. As well, the advent of multiple marketplaces has provided greater opportunity to trade the same securities on different marketplaces, including on "dark pools". Further, direct electronic access to marketplaces is offered, including co-location services to market participants who may place their computer servers in close proximity to the marketplace matching engine to further reduce latency in the transmission of market data and order messages. In addition, a number of marketplaces have implemented a "maker-taker" fee model whereby fee rebates are granted to market participants that post limit orders, so as to "attract" net providers of liquidity through improved trading economics, and conversely charging fees for orders that "take" liquidity by interacting with posted limit orders.

These innovations have, in turn, brought changes in the profile of market participants, most evidently the emergence of traders that engage in various trading strategies effected by automated order systems, which encompasses activities commonly known commonly as "algorithmic trading" and "high frequency trading" ("HFT"). In the Concept Release on Equity Market Structure[5] ("SEC Concept Release") issued in 2010, the Securities and Exchange Commission ("SEC") identified and discussed four broad types of trading strategies as illustrative of HFT: passive market making; arbitrage; structural/latency trading and directional strategies. The SEC Concept Release noted that general characteristics often attributed to HFT are:

- the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders;
- the use of co-location services and individual direct data feeds offered by exchanges and others to minimize network and other types of latencies;

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[5] See pp. 44-57 of the SEC Concept Release, at http://www.sec.gov/rules/concept/2010/34-61358.pdf.

- very short timeframes for establishing and liquidating positions;
- the submission of numerous orders that are cancelled shortly after submission; and
- ending the trading day in as close to a flat position as possible (that is, not carrying significant, un-hedged positions over-night).

There is currently no consensus definition of HFT that exists among market participants, academics and regulators. Nonetheless, recent industry estimates peg HFT activity at between 25% and 40% of trades on Canadian marketplaces. IIROC is in the process of undertaking a study of HFT activity in the Canadian market ("IIROC HFT Study"). The purpose of the IIROC HFT Study is to examine certain trading characteristics commonly associated with high frequency trading, such as a high order-to-trade ratio. The IIROC HFT Study will include a statistical review of market activity and provide an impact analysis of the effects of these characteristics on market quality and integrity.

In October of 2011, the Final Report of the Technical Committee of the International Organization of Securities Commissions entitled *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* ("IOSCO Report")[6] reviewed academic research and anecdotal evidence concerning the suggested impacts to trading and markets related to HFT, including:

- increased liquidity;
- improved consistency of pricing of instruments across market venues;
- the potential to contribute to shocks across trading venues;
- the potential for certain market participants to withdraw from the market due to lack of confidence in market integrity; and
- increased messaging at high speed that has come with extensive use of algorithms, raising costs for many participants and which may result in unintended consequences or potentially be manipulative.[7]

While market abuse may be facilitated as a result of technological developments, it is the abusive nature of the practice, not the means through which the practice is conducted, that produces deleterious impacts to market integrity. Accordingly, manipulative and deceptive trading practices are prohibited whether such activities are conducted manually or electronically and whether conducted with or without the use of automated order systems or direct electronic access.

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[6] See pp.11-14 of the IOSCO Report at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf.

[7] The IOSCO Report notes at p. 30 that "...existing trading practices which may have an abusive and manipulative purpose ...may benefit from the edge of HFT-style technology and the complex and fragmented nature of modern financial markets."

2.2 Manipulative and Deceptive Activity

2.2.1 Prohibitions under UMIR

Rule 2.2 of UMIR is the existing anti-manipulation rule which prohibits manipulative and deceptive activities by Participants and Access Persons, no matter the method used for trading.[8] Technological innovation that is intrinsic to current market structure does not impact the scope of application of the rule which is designed to capture abusive trading strategies, whether effected using automated order systems, by direct electronic access, or otherwise manually. The rule contains two distinct types of prohibitions. The first is a prohibition on the use of a manipulative or deceptive method of trading (that applies irrespective of whether the use of the method creates a false or misleading appearance of trading activity or an artificial price). The second prohibits the entry of an order or the execution of a trade if the person knows or ought reasonably to know that the result would be to create a false or misleading appearance of trading activity or an artificial price.

Policy 2.2 does not limit the general scope of application of Rule 2.2 but describes various activities that would contravene Rule 2.2 when undertaken on a marketplace by persons who know or ought to reasonably know they are engaging or participating in the following or similar types of activity, which include:

- making a fictitious trade;
- effecting a trade in a security which involves no change in beneficial or economic ownership; and
- effecting trades by a single interest or group with the intent of limiting the supply of a security for settlement of trades made by other persons except at prices and on terms arbitrarily dictated by such interest or group.

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8 The text of Rule 2.2 of UMIR provides as follows:

(1) A Participant or Access Person shall not, directly or indirectly, engage in or participate in the use of any manipulative or deceptive method, act or practice in connection with any order or trade on a marketplace if the Participant or Access Person knows or ought reasonably to know the nature of the method, act or practice.

(2) A Participant or Access Person shall not, directly or indirectly, enter an order or execute a trade on a marketplace if the Participant or Access Person knows or ought reasonably to know that the entry of the order or the execution of the trade will create or could reasonably be expected to create:

(a) a false or misleading appearance of trading activity in or interest in the purchase or sale of the security; or

(b) an artificial ask price, bid price or sale price for the security or a related security.

(3) For greater certainty, the entry of an order or the execution of a trade on a marketplace by a person in accordance with the Marketplace Trading Obligations shall not be considered a violation of subsection (1) or (2) provided such order or trade complies with applicable Marketplace Rules or terms of the contract with the marketplace and the order or trade was required to fulfill applicable Marketplace Trading Obligations.

