

# IIROC NOTICE

## Rules Notice Request for Comments

UMIR

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**12-0316**  
**October 25, 2012**

## Proposed Guidance Respecting Third-Party Electronic Access to Marketplaces

### Executive Summary

This Rules Notice requests comments on draft guidance that IIROC proposes to issue relating to the provision by a Participant of third-party electronic access to marketplaces (“Proposed Guidance”).

IIROC has previously set out guidance under Rule 7.1 and Policy 7.1 of UMIR - *Trading Supervision Obligations*, relating to:

- supervision and compliance requirements under UMIR for “direct access” to marketplaces;<sup>1</sup> and
- requirements for including identifiers and designations on orders received from other dealers and entered by, or with the identifier of, the Participant on a marketplace.<sup>2</sup>

<sup>1</sup> 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); and Market Integrity Notice 2007-011 – *Guidance - Compliance Requirements for Order Execution Services* (April 20, 2007).

<sup>2</sup> Market Integrity Notice 2005-003 – *Guidance - Marking Jitney Orders* (March 4, 2005) and Market Integrity Notice 2007-004 – *Guidance - Marking Orders Received from Other Dealers* (February 28, 2007).



With the publication by the Canadian Securities Administrators (“CSA”) of the proposed amendments to National Instrument 23-103 *Electronic Trading* regarding direct electronic access to marketplaces (the “CSA Access Proposals”)<sup>3</sup> together with proposed amendments to UMIR regarding the requirements for providing electronic access to marketplaces to third parties (“Proposed Amendments”),<sup>4</sup> the Proposed Guidance would expand on and replace the guidance already issued and set out IIROC’s expectations for:

- supervision of trading when a Participant has provided electronic access to marketplaces to third parties; and
- the marking of orders entered on a marketplace by a person with third-party access.

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<sup>3</sup> Published at (2012) 35 OSCB beginning at page 8599.

<sup>4</sup> IIROC Notice 12-0315 - Rules Notice – Request for Comments – UMIR – *Provisions Respecting Third-Party Electronic Access to Marketplaces* (October 25, 2012), which includes proposed amendments to Dealer Member Rules 1300.1 and 3200 (the “Proposed DMR Amendments”) relating to a proposed suitability exemption for clients provided with direct electronic access and a prohibition on allowing clients of an order execution service to use an automated order system or to manually send orders that exceed the volume threshold set by IIROC from time to time.



## 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 Operation 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.<sup>5</sup> 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.<sup>6</sup>

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 **January 23, 2013** 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](http://www.iiroc.ca)) under the heading “Policy” and***

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<sup>5</sup> 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.

<sup>6</sup> The review by MRAC of the Proposed Guidance should not be construed as approval or endorsement of the Proposed Guidance. Members of MRAC are expected to provide their personal advice 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.**

**In order to facilitate the preparation of comments on the Proposed Guidance, IIROC intends to hold information sessions with industry participants during the comment period to address questions related to the Proposed Amendments and Proposed Guidance. Notice of dates and locations for the information session will be published in a separate IIROC Notice in the near future.**

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

## **2. Background to the Proposed Guidance**

### **2.1 Proposed Amendments to National Instrument 23-103 Electronic Trading**

In April of 2011, the CSA published for comment proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* and its Companion Policy (23-103 CP) (the “Proposed ETR”).<sup>7</sup> Proposed provisions respecting direct electronic access to marketplaces that were included in the Proposed ETR were not included in the final version of National Instrument 23-103 *Electronic Trading* which was published by the CSA on June 28, 2012 and which will become effective March 1, 2013.<sup>8</sup> Concurrent with the publication of this IIROC Notice, the CSA published the CSA Access Proposals.

### **2.2 Proposed UMIR Amendments Respecting Third-Party Electronic Access to Marketplaces**

The Proposed Amendments align UMIR with the requirements set out in the CSA Access Proposals and introduce a regulatory framework for electronic access to marketplaces for Participants and Access Persons, confirming that access to a marketplace is a “closed system” in that each means by which an order may be entered on a marketplace must be subject to appropriate regulatory oversight. The Proposed Amendments contain provisions related to electronic access to marketplaces through the mechanisms of:

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<sup>7</sup> See (2011) 34 OSCB 4133.

<sup>8</sup> See (2012) 35 OSCB 6061.



- direct electronic access<sup>9</sup> provided by Participants to certain Canadian registrants and other clients;
- order routing arrangements<sup>10</sup> entered into by a Participant with investment dealers, foreign dealer equivalents<sup>11</sup> and other Participants; and
- order execution services<sup>12</sup> presently offered to a range of client account types.