Policy 2.2 presently provides that activities which create or could reasonably create a false or misleading appearance of trading activity or interest in the purchase or sale of a security or an artificial bid, ask or sale price when undertaken on a marketplace by persons who know or ought reasonably to know that they are engaging or participating in these or similar types of activities, include:

- entering an order or orders for the purchase of a security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price for the sale of that security, has been or will be entered by or for the same or different persons;
- entering an order or orders for the sale of a security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price for the purchase of that security, has been or will be entered;[9]
- making purchases of, or offers to purchase, a security at successively higher prices or in a pattern generally of successively higher prices;
- making sales of or offers to sell a security at successively lower prices or in a pattern generally of successively lower prices;
- entering an order or orders for the purchase or sale of a security to:
  - establish a predetermined sale price, ask price or bid price,
  - effect a high or low closing sale price, ask price or bid price, or
  - maintain the sale price, ask price or bid price within a predetermined range;[10]
- entering an order or a series of orders for a security that are not intended to be executed;

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9 Rule 1.1 of UMIR defines a pre-arranged trade as a trade in respect of which the terms of the trade were agreed upon, prior to the entry of either the order to purchase or to sell on a marketplace, by the persons entering the orders or by the persons on whose behalf the orders are entered. An order for the purchase or sale of a security that is entered as part of a "pre-arranged trade" is acceptable as a *bona fide* trade that would not be prohibited under Rule 2.2, in distinction to trades pre-arranged with the intent to create a false or misleading appearance of trading activity or interest in the purchase or sale of a security or an artificial bid, ask or sale price.

10 Rule 7.7 of UMIR specifically provides that market stabilization or market balancing activities for the purpose of maintaining a fair and orderly market in an "offered security" that undertaken in accordance with the price limitations set out in Rule 7.7, will not be considered to contravene Rule 2.2. Policy 7.7 makes clear, however, that the market stabilization exemption would not be available in the circumstance when a dealer knows or ought reasonably know that the market price is not fairly and properly determined by supply and demand, such as when the dealer is aware that the market price is a result of inappropriate activity by a market participant or that there is undisclosed material information regarding the issuer.

- entering an order for the purchase of a security without, at the time of entering the order, having the ability or the reasonable expectation to make the payment that would be required to settle any trade that would result from the execution of the order;
- entering an order for the sale of a security without, at the time of entering the order, having the reasonable expectation of settling any trade that would result from the execution of the order;[11] and
- effecting a trade in a security, other than an internal cross, between accounts under the direction or control of the same person.

It is important to note that these activities listed in Policy 2.2 are manipulative and deceptive if they are undertaken with the intention to create a false or misleading appearance of trading activity or interest in the purchase or sale of a security or an artificial bid, ask or sale price.

Policy 2.2 also elaborates on considerations related to determining whether an ask price, bid price or sale price is "artificial" in a particular set of circumstances (the absence of any one or more of which does not rule out an artificial price) and includes:

- the prices of the preceding trades and succeeding trades;
- the change in the last sale price, best ask price or best bid price that results from the entry of the order on a marketplace;
- the recent liquidity of the security;
- the time the order is entered and any instructions relevant to the time of entry of the order; and
- whether any Participant, Access Person or account involved in the order:
  - o has any motivation to establish an artificial price, or
  - o represents substantially all of the orders entered or executed for the purchase or sale of the security.

Rule 2.3 of UMIR prohibits the entry of orders or execution of trades if the Participant or Access Person knows or ought reasonably to have known that the order or trade would not be in compliance with regulatory requirements. Rule 2.3 is intended to be a specific statement of the general requirement not to trade in violation of "just and equitable principles of trade".

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[11] See IIROC Notice 12-0078 – Rules Notice – Notice of Approval – UMIR – *Provisions Respecting Regulation of Short Sales and Failed Trades* (March 2, 2012) at pp. 9-10. With the repeal of the "tick test" to be effective October 15, 2012, the provision in Policy 2.2, Part 1(d) which stipulates that "purchasing a security with the intention of making a sale of the same or a different number of units of the security or a related security on a marketplace at a price which is below the price of the last sale of a standard trading unit of such security displayed in a consolidated market display" is a manipulative and deceptive method, act or practice, will also be repealed.

IIROC has issued guidance on the interpretation and application of Rules 2.2 and 2.3 of UMIR in certain contexts.[12] The prohibitions on manipulative trading practices discussed in the previous guidance apply uniformly to Access Persons or Participants entering proprietary orders or Participants entering orders on behalf of clients, including HFTs. Notwithstanding that the manipulative activity may originate with a client, the Participant will be liable if engaging or participating in the use of the manipulative or deceptive method, act or practice in connection with any order or trade on a marketplace on behalf of the client when the Participant knows or ought reasonably to know the nature of the method, act or practice, or knows or ought reasonably to have known that that the entry of the order or the execution of the trade would create or could reasonably be expected to create a false or misleading appearance of trading activity in or interest in the purchase or sale of the security or an artificial ask price, bid price or sale price for the security or a related security.

2.2.2 Trading Supervision and Gatekeeper Obligations

While a Participant may not, depending on the circumstances, be liable under Rule 2.2 or 2.3 for the manipulative and deceptive trading activity of a client, a Participant must:

- pursuant to Rule 7.1 and Policy 7.1, adopt a supervisory system to specifically address manipulative and deceptive activities; and
- under Rule 10.16 and Policy 10.16, act as "gatekeeper" by investigating and reporting to IIROC any violations of specified provisions of UMIR (and guidance issued by IIROC encourages the reporting of any "red flags" which may be indicative of possible improper behaviour that may violate UMIR).

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[12] Guidance has been issued on the following subjects:

- "double printing": Market Integrity Notice 2003-002 – *Guidance - Prohibition on Double Printing* (January 13, 2003); Market Integrity Notice 2005-004 – *Guidance - Double Printing and the Entry of Orders* (March 4, 2005); Market Integrity Notice 2005-030– *Guidance - Avoiding Double Printing in the Use of an Error Account* (September 1, 2005); Market Integrity Notice 2006-004 – *Guidance - Facilitation of a Client Special Settlement Trade and Double Printing* (February 6, 2006) and IIROC Notice 11-0043 – Rules Notice – Guidance Note - *Guidance on "Locked" and "Crossed" Markets* – Question 4 (February 1, 2011);
- "wash trades": Market Integrity Notice 2004-021 – *Guidance - Entry of Off-Setting Market-on-Close Orders* (August 26, 2004); Market Integrity Notice 2005-029 – *Guidance - Entering Orders on Both Sides of the Market* (September 1, 2005); Market Integrity Notice 2006-008 – *Guidance - Use of the Market-on-Close Facility* (March 10, 2006); and IIROC Notice 11-0043 – Rules Notice Guidance Note - *Guidance on ""Locked" and "Crossed" Markets* – Question 3 (February 1, 2011);
- "artificial prices": Market Integrity Notice 2002-021 – *Guidance - Prohibition Against Establishing Artificial Prices* (December 16, 2002) and Market Integrity Notice 2007-015 – *Guidance - Specific Questions Related to Trading on Multiple Marketplaces* - Question 2 (August 10, 2007); and
- "improper orders and trades": IIROC Notice 11-0043, op. cit., explaining that the entry of an order that does not comply with the Locked and Crossed Order Provisions in the CSA Trading Rules will constitute a violation of Rule 2.3 and may constitute a violation of other provisions of UMIR.

Failure of a Participant to adhere to these obligations may result in a finding of responsibility for failure to supervise and act as "gatekeeper" to detect and prevent manipulative and deceptive activities from being undertaken by a client, putting market integrity at risk.

In particular, a Participant must have reasonable procedures to address fact situations when manipulative and deceptive activities may be more prevalent, such as to:

- determine whether orders are being entered by insiders or other persons with an "interest" in affecting the price of a security;
- monitor trading activity by persons with multiple accounts;
- implement additional compliance procedures in circumstances when the Participant is unable to verify certain information regarding an account such as the ultimate beneficial ownership of the account unless that information was otherwise required by applicable regulatory requirements;
- address the additional risks resulting from the fact that efforts to manipulate a security are more likely to:
  - occur at the end of a calendar month or on the expiry of derivatives; or
  - be centered on illiquid securities.

In addition, Policy 7.1 of UMIR elaborates on the responsibility of Participants for trading supervision and compliance specifically where an order is entered on a marketplace without the involvement of a registrant, as the client maintains a "systems interconnect arrangement" in accordance with marketplace requirements. The obligation to supervise:

- applies to the Participant whatever the means with which an order is entered on a marketplace, including if entered directly by a client and routed to a marketplace through the trading system of the Participant; and
- requires adequate supervision policies and procedures to address the potential additional risk exposure with orders not directly handled by the Participant prior to the entry on a marketplace but which are the Participant's responsibility.

IIROC has issued guidance[13] confirming that a Participant providing "direct access" to a marketplace is not relieved from any obligations under UMIR with respect to the supervision of trading activities by a "direct access client" and retains full responsibility for any order entered by a direct access client, even though that order would be electronically routed to the

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[13] See Market Integrity Notice 2005-006 – Guidance - *Obligations of an "Access Person" and Supervision of Persons with "Direct Access"* (March 4, 2005); Market Integrity Notice 2007-010 – Guidance - *Compliance Requirements for Dealer Sponsored Access* (April 20, 2007), Market Integrity Notice 2007-011 – Guidance - *Compliance Requirements for Order Execution Services* (April 20, 2007) and Market Integrity Notice 2008-003 – Guidance – *Supervision of Algorithmic Trading* (January 18, 2008), and IIROC Notice 09-0081– Rules Notice – Guidance Note – UMIR - *Specific Questions Related to Supervision of Algorithmic Trading* (March 20, 2009).

marketplace.[14] The guidance set out regulatory expectations concerning compliance and supervision obligations under Policy 7.1 of UMIR in regard to order-execution services provided to a client that is not an "institutional customer", dealer-sponsored access services or DMA provided to a client, (a "DMA client") and algorithmic trading. The guidance emphasized that the source of, or means with which, an order is entered does not relieve a Participant of responsibility for, and the supervision of, such orders including:

- the detection of possible UMIR violations such as:
  - orders that may have been entered for "spoofing" in the pre-opening session of a marketplace, contrary to Rule 2.2 of UMIR (the entry of an order or orders which are not intended to be executed for the purpose of determining the depth of the market, checking for the presence of an "iceberg" order, affecting a calculated opening price or other similar improper purpose),
  - orders that may have been entered on a marketplace and trades that may have been executed for the creation of an "artificial price" contrary to Rule 2.2 of UMIR (particularly since institutional investors are among the investors which may have an interest in "high closing" particular securities in their portfolios at the end of a reporting period),
  - "wash trading" (particularly if a DMA client has more than one account with a Participant), and
  - trades which fail in settlement; and
- implementation of systems reasonably designed to prevent the entry and execution of "unreasonable" orders and trades on a marketplace whether the Participant or a DMA client of the Participant, is using an algorithmic trading system.