The framework is designed to address areas of concern and risks brought about by electronic access to marketplaces, including those relating to: liability; credit; market integrity; sub-delegation; technology or systems; and regulatory arbitrage.

The most significant impacts of the Proposed Amendments would be:

- Participants who provide direct electronic access to a client must:
  - o establish standards to manage the attendant risks,
  - o enter into written agreements with each client to which the Participant will provide access,
  - o establish and apply appropriate supervisory and compliance procedures for orders entered under direct electronic access,
  - o at least annually review the standards and compliance of each client with the standards and written agreement, and
  - o establish procedures for reporting to IIROC non-compliance by a client with the standards or written agreement;
- Participants who provide electronic access to a marketplace to an investment dealer or foreign dealer equivalent under a routing arrangement must:

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<sup>9</sup> The Proposed Amendments would define “direct electronic access” as 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.

<sup>10</sup> The Proposed Amendments would define “routing arrangement” as an arrangement under which a Participant permits an investment dealer or foreign dealer equivalent to electronically transmit an order relating to a security:

- (a) through the systems of the Participant for automatic onward transmission to:
  - (i) a marketplace to which the Participant has access using the identifier of the Participant, or
  - (ii) a foreign organized regulated market to which the Participant has access directly or through a dealer in the other jurisdiction;or
- (b) directly to a marketplace using the identifier of the Participant without being electronically transmitted through the systems of the Participant.

<sup>11</sup> The Proposed Amendments would define a “foreign dealer equivalent” as “a person registered in a category analogous to that of investment dealer in a foreign jurisdiction that is a signatory to the International Organization of Securities Commissions’ Multilateral Memorandum of Understanding”.

<sup>12</sup> The Proposed Amendments would define “order execution service” as a service that meets the requirements, from time to time, under Dealer Member Rule 3200 – *Minimum Requirements for Dealer Members Seeking Approval under Rule 1300.1 for Suitability Relief for Trades Not Recommended by the Member*.



- establish standards to manage the attendant risks,
  - enter into written agreements with each investment dealer or foreign dealer equivalent for which the Participant will provide access,
  - establish and apply appropriate supervisory and compliance procedures for orders entered under the routing arrangement,
  - at least annually review the standards and compliance of each investment dealer or foreign dealer equivalent with the standards and written agreement, and
  - establish procedures for reporting to IIROC non-compliance by an investment dealer or foreign dealer equivalent with the standards or written agreement;
- Participants who provide order execution services must:
- review client accounts on an on-going basis to ensure that those that are not eligible to transact within an order execution service are transferred or directed to a Participant that provides direct electronic access to clients,
  - prior to implementation of the Proposed DMR Amendments and at least annually thereafter, confirm that order execution service client accounts are not employing an automated order system<sup>13</sup> that is not provided by the order execution service, and
  - monitor client orders on an ongoing basis from an order execution service to ensure that they are not generated from such an automatic order system; and
- marketplaces will have to review their policies and procedures to ensure that:
- orders entered on the marketplace are from a Participant that is a member, user or subscriber or that marketplace or an Access Person with access to trading on that marketplace, and
  - the marketplace reports to IIROC any termination of access to the marketplace, potential material breach of any Marketplace Rule or agreement pursuant to which access was granted to a marketplace.

IIROC would expect that, if the Proposed Amendments are approved by the Recognizing Regulators, the amendments would be implemented on the later of:

- the date the CSA Access Proposals become effective; and

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<sup>13</sup> The term “automated order system” is defined in ETR as “a system used to automatically generate or electronically transmit orders 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.”



- 180 days following the publication of notice of approval of the amendments.

IIROC would expect that the final Guidance Note would be issued at the same time as, or shortly following, the publication of the notice of approval of the amendments.

### **3. Summary of the Proposed Guidance**

The Proposed Guidance assumes that the Proposed Amendments are approved as published. It would update the previously issued IIROC guidance and sets out IIROC's expectations for provision of third-party electronic access to marketplaces to align with the regulatory framework under the Proposed Amendments for electronic access to marketplaces. The Proposed Guidance would:

- expand upon the obligations of Participants, Access Persons and Marketplaces under the framework for third-party electronic access to marketplaces;
- provide examples relating to the requirements for order identification and designation, including the use of the "jitney" marker;
- highlight specific changes respecting order execution services and direct electronic access; and
- outline the effect of the expanded definition of "Participant" to include investment dealers who, while not a member, user or subscriber to a marketplace, have under a routing arrangement:
  - o the ability to enter orders on a marketplace without the order being transmitted through the system of a Participant and who have been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management or supervisory control, policy or procedure respecting orders from client accounts, or
  - o been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management and supervisory controls, policies and procedures for accounts in which the investment dealer has a direct or indirect interest in addition to those of its clients.