2.2.3 Prohibitions under Securities Legislation

Securities legislation in Canada, including Part 3 of the CSA Trading Rules, broadly prohibits manipulation in the conduct of trading securities by any person or company.[15] Activities that would normally be considered to create a misleading appearance of trading activity in, or an artificial price for a security are described in section 3.1 of Companion Policy 23-101. These activities are largely comparable to the prohibitions under UMIR. Every person who trades in

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14 See also the following disciplinary notices: IIROC Notice 11-0232 – Enforcement Notice – Decision - *In the Matter of Morgan Stanley Canada Limited - Settlement* (August 3, 2011) and IIROC Notice 11-0045 - Enforcement Notice – Decision - *In the Matter of Credit Suisse Securities (Canada) Inc. - Settlement* (February 2, 2011).

15 The *Securities Acts* of Alberta, British Columbia, Ontario, Québec and Saskatchewan prohibit manipulation by a person or company that participates in any transactions or methods of trading if the person or company knows or reasonably ought to know that the transactions or method of trading or any act, practice or course of conduct by persons of companies results in or contributes to a misleading appearance of trading activity in, or an artificial price for a security or derivative of that security.

a security (including any client but not including any Participant or Access Person who is subject to UMIR) is subject to Part 3 of the CSA Trading Rules.

2.3 Automated Trading Strategies and Risks to the Fairness and Integrity of Markets

The IOSCO Report notes that there is concern that technological advantages offer HFTs the possibility of engaging in abusive practices on a larger scale than would have previously been possible.[16] In addition, the increased prevalence of proprietary computer trading systems has caused concerns that automated trading strategies, including algorithmic and HFT trading, pose systemic risks because of their effects on market volatility in less liquid markets. This concern has grown especially since the "Flash Crash" of May 6, 2010 in which very large intra-day movements in stock prices occurred.

The IOSCO Report recommended that regulators review their capabilities for the continuous monitoring of trading (including transactions, orders entered or orders cancelled) to help ensure that they remain effective, monitor for novel forms or variations of market abuse that may arise as a result of technological developments and take action as necessary to maintain market integrity and a high degree of investor protection.

IIROC and the securities regulatory authorities already employ their examination and enforcement resources to detect potentially manipulative and deceptive activity and to bring appropriate proceedings against offenders.[17] IIROC monitors trading activity within and between all equity marketplaces with its "Surveillance Technology Enhancement Platform" ("STEP"). IIROC created STEP as a necessary regulatory tool to keep pace with the dramatic increase in the speed and volume of trading and to ensure IIROC has the capacity for consolidated surveillance of multiple marketplaces in real-time. STEP also enables detailed post-trade analysis in the search for underlying trends in trading activity.

IIROC is further enhancing its monitoring capabilities through automated regulatory alerts to detect highly-automated manipulative activity that may otherwise be challenging to identify. The IIROC HFT Study currently being conducted also may yield further insights into novel forms of manipulative and deceptive activity requiring additional alerts.

The IOSCO Report and the SEC Concept Release specifically identified four trading practices which may have an abusive and manipulative purpose and that may be facilitated by the

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16 It is noted, however, at p.30 of the IOSCO Report that clear evidence of the systematic and widespread use of abusive practices by those engaging in HFT has not been presented by market participants and that while there have been a number of successful prosecutions and other potentially abusive patterns are being scrutinized, globally, regulators cannot yet conclude whether the use of abusive trading practices is more or less widespread within the HFT community than within the traditional trading community.

17 See Annotated UMIR at http://www.iiroc.ca/English/ComplianceSurveillance/RuleBook/Pages/UMIR.aspx for case summaries related to enforcement of UMIR 2.2, 2.3, 7.1 and related Policies.

sophisticated technological infrastructure and communication systems employed by HFTs, including: momentum ignition or layering; quote stuffing; spoofing and abusive liquidity detection.

2.3.1 Momentum Ignition or Layering

"Momentum ignition" or "layering" is a strategy which initiates a series of orders and trades (sometimes along with spreading false rumours in the marketplace) in an attempt to ignite a rapid price move either up or down and induce others to trade at artificially high or low prices. An example is a "layering" strategy whereby a market participant places a *bona fide* order on one side of the market and simultaneously "layers" the book with non-*bona fide* orders on the other side of the market to bait other market participants to react to the non-*bona fide* orders and trade with the *bona fide* order. There are several variations of this strategy in terms of number, price and size of the non-*bona fide* orders but the essential purpose remains the same; to falsely create an impression that there is more supply or demand in the market for a security than actually exists and to make profits from the resulting price manipulation.

2.3.2 Quote Stuffing

"Quote-stuffing" is the practice of placing an unusual number of buy or sell orders on a particular security and then immediately cancelling them, to "flood" trading systems with excessive market data messages. An objective may be to increase data latencies for marketplaces or other market participants in order to create "information arbitrage" opportunities.

2.3.3 Spoofing

"Spoofing" is a practice using limit orders that are not intended to be executed, to manipulate prices. Some strategies are related to the open or the close of regular market hours that involve distorting disseminated market imbalance indicators through the entry of non-*bona fide* orders, checking for the presence of an "iceberg" order, affecting a calculated opening price and/or aggressive trading activity near the open or close for an improper purpose.

2.3.4 Abusive Liquidity Detection

"Abusive liquidity detection" strategies enter large orders (disclosed or iceberg) during the pre-open or employ "pinging" orders[18] to detect the existence of a large buyer or seller with the intent to trade ahead of, rather than with, the large buyer or seller. After a profitable price movement, the trades are reversed, or in the event the price moves contrary to the position taken, the trading interest of the large buyer or seller may be viewed as a free option to trade against.[19]

2.3.5 Quote Manipulation

In addition to the four broad categories identified in the IOSCO Report and the SEC Concept Release, IIROC has concern with another practice identified as "quote manipulation" which may have an abusive and manipulative purpose that may be facilitated by the sophisticated technological infrastructure and communication systems employed by HFTs.

Quote manipulation is trading activity intended to affect the price at which dark orders that are tied to prices on visible marketplaces, trade in dark pools or displayed marketplaces. Non-*bona fide* orders are entered on visible marketplaces which change the best bid price and/or the best ask price in order to affect the price calculation at which a trade will occur with a dark order. This activity (which may be combined with abusive liquidity detection) results in a trade with a dark order at an improved price, following which orders are removed from the visible marketplaces.

2.4 Recent International Regulatory Initiatives on Manipulative Practices

Given market developments such as the increasing use of automated order systems, European and U.S. securities regulators have sought to adapt their existing market abuse regulation. In October, 2011 the European Commission ("EC") adopted market abuse regulation (the "MAR")[20] which replaced and extended the Market Abuse Directive in place since 2003.[21] The MAR acknowledged that the existing definition of market manipulation was very broad and already capable of applying to abusive behaviour no matter the medium used for trading.

18 In the SEC Concept Release at page 47, the term "pinging" refers to a tradeable order that can be used to search for and access all types of undisplayed liquidity, including in dark pools and dark orders on displayed marketplaces.

19 The SEC Concept Release notes that there is an important distinction between using tools such as pinging orders as part of a normal search for liquidity with which to trade so that both a long-term investor and large buyer/seller benefit from the liquidity seeking strategy, and using such tools to detect and trade in front of, thus harming, a large trading interest as part of an "order anticipation" trading strategy.

20 See *A Proposal for the Regulation of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse)* or "Market Abuse Regulation" (MAR) at COM (2011) 651.

21 Market Abuse Directive 2003/6/EC.

However, it was determined appropriate to provide specific examples in the MAR of strategies using algorithmic trading and high frequency trading that fall within the prohibition against market manipulation, in order to ensure a consistent approach in monitoring and enforcement by regulatory authorities. In particular, Article 8 of the MAR contains a non-exhaustive list of market manipulation techniques, including the sending of orders to a trading venue by means of algorithmic trading without an intention to trade but for the purpose of:

- disrupting or delaying the functioning of the trading system of the trading venue;
- making it more difficult for other persons to identify genuine orders on the trading system of the trading venue; or
- creating a false or misleading impression about the supply of or demand for a financial instrument.

In December, 2011 the European Securities and Markets Authority ("ESMA")[22] identified, in its guidelines on systems and controls in an automated trading environment,[23] potential cases of market manipulation which may be of particular concern in an automated trading environment. In addition to the trading practices identified in the IOSCO Report and the SEC Concept Release, ESMA identified the use of "ping orders" described as entering small orders in order to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform.

2.5 Market Abuse Cases Related to the "Layering" Strategy

Enforcement proceedings have been undertaken by foreign regulators, in particular FINRA in the U.S. and the Financial Services Authority ("FSA") in the U.K., with respect to market abuse undertaken through "layering", in certain cases using "HFT" strategies. In September 2010, FINRA Rule 5210 was successfully used in a case involving Trillium Brokerage Services, LLC ("Trillium")[24] in New York, which resulted in a $2.26 million settlement by FINRA with the brokerage and its employees for "illicit" HFT trading strategies. Traders at Trillium were alleged to have repeatedly entered numerous non-*bona fide* "layered" orders to create the appearance of substantial pending buying or selling interest and to have taken advantage of algorithmic trading programs at other firms. FINRA's position was that Trillium's trading conduct was designed to improperly bait unsuspecting market participants into executing

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22 ESMA is an independent European Union Authority that fosters supervisory convergence both amongst securities regulators, and across financial sectors.

23 See *Final Report - Guidelines on Systems and Controls in an Automated Trading Environment for Trading Platforms, Investment Firms and Competent Authorities* at ESMA/2011/456.

24 See details at: http://www.finra.org/Newsroom/NewsReleases/2010/P121951.

trades at illegitimately high or low prices. Trillium traders placed and then canceled multiple orders within seconds before a real order was entered to profit from artificially inflated or deflated stock prices on at least 46,152 occasions, according to FINRA. The case came to light after a complaint to Nasdaq, and was the first U.S. case involving "layering". FINRA has indicated that Trillium was not an isolated case and the regulator has created a surveillance program to monitor all markets for the activity.

A market abuse case by the FSA in 2011 involving Swift Trade Inc. ("Swift Trade") also concerned the practice of "layering".[25] The FSA alleged that Swift Trade's manipulative trading caused a succession of small price movements in a wide range of securities on the London Stock Exchange from which Swift Trade made profits estimated in excess of £1.75 million. The case was deemed particularly serious by the FSA as it involved tens of thousands of trading orders by traders acting in concert with each other across many locations worldwide. The trading was alleged to have led to a false or misleading impression of supply and demand and an artificial share price in the shares traded to the detriment of other market participants. The FSA fined Swift Trade £8 million and Swift Trade has appealed the decision.