### **4. Questions**

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



1. Are there any additional matters which should be addressed in the final Guidance Note? In particular, are there any questions which should be added to the “Question and Answer” section of the final Guidance Note?



## Appendix A – Text of Proposed Guidance



# IIROC NOTICE

## Rules Notice Request for Comments

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**13-0\*\*\*  
\*, 2013**

## Guidance Respecting Third-Party Electronic Access to Marketplaces

### Executive Summary

This Rules Notice provides guidance relating to the requirements under UMIR with respect to a Participant granting a third-party electronic access to a marketplace. The Guidance updates previous guidance issued with respect to aspects of electronic access to marketplaces and specifically addresses provisions established under both National Instrument 23-103 (the “CSA Access Rule”)<sup>14</sup> and amendments to UMIR (“Amendments”).<sup>15</sup> The Guidance expands upon the obligations of Participants under the framework for third-party electronic access to marketplaces by means of:

- direct electronic access;

<sup>14</sup> Published at (201\*) \*\* OSCB beginning at page \*.

<sup>15</sup> IIROC Notice 13-0\*\*\* - Rules Notice – Notice of Approval – UMIR – *Provisions Respecting Third-Party Electronic Access to Marketplaces* (\* \*, 2013).



- a routing arrangement; or
- an order execution service.

In particular, the Guidance:

- provides examples relating to the requirements for order identification and designation, including the use of the “jitney” marker;
- highlights specific changes respecting order execution services and direct electronic access; and
- outlines the effect of the expanded definition of Participant to include investment dealers who, while not a member, user or subscriber to a marketplace, have under a routing arrangement:
  - o the ability to enter orders on a marketplace without the order being transmitted through the system of a Participant and who have been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management or supervisory control, policy or procedure respecting orders from client accounts, or
  - o been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management and supervisory controls, policies and procedures for accounts in which the investment dealer has a direct or indirect interest in addition to those of its clients.

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## 1. Background

### 1.1 CSA Access Rule and UMIR Amendments

On \*\*, 2013, IIROC published notice of the approval of the Amendments which Amendments align UMIR with the requirements set out in the CSA Access Rule and introduce a regulatory framework for third-party electronic access to marketplaces. The Amendments confirm that a third-party may only obtain electronic access to marketplaces through a Participant using the mechanisms of:

- direct electronic access (“DEA”) provided by Participants to certain Canadian registrants and other clients (“DEA clients”);
- order routing arrangements between investment dealers or foreign dealer equivalents<sup>16</sup> and Participants; or
- order execution services presently offered to a range of client account types.

The framework is designed to address areas of concern and risks brought about by electronic access to marketplaces. Such risks include those relating to: liability; credit; market integrity; sub-delegation; technology or systems; and regulatory arbitrage.

### 1.2 UMIR Requirements for Identifiers and Designations

Prior to the Amendments, Rule 1.1 of UMIR defined a “Participant” generally as a registered dealer that is a:

- member of an exchange;
- user of a quotation and trade reporting system; or
- subscriber to an alternative trading system.

Under the Amendments, the definition of “Participant” was expanded to include an investment dealer that is a party to a routing arrangement with a Participant and, in the applicable written agreement, the investment dealer:

- may enter orders directly to the marketplace without being electronically transmitted through the Participant’s systems and is authorized to set or adjust on behalf of the Participant the various controls, policies or procedures respecting such orders; or
- has been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management or supervisory control, policy or procedure respecting an

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<sup>16</sup> The Amendments define a “foreign dealer equivalent” as “a person registered in a category analogous to that of investment dealer in a foreign jurisdiction that is a signatory to the International Organization of Securities Commissions’ Multilateral Memorandum of Understanding”.



account in which the investment dealer or a related entity of the investment dealer holds a direct or indirect interest other than in the commission charged on a transaction or reasonable fee for the administration of the account (that is an account in which proprietary trading is taking place).

Rule 1.1 of UMIR defines a “jitney order” as an order entered on a marketplace by a Participant acting for or on behalf of another Participant. In light of the expansion of the definition of “Participant” under the Amendments, the definition of “jitney order” will include orders from an investment dealer that, while not a member, user or subscriber, has become a “Participant” under the expanded definition.