In a subsequent proceeding in 2011, the FSA obtained an injunction against a firm known as DaVinci Invest Ltd.[26] and related companies and individuals, from trading in the market in UK listed shares on the basis that the companies and individuals had allegedly engaged in a manipulative "layering" trading practice. The FSA estimated that over £1 million in profits were made from the activity in which misleading orders had the effect of moving the share price up and down as the market reacted to perceived changes in supply or demand for the shares which the traders would then take advantage of, by repeatedly buying (when the price had been manipulated downwards) or selling shares (when the price had been manipulated upwards). At the same time, the initial orders which had manipulated the share price were deleted.

3. Questions

While comment is sought on all aspects of the Proposed Guidance, IIROC would specifically request response on the following questions:

1. Are there other trading strategies not discussed in the Proposed Guidance that could, by their nature, be considered manipulative and deceptive?
2. Are there any matters which should be added to the "Question and Answer" section of the final Guidance Note?

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[25] See FSA/PN/075/2011.

[26] See FSA/PN/077/2011.

Appendix A – Text of Proposed Guidance

IIROC OCRCVM
Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Request for Comments
UMIR

Please distribute internally to:
Institutional
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Trading Desk

Contact:
Naomi Solomon
Senior Policy Counsel, Market Regulation Policy
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12-0* * *
*** *, 2012**

Guidance on Certain Manipulative and Deceptive Trading Practices

Executive Summary

This Rules Notice provides guidance on the obligations of Participants and Access Persons related to manipulative and deceptive trading practices, particularly trading strategies using automated order systems[27] or direct electronic access.[28] The Guidance confirms IIROC's position that employing certain trading strategies commonly known as:

- "Layering";

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[27] An automated order system is a "system used to automatically generate or electronically transmit orders that are made on a pre-determined basis". As set out in section 1.2(1) of National Instrument 23-103 CP, an automated order system would encompass "both hardware and software used to generate or electronically transmit orders on a pre-determined basis and would include smart order routers and trading algorithms that are used by marketplace participants, offered by marketplace participants to clients or developed or used by clients."

[28] For this purpose, "direct electronic access" means an arrangement between a Participant and a client that permits the client to electronically transmit an order containing the identifier of the Participant:

(a) through the systems of the Participant for automatic onward transmission to a marketplace; or

(b) directly to a marketplace without being electronically transmitted through the systems of the Participant.

- "Quote Stuffing";
- "Quote Manipulation";
- "Spoofing"; or
- "Abusive Liquidity Detection"

on a marketplace is considered a manipulative and deceptive trading practice for the purposes of UMIR. While these strategies are often associated with the use of automated order systems, including "algorithmic" and "high frequency" trading, IIROC would remind Participants and Access Person that these strategies are prohibited whether they are conducted manually or electronically.

Rules Notice – Table of Contents

1. Risks to Market Integrity from Certain Strategies Using Automated Order Systems

An important development related to technology's impact on market integrity is the advent of various trading strategies effected by automated order systems at high speed and including activity commonly referred to as "algorithmic trading" or "high frequency trading" ("HFT"). The increase in the use of automated order systems in the trading of securities has been valued by some market participants for its perceived benefits to market efficiency, but it has also led to concerns that such high velocity trading may enable abusive practices in the securities markets on a larger scale and pose systemic risks to market integrity.

The submission of large numbers of orders across multiple marketplaces in Canada, often with the use of direct electronic access to marketplaces, presents significant challenges for monitoring trading activity and enforcing existing securities regulations. IIROC recognizes that many complex trading strategies that may be potentially abusive and manipulative may be facilitated by the sophisticated technological infrastructure and communication systems often employed by users of automated order systems. Active focus is being placed by the regulators on monitoring for and pursuing illegal practices, including strategies linked to algorithmic and HFT trading that are of a manipulative nature whether in a known or novel form.

While market abuse may be facilitated as a result of technological developments, it is the abusive nature of the practice, not the means through which the practice is conducted, that produces deleterious impacts to market integrity. Accordingly, manipulative and deceptive trading practices are prohibited whether such activities are conducted manually or electronically and whether conducted with or without the use of automated order systems and direct electronic access. An Access Person, Participant or any client that manipulates the market by any means has engaged in misconduct that is prohibited under UMIR or otherwise under securities legislation.

Participants are further reminded that as gatekeepers to the securities market, they must develop and implement appropriate policies and procedures to effectively address, detect, prevent and report manipulative and deceptive activity, in accordance with the requirements of Policy 7.1, failing which disciplinary action may be taken against the firm, its management and its directors. As part of each trade desk review undertaken by staff of IIROC, the policies and procedures that have been adopted by a Participant will be reviewed in regard to their adequacy to detect and prevent violations of Requirements in light of the type and volume of business undertaken by the Participant. As applicable, this would include assessing whether firms have adequate testing and controls related to trading strategies that may be implemented by users of an automated order system to detect and prevent potential trading abuses. The review of the policies and procedures does not, however, constitute an approval of the policies and procedures by IIROC.

2. Questions and Answers

The following is a list of questions regarding the obligations of a Participant or Access Person under UMIR with respect to manipulative or deceptive acts or practices in the context of the use of automated order systems and direct electronic access to marketplaces together with IIROC's response to each question:

1. Are there trading strategies which could be employed through an automated order system that IIROC considers manipulative and deceptive practices?