Prior to the Amendments, Rule 6.2 of UMIR required that each order entered on a marketplace contain various identifiers and designations that may be applicable to the order including:

- the identifier of the Participant entering the order on a marketplace (the “Executing Participant”);
- in the case of a jitney order, the identifier of the Participant for or on behalf of whom the order is entered;
- the designation that the order is:
  - a jitney order,
  - a principal or non-client order,
  - an order that will be a short sale or a short-marking exempt sale, and
  - an order from an insider or significant shareholder.

The Amendments expanded the identifiers which must be included on an order to add:

- the identifier of the client for or on behalf of whom an order is entered under direct electronic access; and
- the identifier of the investment dealer or foreign dealer equivalent for or on behalf of whom the order is entered under a routing arrangement.

At this time, IIROC will require that these new identifiers, as designated by the marketplace on which the order is entered, be included in the “User ID” field.

Reference should be made to the text of Rule 6.2 for a listing of all of the required identifiers and designations to be attached to an order entered on a marketplace.



### **1.3 Origination and Routing of Orders for Execution**

Only a Participant that is a member, user or subscriber may provide direct third-party access to a marketplace through:

- DEA to clients; or
- a routing arrangement with other Participants, investment dealers or foreign dealer equivalents.

A client order, principal order or non-client order may originate with a dealer that is either a Participant<sup>17</sup> (an “Originating Participant”) or with an investment dealer or foreign dealer equivalent that is not a Participant for the purposes of UMIR (an “Originating Dealer”). The order may be routed to another dealer to act as intermediary (a “Participant Intermediary” if the other dealer is a Participant for the purposes of UMIR or otherwise a “Dealer Intermediary”) in on-routing the order to an Executing Participant.

### **1.4 Responsibility for Ensuring Proper Order Marking**

With the Amendments, an order will be able to carry up to three separate identifiers. Each of the Executing Participant and any Originating Participant or Participant Intermediary has an obligation to ensure that all applicable designations and identifiers are included on the entry of an order on a marketplace. With respect to identifiers:

- the Broker ID Field must always contain the identifier of the Executing Participant;
- the Jitney ID Field must contain the identifier of the first Participant involved in the routing of the order if an Originating Participant or a Participant Intermediary is involved in the routing of the order and the order must be marked “jitney”; and
- the User ID Field must contain:
  - the identifier of the DEA client if a client enters an order using DEA provided by a Participant, or
  - if no DEA client is involved, the identifier of the first Participant, investment dealer or foreign dealer equivalent that receives access under a routing arrangement with a Participant (regardless if there are other intermediaries in

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<sup>17</sup> This would include an investment dealer which, while not being a member, user or subscriber of a marketplace, has either:

- direct access to a marketplace under a routing arrangement with a Participant that permits the investment dealer to enter orders directly to the marketplace without being electronically transmitted through the Participant’s systems and who have been authorized to perform on behalf of the Participant the setting or adjustment of a specific risk management or supervisory control, policy or procedure respecting orders from client accounts; or
- been authorized to perform on behalf of a Participant the setting or adjustment of a risk management or supervisory control, policy or procedure related to the handling of the dealer’s proprietary orders.



the chain) and is using the routing arrangement in the transmission of the order.

With respect to designations, an order must contain all designations required under Rule 6.2 that are relevant to the order (e.g. non-client, insider, short sale, short-marking exempt, etc.).

The Originating Participant has the same obligations regarding client knowledge that it would have if it entered the order directly onto the marketplace and must therefore provide any intermediary or the Executing Participant with all required designations and identifiers.

If an Executing Participant receives an order directly from an Originating Dealer or from a Dealer Intermediary that is acting on behalf of an Originating Dealer that order will not be considered a “jitney order” for the purposes of UMIR. In these circumstances, the Executing Participant is responsible for ensuring that its identifier and all designations relevant to the order as required under Rule 6.2 of UMIR are included on the entry of the order to a marketplace.

An Originating Participant that uses a Dealer Intermediary for routing orders to an Executing Participant must ensure that the Dealer Intermediary is able to receive and to pass on to the Executing Participant all required identifiers and designations on an order. Similarly, a Participant Intermediary or Executing Participant must ensure that a Dealer Intermediary or Originating Dealer has adequate policies and procedures in place to assure that orders routed to the Executing Participant contain all of the designations and identifiers that are required by Rule 6.2 of UMIR.

If a Participant has provided DEA to a client, the Participant must have established standards that require the client to have reasonable knowledge of and the ability to comply with all applicable requirements, including the marking of each order with the designations and identifiers as by required by Rule 6.2. On an on-going basis, the Participant would be expected to supervise the entry of orders on a marketplace and to undertake compliance testing (including testing of compliance with order marking requirements). The Participant is expected to review and confirm at least annually that the client is in compliance with standards established by the Participant. Under the Amendments, each client with direct electronic access will be assigned a unique identifier which must be included in the User ID field on each order that the client enters using direct electronic access.

While a client that enters orders through an order execution service will not be assigned a separate unique identifier, any Participant handling the orders at any stage in the transmission to a marketplace must take reasonable steps to ensure that the orders comply with all applicable requirements, including the marking of each order with designation and identifiers as required by Rule 6.2.



The following table sets out the identifiers which should be attached to an order based on a number of order routing and transmission scenarios. The table includes situations where there would be no change in the current order marking practices but these are provided in order to better illustrate the changes that are introduced by the Amendments. For the purposes of this table, “intermediated” means the provision of an order by a means other than third-party electronic access through:

- direct electronic access;
- a routing arrangement; or
- an order execution services account.

Originator	Method of Transmission	Intermediary Dealer/ Participant	Method of Transmission	Executing Participant	Unique Identifiers to be Included on Order Upon Entry to Marketplace		
					Broker ID Field	Jitney ID Field	User ID Field
<b>No Intermediary</b>							
Participant A	Routing Arrangement	N/A	N/A	Participant C	Participant C	Participant A	Participant A
Investment Dealer A	Routing Arrangement	N/A	N/A	Participant C	Participant C		Investment Dealer A
Client	Direct Electronic Access	N/A	N/A	Participant C	Participant C		DEA Client
Foreign Dealer Equivalent	Routing Arrangement	N/A	N/A	Participant C	Participant C		Foreign Dealer Equivalent
<b>Dealer Intermediary</b>							
Participant A	Intermediated	Investment Dealer B	Routing Arrangement	Participant C	Participant C	Participant A	Investment Dealer B
Investment Dealer A	Intermediated	Investment Dealer B	Routing Arrangement	Participant C	Participant C		Investment Dealer B
<b>Participant Intermediary</b>							
Participant A	Intermediated	Participant B	Routing Arrangement	Participant C	Participant C	Participant A	Participant B
Participant A	Routing Arrangement	Participant B	Routing Arrangement	Participant C	Participant C	Participant A	Participant A (See Note 1)
Investment Dealer A	Intermediated	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	Participant B
Investment Dealer A	Routing Arrangement	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	Investment Dealer A
Client	Intermediated	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	Participant B
Client	Direct Electronic Access	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	DEA Client
Foreign Dealer Equivalent	Intermediated	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	Participant B
Foreign Dealer Equivalent	Routing Arrangement	Participant B	Routing Arrangement	Participant C	Participant C	Participant B	Foreign Dealer Equivalent



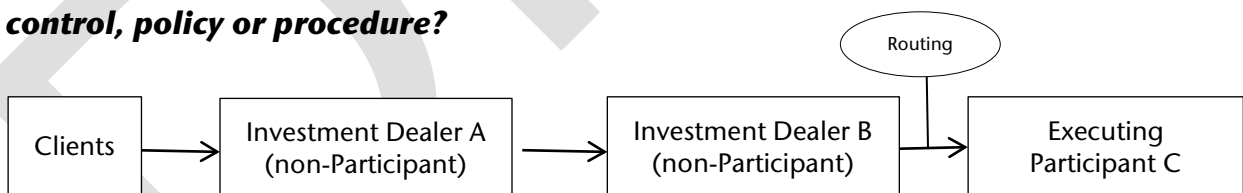
Originator	Method of Transmission	Intermediary Dealer/ Participant	Method of Transmission	Executing Participant	Unique Identifiers to be Included on Order Upon Entry to Marketplace		
					Broker ID Field	Jitney ID Field	User ID Field
<b>Traditional Intermediated Activity</b>							
Participant A	Intermediated	N/A-	N/A	Participant C	Participant C	Participant A	
Investment Dealer A	Intermediated	N/A	N/A	Participant C	Participant C		
Client	Intermediated	N/A	N/A	Participant C	Participant C		
Foreign Dealer Equivalent	Intermediated	N/A	N/A	Participant C	Participant C		
Participant A	Intermediated	Investment Dealer B	Intermediated	Participant C	Participant C	Participant A	
Investment Dealer A	Intermediated	Investment Dealer B	Intermediated	Participant C	Participant C		

Note 1: If Participant A received the order through a routing arrangement with an investment dealer or foreign dealer equivalent, the User ID Field would contain the identifier of the investment dealer or foreign dealer equivalent rather than the identifier of Participant A. If Participant A received the order from a client through DEA, the User ID Field would contain the identifier of the DEA client rather than the identifier of Participant A.