Yes. Use of the following strategies through an automated order system as part of "algorithmic trading", "high frequency trading" or any other means of trading will be considered by IIROC to be manipulative and deceptive activities that contravene Rule 2.2 or otherwise violate securities legislation:

- ***Layering:*** It is the position of IIROC that placing a *bona fide* order on one side of the market while simultaneously "layering" orders in the consolidated market display on the other side of the market without intention to trade is a contravention of Rule 2.2(2) and Policy 2.2, Parts 2 and 3 as inducing a false or misleading appearance of trading activity or artificial price. In this case, the purpose of the "layering" is to "bait" other market participants to react and trade with the *bona fide* order on the other side of the market at an artificial price.
- ***Quote Stuffing***: It is the position of IIROC that the input by a Participant or Access Person of excessive market data messages with the intent to "flood" systems and create "information arbitrage" opportunities for itself, is a contravention of Rule 2.2(1) as an activity which, by its very nature, will be considered to be a manipulative or deceptive method, act or practice.
- ***Quote Manipulation:*** IIROC is concerned about potential manipulative activity intended to affect the price at which dark orders that are tied to prices on visible markets, trade in dark pools or visible markets. It is the position of IIROC that entering non-*bona fide* orders on visible markets in an attempt to change the best bid price and/or the best ask price and affect the price calculation at which a trade will occur with a dark order, contravenes Rule 2.2(1), (2)(b) and Policy 2.2, Part 2(e). This activity (which may be combined with liquidity detection) results in a

trade with a dark order at an improved price, following which orders are removed from the visible market.

- ***Spoofing:*** It is the position of IIROC that the entry of non-*bona fide* orders in the pre-opening on a marketplace that displays a "Calculated Opening Price" (indicating the price at which trading would commence based on the orders entered to that point on the marketplace), with the intent of affecting the Calculated Opening Price to the advantage of the party that entered the order, contravenes Rule 2.2(2) and Policy 2.2, Part 2(f).
- ***Abusive Liquidity Detection***: IIROC is of the view that strategies which enter orders (disclosed or iceberg during the pre-open, or "pinging"[29]) to detect the existence of a large buyer or seller with the intention to trade ahead of, rather than with, the large buyer or seller, is a manipulative and deceptive practice contrary to Rule 2.2(1). This strategy harms the large trading interest when after a profitable price movement, the trades are reversed, or in the event the price moves contrary to the position taken, the trading interest of the large buyer or seller may be viewed as a free option to trade against.

2. Is a Participant required to undertake compliance testing to detect for any manipulative and deceptive trading strategies?

Yes. As a gatekeeper to the securities markets, a Participant plays an important role in acting at first instance to mitigate the risks associated with the use of automated order systems that facilitate algorithmic or high frequency trading strategies so that market integrity may be maintained. Part 7.1 of UMIR requires that a Participant adopt policies and procedures that are adequate to ensure compliance with all Requirements and the level and nature of testing for compliance with the Requirements must be appropriate to the size and type of business conducted by the Participant.

In the event that algorithmic or high frequency trading is engaged in by the Participant or its clients, IIROC expects the Participant to ensure that compliance procedures adopted include the monitoring of all orders, the use of automated pre-trade controls and real-time alert systems that are programmed to detect patterns related to manipulative practices including, without limitation, layering, spoofing, quote manipulation, quote stuffing and abusive liquidity detection strategies. IIROC also expects the Participant to engage in regular post-trade review and analysis using higher sample sizes of orders given the greater risks of manipulative and deceptive acts or

[29] A "pinging" order is a tradeable order that can be used to search for and access all types of non-displayed liquidity, including in dark pools and dark orders on displayed marketplaces.

practices that may be associated with algorithmic or HFT trading. In addition, IIROC expects a Participant to follow gatekeeper obligations concerning manipulative trading activity and take steps to ensure that any problematic strategies detected be further prevented and immediately terminated.

3. *Is there an exception from the prohibition on manipulative and deceptive trading available for persons with Marketplace Trading Obligations?*

Rule 2.2 confirms that the entry of an order or the execution of a trade on a marketplace by a person in accordance with the Marketplace Trading Obligations shall not be considered a violation of prohibitions on manipulative and deceptive activities provided such order or trade complies with applicable Marketplace Rules or marketplace requirements and the order or trade was required to fulfill applicable Marketplace Trading Obligations. However, a person with Marketplace Trading Obligations that manipulates the market in any way for personal financial purposes without the intention of fulfilling their obligations would be considered to contravene Rule 2.2. In addition, a person with Marketplace Trading Obligations that "takes advantage" of a party to a trade would be considered not to be trading "openly and fairly" and such trades would be subject to regulatory intervention by cancellation.[30]

4. *In what circumstances would IIROC consider that a Participant or Access Person is not participating in a manipulative or deceptive activity while engaging in algorithmic or high frequency trading strategies?*

In the view of IIROC, the regulatory initiatives that have been undertaken are targeted only to curbing potentially harmful and manipulative trading behaviours, without restraint on legitimate trading activity and strategies that do not put market integrity at risk. Algorithmic and HFT trading are components of the current market structure and some of the strategies may benefit market quality even while others do not.

For example, passive market making strategies consisting of the submission of limit orders that provide liquidity to the marketplace at specified prices are an important source of liquidity. While the firm engaging in passive market making may sometimes take liquidity if necessary to liquidate a position rapidly, the primary sources of profits

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[30] See IIROC Notice 12-0112 – Rules Notice – Request for Comments – *Proposed Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (March 30, 2012) at p. 14.

are from earning the spread by buying at the bid and selling at the offer and capturing any liquidity rebates offered by marketplaces to liquidity-supplying orders.[31]

As well, some HFT arbitrage strategies seek to capture pricing inefficiencies between related products or markets such as discrepancies between the price of an Exchange-traded Fund and the underlying basket of stocks, and may involve trading with a firm using a passive market making strategy, in which case both firms profit from the trade.