## 2. Questions and Answers

The following is a list of questions regarding the supervision and compliance obligations of a Participant or Access Person under the Amendments and IIROC’s response to each question:

- 1. May a Participant in a routing arrangement authorize ANY investment dealer with an ultimate client that originates the orders to perform on behalf of the Participant the setting or adjustment of a risk management or supervisory control, policy or procedure?**



No. A Participant may only authorize an investment dealer that is a party to a routing arrangement with the Participant to perform on behalf of the Participant the setting or adjustment of a risk management or supervisory control, policy or procedure. The routing arrangement is subject to minimum standards, a written agreement and regulatory oversight under UMIR.

If the investment dealer is authorized, pursuant to the applicable routing agreement, to:





- enter orders directly to the marketplace without being transmitted through the Participant’s systems and the investment dealer is authorized to set or adjust the various controls, policies or procedures respecting client orders; or
- engage in “proprietary” trading on its own behalf or that of a related entity in which the investment dealer holds a direct or indirect interest,

the investment dealer will be considered a Participant subject to UMIR under the expanded definition of “Participant”. This is to ensure that all proprietary trading or trading outside the Participant’s systems is equally subject to UMIR and regulatory oversight to mitigate the higher risk associated with these trading activities.

Market Regulation Policy staff may consider requests for exemptions related to allocation of controls in certain circumstances if it is demonstrated that each dealer in the chain of order transmission has reasonable controls so as to manage their individual risks and comply with the requirements under UMIR, National Instrument 23-103 and the CSA Access Rule.

## **2. *Are Exempt Market Dealers permitted electronic access to marketplaces?***

No. Registered dealers such as Exempt Market Dealers may not gain direct access to a marketplace through a Participant under a routing arrangement or direct electronic access and would not be eligible to trade through an order execution account for Retail Customers. These restrictions are intended to prevent regulatory arbitrage with respect to trading and encourage registered dealers wishing to have direct access to a marketplace to become a member of IIROC (and be subject to the Dealer Member Rules and, in certain cases, UMIR).<sup>18</sup>

## **3. *Does the form of electronic access to markets impact whether a Participant should apply the “short-marking exempt” designation to purchases and sales in an account?***

No. The characteristics of the account activity govern whether the short-marking exempt designation should apply, not the means of electronically accessing the marketplace.<sup>19</sup> In particular, UMIR defines a “short-marking exempt order” (“SME

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<sup>18</sup> IIROC has issued a concept proposal regarding the establishment of a new class of IIROC Member to be called a “Restricted Dealer Member”. If the concept proposal is pursued and adopted, a firm with exempt market dealer or restricted dealer registration under applicable securities legislation would be able to apply for registration as an investment dealer and for membership in IIROC as a “Restricted Dealer Member”. See IIROC Notice 12-0217 – Rules Notice – Concept Paper – Request for Comments – Dealer Member Rules – IIROC Concept Proposal – Restricted Dealer Member Proposal (July 12, 2012).

<sup>19</sup> See IIROC Notice 12-0078 - Provisions Respecting Regulation of Short Sales and Failed Trades (March 2, 2012) and IIROC Notice 12-0079 - Proposed Guidance on “Short Sale” and “Short-Marking Exempt” Order Designations (March 2, 2012).



order”) as including an order for the purchase or sale of a security from an account that is an arbitrage account. Whether an arbitrage account is held by an order execution services client, a DEA client or an investment dealer in a routing arrangement, the arbitrage account would qualify for the SME order designation. Accounts which use automated order generation and entry and which are generally “directionally neutral” in their trading activity will also have SME order.

A Participant that provides electronic access to a marketplace must ensure that orders entered through any form of such arrangements are correctly designated. IIROC expects the Participant to review the designation of orders by clients with SME order designations as part of the Participant’s supervisory procedures required by Rule 7.1 and Policy 7.1 of UMIR.

**4. *Are the standards to be established by a Participant for granting direct electronic access to a client or entering a routing arrangement with an investment dealer or foreign dealer equivalent the same for each DEA client and for each investment dealer or foreign dealer equivalent?***

No. While the general standards that must be established by the Participant in granting access to a marketplace are included in Rule 7.12 for routing arrangements and Rule 7.13 for direct electronic access, their application must be appropriate and customized to the type, risk and level of sophistication of trading that would be undertaken by the client or by the investment dealer or foreign dealer equivalent that the Participant would grant access to. As the provider of electronic access to marketplaces, the Participant’s role in undertaking due diligence with respect to its clients is a key method of managing risks associated with electronic access to marketplaces and necessitates a thorough vetting of potential DEA clients and parties to routing arrangements. This process is accordingly integral to the preservation of market integrity, which can only be accomplished if the standards are meaningfully set by Participants.

A Participant should assess and determine what additional standards are reasonable given the particular circumstances of the Participant and each client or investment dealer. This includes an evaluation of the suitability of the form of access that should be provided to any client. In the case of a Retail Customer considered for direct electronic access, IIROC expects such would only be provided in exceptional circumstances upon application of more stringent standards than to an institutional client. Additional factors a Participant may consider when setting such standards for prospective DEA clients and investment dealers include prior sanctions for improper trading activity, evidence of a proven track record of responsible trading, knowledge



and of and proficiency regarding use of an automated order system, knowledge of trading rules, supervisory oversight, the proposed trading strategy and associated volumes of trading.

**5. *What level of “knowledge” must a DEA client have before being provided DEA by a Participant?***

A Participant must provide its DEA client with the applicable Requirements and standards established by the Participant and further must regularly update this information with all relevant amendments as they are introduced.

In addition, a Participant must assess each client’s knowledge and determine what, if any, training is reasonably required in the particular circumstances. The training must at a minimum enable the client to understand the applicable marketplace and regulatory requirements and how trading on the marketplace system occurs. It may be appropriate for the Participant dealer to require that the client have the same training and proficiency required of registrants.

After DEA has been granted, an assessment of the DEA client’s knowledge of applicable marketplace and regulatory requirements would be considered necessary if significant changes to these Requirements are made or if the Participant detects unusual trading activity by the DEA client. If the Participant finds the DEA client’s knowledge to be deficient after such an assessment, the Participant may require additional training for the DEA client.

**6. *Should a Participant employ the same compliance and supervision standards to monitor trading conducted by order execution clients as with other forms of electronic access to marketplaces?***

Yes. A Participant is expected to comply with the trading supervision obligations set out in Rule 7.1 and Policy 7.1 with respect to all forms of electronic access to marketplaces, which emphasize the higher risks attendant with trading which does not involve a Participant’s staff directly. It is important to note, however, that these risks may be heightened for trading by order execution clients as, in distinction to DEA and routing arrangements, a Retail Customer seeking to open an order execution service account would not be subject to a similar “screening” process and would not be provided training. There may be a disparity in knowledge of trading rules and obligations causing a higher proportion of unintentional offending orders or a greater degree of unscrupulous trading by sophisticated clients given the relative “anonymity” afforded in the order execution service.



In order to mitigate some of these risks, the Dealer Member Rules provide that an order execution client must not employ an automated order system that is not provided by the order execution service and Policy 7.1 of UMIR requires that a Participant providing an order execution service must, in addition to the other applicable compliance and supervision obligations, monitor to determine if the order execution client may be using such an automated order system and confirm at least annually with the client that an automated order system is not used.

**7. Are there any new “gatekeeper obligations” in regard to trading activities of: a DEA client; investment dealer or foreign dealer equivalent in a routing arrangement; and order execution service client?**

Yes. Policy 7.1 provides for trading supervision obligations with regard to all forms of electronic access to a marketplace and requires the monitoring of all orders entered by the party provided with electronic access to a marketplace for UMIR violations such as “manipulative and deceptive” trading activities and “improper orders and trades”. However, the scope of supervision is expanded to include potential breaches of any standard set by a Participant or term of a written agreement, unauthorized trading or improper use of an automated order system, associated with the grant of electronic access to a marketplace.

Rule 10.16 already requires a Participant or Access Person to conduct further investigation or review where the Participant or Access Person has reason to believe that there may have been a violation of UMIR.<sup>20</sup> A Participant or Access Person cannot ignore “red flags” which may be indicative of improper behaviour by a client, director, officer, partner or employee of the Participant, Access Person or related entity.

A Participant that has provided third-party electronic access must, as part of its gatekeeper responsibilities, report to IIROC:

- any termination by the Participant of access to a marketplace; and
- knowledge of, or a reason to believe that any person who has been granted access has materially breached:
  - a Marketplace Rule,
  - a term of the agreement governing third-party access, or
  - a standard established by the Participant governing third-party access.

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<sup>20</sup> See also IIROC Notice 12-0221 - *Proposed Guidance on Certain Manipulative and Deceptive Trading Practices* (July 17, 2012), which proposes guidance on manipulative and deceptive activities related to trading strategies using automated order systems or direct electronic access.