Some "directional" HFT strategies also exist which may be straightforward and contribute to the quality of price discovery in a stock, such as establishing a position in the belief that the price of a stock has moved away from its "fundamental value" and will return to such value.

5. Is an Access Person, Participant or client engaging in algorithmic or high frequency trading subject to the order designation requirements?

Yes. All orders entered on a marketplace must be properly designated. This includes ensuring that the identifier of a client who has been provided with direct access to a marketplace is included with all orders for the account of the client whether or not the client is engaging in algorithmic or HFT trading. IIROC expects the Participant to review the designation of orders by clients with direct access as part of the Participant's supervisory procedures required by Rule 7.1 of UMIR.

Effective October 15, 2012, an order to purchase or sell a security must carry a "short-marking exempt" designation if the order is entered on a marketplace for certain accounts that adopt a "directionally neutral" strategy in the trading of securities. In particular, this designation will be required for a client, non-client or principal account:

- for which order generation and entry is fully-automated; and
- which, in the ordinary course, does not have at the end of each trading day more than a nominal position, whether short or long, in a particular security.

The Participant should review periodically, and no less frequently than monthly, whether an account should be designating purchase and sale orders for particular securities as "short-marking exempt".[32]

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31 See, however, IIROC Notice 11-0043 - *Guidance on "Locked" and "Crossed" Markets* (February 1, 2011) where it is discussed at Question 4 that If a market participant intentionally creates or continues a "locked" market in an attempt to maximize the amount of liquidity rebates that the market participant earns, such behaviour is not in compliance with the Locked and Crossed Order Provisions and is therefore not in compliance with Rule 2.3 of UMIR dealing with improper orders and trades. In addition, in the view of IIROC, a Participant or Access Person is engaging in an activity analogous to "double printing" contrary to Rule 2.2 of UMIR if the Participant or Access Person enters orders on a protected marketplace that, upon execution, is followed immediately by the entry on a protected marketplace of an order for the same security at the same price on the other side of the market which has the effect of creating or continuing a "locked" market.

3. Impact on Existing Guidance

This Rules Notice supplements earlier guidance on manipulative and deceptive trading practices and guidance related to trading supervision obligations. In particular, reference should be made to the guidance issued on the following topics:

- "double printing": Market Integrity Notice 2003-002 – *Guidance - Prohibition on Double Printing* (January 13, 2003); Market Integrity Notice 2005-004– *Guidance - Double Printing and the Entry of Orders* (March 4, 2005); Market Integrity Notice 2005-030– *Guidance - Avoiding Double Printing in the Use of an Error Account* (September 1, 2005); Market Integrity Notice 2006-004 – *Guidance - Facilitation of a Client Special Settlement Trade and Double Printing* (February 6, 2006) and IIROC Notice 11-0043 – Rules Notice – Guidance Note - *Guidance on "Locked" and "Crossed" Markets* – Question 4 (February 1, 2011);
- "wash trades": Market Integrity Notice 2004-021– *Guidance -Entry of Off-Setting Market-on-Close Orders* (August 26, 2004); Market Integrity Notice 2005-029– *Guidance - Entering Orders on Both Sides of the Market* (September 1, 2005); Market Integrity Notice 2006-008– *Guidance - Use of the Market-on-Close Facility* (March 10, 2006); and IIROC Notice 11-0043 – Rules Notice Guidance Note - *Guidance on "Locked" and "Crossed" Markets* – Question 3 (February 1, 2011);
- "artificial prices": Market Integrity Notice 2002-021 – *Guidance - Prohibition Against Establishing Artificial Prices* (December 16, 2002) and Market Integrity Notice 2007-015 – *Guidance - Specific Questions Related to Trading on Multiple Marketplaces*- Question 2 (August 10, 2007);
- "improper orders and trades": IIROC Notice 11-0043 – Rules Notice Guidance Note - *Guidance on "Locked" and "Crossed" Markets* explaining that the entry of an order that does not comply with the Locked and Crossed Order Provisions in the CSA Trading Rules will constitute a violation of Rule 2.3 and may constitute a violation of other provisions of UMIR; and
- "trading supervision": Market Integrity Notice 2005-006 – Guidance - *Obligations of an "Access Person" and Supervision of Persons with "Direct Access"* (March 4, 2005); Market Integrity Notice 2007-010 – Guidance - *Compliance Requirements for Dealer Sponsored Access* (April 20, 2007); Market Integrity Notice 2007-011 – Guidance - *Compliance Requirements for Order Execution Services* (April 20, 2007); Market Integrity

[32] See IIROC Notice 12-0078 – Rules Notice – Notice of Approval - UMIR – *Provisions Respecting Regulation of Short Sales and Failed Trades* (March 2, 2012). See also IIROC Notice 12-0079 – Rules Notice – Request for Comments – UMIR - *Proposed Guidance on "Short Sale" and "Short-Marking Exempt" Order Designations* (March 2, 2012).

Notice 2008-003 – Guidance – *Supervision of Algorithmic Trading* (January 18, 2008), and IIROC Notice 09-0081– Rules Notice – Guidance Note – UMIR - *Specific Questions Related to Supervision of Algorithmic Trading* (March 20, 2009).