**8. Can a Participant use the same compliance sampling and testing standards to monitor trading conducted by persons with third-party electronic access as it does for other trading activity?**

Under Policy 7.1 of UMIR, if an order is entered on a marketplace without the involvement of a trader, a Participant's supervision policies and procedures should adequately address the additional risk exposure which the Participant may have for orders that are not directly handled by staff of the Participant. To the extent that a Participant does not conduct separate testing of trading by persons with third-party electronic access to marketplaces, it may be appropriate for a Participant to sample for compliance testing a higher percentage of orders entered by these persons that have not been handled by staff of the Participant (i.e. orders that were not "flagged" or otherwise handled by staff of the Participant) than the percentage of orders sampled in other circumstances.

**9. Are there any particular "risks" that need to be addressed in compliance procedures for trading by persons with third-party electronic access?**

Part 3 of Policy 7.1 under UMIR sets out the minimum compliance procedures for trading on a marketplace. However, Policy 7.1 also stipulates that the compliance procedures must be appropriate for the lines of business conducted by a Participant. Given that orders entered by a person with third-party electronic access will be subject to pre-entry filtering as set out in Part 7 of Policy 7.1 but, in most circumstances, will be subject to limited supervision prior to being sent to the order routing system of the Participant, the compliance procedures for persons with third-party electronic access should, at a minimum, address the procedures for testing:

- markers and identifiers as required by Rule 6.2 of UMIR, and in particular:
  - the "short sale" or "short-marking exempt" markers, and
  - the insider or significant shareholder order markers;
- orders that have been entered for "spoofing" contrary to Rule 2.2 of UMIR (such as the entry of an order or orders which are not intended to be executed and are entered 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 have been entered on a marketplace and trades that have executed for the creation of an "artificial price" contrary to Rule 2.2 of UMIR;



- orders that have been entered on one or more marketplaces with the intention of “quote stuffing” (intentionally submitting a high volume of orders or messages for the purpose of interfering with the timely execution of trades or dissemination of order and trade data) contrary to Rule 2.2 of UMIR;
- orders that have been entered which seek to abuse the minimum guaranteed fill facility of a person with Marketplace Trading Obligations;
- orders that have been entered at unreasonable prices;
- “wash trading” (particularly if the person with third-party electronic access has more than one account with the Participant); and
- trades for failure deliver or settle.

As required by Rule 7.1, any special compliance procedures employed for trading by persons with third-party electronic access to a marketplace must be in writing and must contain detailed guidance on how testing of orders and trades is to be conducted.

Part 5 of Policy 7.1 requires that the procedures adopted by a Participant address the steps to be taken to monitor the trading activity of any person who has multiple accounts with the Participant including other accounts in which the person has an interest or over which the person has direction or control.

**10. What are the obligations if a client sends orders directly to a smart order router offered by the Participant?**

If a client has direct access to a smart order router offered by the Participant (such that an order from the client does not pass through the systems of the Participant), the client will be considered to have received “direct electronic access” from the Participant and would be subject to the requirements of Rule 7.13 of UMIR. In this case, the identifier assigned to a direct electronic access client will be in the “User ID” field.

However, it should also be noted that in accordance with the requirement of National Instrument 23-103 *Electronic Trading Rule* and Part 7 of Policy 7.1 of UMIR, each order must be subject to examination prior to entry on a marketplace by automated controls to prevent the entry of an order which would result in:

- the Participant exceeding pre-determined credit or capital thresholds;
- a client of the Participant exceeding pre-determined credit or other limits assigned by the Participant or to that client; or



- the Participant or client of the Participant exceeding pre-determined limits on the value or volume of unexecuted orders for a particular security or class of securities.

As such, any order entered to a smart order router must be subject to the automated controls of the Participant before the smart order router transmits the order to a marketplace.

### **3. Impact on Existing Guidance**

This Rules Notice repeals and replaces, effective [the date the CSA Access Rule and the Amendments become effective], the guidance set out in:

- Market Integrity Notice 2005-003 - *Guidance - Marking Jitney Orders* (March 4, 2005);
- Market Integrity Notice 2005-006 – *Guidance - Obligations of an “Access Person” and Supervision of Persons with “Direct Access”* (March 4, 2005);
- Market Integrity Notice 2007-004 - *Guidance - Marking Orders Received from Other Dealers* (February 28, 2007);
- Market Integrity Notice 2007-010 – *Guidance - Compliance Requirements for Dealer Sponsored Access* (April 20, 2007); and
- Market Integrity Notice 2007-011 – *Guidance - Compliance Requirements for Order Execution Services* (April 20, 2007).