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Guidance on Regulatory Intervention for the Variation or Cancellation of Trades

Executive Summary

This Rules Notice provides guidance (the "Guidance") on the circumstances in which IIROC may undertake discretionary regulatory intervention under the authority of Rule 10.9 of UMIR in order to vary or cancel any trade that is, in the opinion of the Market Integrity Official:

- "unreasonable" as undertaken when material information related to the issuer of the security may be known to certain parties trading in the market but the information has not been publicly disseminated in accordance with applicable timely disclosure standards ("asymmetric dissemination of material information");
- "unreasonable" in connection with an unintentional "erroneous" trade; or
- not in compliance with the provisions of UMIR.

The Guidance is intended to provide transparency and greater certainty respecting the criteria for discretionary regulatory intervention, which may be exercised in these circumstances outside the scope of operation of the Single-Stock Circuit Breakers[1] to ensure a "fair and orderly market" in the trading of a listed security.

Under the Guidance, the discretion of a Market Integrity Official to vary or cancel a trade under Rule 10.9 of UMIR is subject to guidelines that include:

- a "no touch zone" for which there will generally be no regulatory intervention by IIROC when the price difference between an "erroneous" trade and the current fair value of the security does not exceed the greater of 10% of the price of the security or 10 trading increments;
- limited conditions under which regulatory intervention to cancel an "erroneous" trade would be considered, in particular circumstances of:
    - extreme price dislocation when there would be no reasonable expectation of execution, or
    - a trading error that does not impact market price but places the issuer at risk; and
- determination based on market conditions as to whether a higher threshold than the "no touch zone" will be used when an "erroneous" trade has been executed during a period of significant market volatility, outside normal trading hours or in a security of limited or very limited liquidity.

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[1] For details on the operation of Single-Stock Circuit Breakers, see IIROC Notice 12-0040 – Rules Notice – Guidance Note – UMIR – *Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012).

1. Background

Rule 10.9 of UMIR provides a Market Integrity Official with the power to vary or cancel trades which in the opinion of the Market Integrity Official are "unreasonable" or not in compliance with UMIR or any Policy and to delay, halt or suspend trading in a security at any time and for such period of time as the Market Integrity Official may consider appropriate in the interest of a "fair and orderly" market. These powers are referred to, collectively, as "regulatory interventions" and have been exercised under IIROC's broad discretion. In the view of IIROC, market forces should generally drive trading activity without interference by IIROC. The Guidance elaborates on and sets out more transparent standards in regard to the exercise of the discretionary power to intervene in trading by a Market Integrity Official under Rule 10.9(1)(d) of UMIR in certain cases of "unreasonable" trades or breaches of UMIR.

The Guidance is intended to operate in conjunction with a multi-tiered approach to controlling short-term, unexplained price volatility. Each set of controls will ultimately play an important role in the overall framework designed to mitigate the risks associated with "unexplained short-term price movement" and promote "fair and orderly" markets. The report on the market events of May 6, 2010 undertaken by IIROC ("May 6 Report") recommended that steps be taken to review or enhance each level of control together with IIROC's policy for regulatory intervention for the cancellation or variation of trades.[2]

The four identified levels of control are described briefly below:

- The first set of controls is currently at the Participant level with Participants required, under Policy 7.1 of UMIR, to have in place policies and procedures reasonably designed to ensure that trading is carried out in compliance with the applicable requirements, which include provisions of securities legislation, UMIR, the Trading Rules and the Marketplace Rules.[3] As a result of the findings in the May 6 Report, IIROC issued additional guidance on best execution and management of orders and on the use of certain order types (particularly "Stop Loss Orders" that are entered as market orders when triggered and which played a role in the price declines on May 6, 2010).[4] The Canadian Securities Administrators have also adopted requirements

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[2] See IIROC News Release – *IIROC announces results of regulatory review of May 6 trading in Canadian equity marketplaces* (September 9, 2010).

[3] Market Integrity Notice 2005-011 – *Notice of Amendment Approval - Provisions Respecting Manipulative and Deceptive Activities* (April 1, 2005), made effective a number of amendments to UMIR, including an amendment to Policy 7.1 to clarify that Participants have supervisory and compliance responsibility for all client orders irrespective of the source of the order or the means by which the order is transmitted to a marketplace. For guidance on the current compliance requirements under UMIR for a Participant that provides a client with "Dealer-Sponsored Access", commonly known as "direct market access", see Market Integrity Notice 2007-010 – Guidance - *Compliance Requirements for Dealer-Sponsored Access Trading* (April 20, 2007).

[4] IIROC Notice 11-0113 – Rules Notice – Guidance Note – UMIR –*Guidance on Best Execution and Management of Orders* (March 30, 2011) and IIROC Notice 11-0114 – Rules Notice – Guidance Note – UMIR – *Guidance Respecting the Use of Certain Order Types* (March 30, 2011).

under National Instrument 23-103 *Electronic Trading* that govern electronic trading by marketplace participants and their clients, including specific obligations for the use of automated order systems.[5]

- The second set of controls would be at the marketplace level with each of the marketplaces expected to have effective volatility parameters in place that would detect "erroneous orders" prior to execution.[6]
- The third level of controls is Single-Stock Circuit Breakers.[7]
- The fourth set of controls are market-wide circuit breakers which would trigger and halt trading on all marketplaces when there are declines in prices which affect the market generally.[8]

Given the "tiered" nature of these controls, the content of the requirements at each level must be co-ordinated to ensure that there are no readily identifiable gaps and that each set of controls is capable of working effectively in conjunction with the other levels. Market integrity requires that there be a "fair and orderly market" in the trading of all listed securities. Notwithstanding the introduction of Single-Stock Circuit Breakers, IIROC retains the discretionary power to intervene, if required, to ensure a "fair and orderly market" in the trading of a listed security when:

- ☐ the security is not subject to Single-Stock Circuit Breakers; and
- ☐ the security is subject to Single-Stock Circuit Breakers but the breaker has not been triggered.

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[5] See also IIROC Notice 12-0200 – *Provisions Respecting Electronic Trading* (June 28, 2012) which proposes UMIR amendments to conform with National Instrument 23-103 *Electronic Trading and* addresses specific supervisory controls, policies and procedures related to the use of automated order systems that must be reasonably designed to prevent the entry of any order that would interfere with fair and orderly markets. .

[6] Canadian marketplaces currently employ a variety of mechanisms to limit risks associated with "erroneous" or "fat finger" orders impacting the price of a particular security at the marketplace level. See "Canadian Marketplaces Volatility Controls – Freeze Parameters, Reject Parameters and Collars" in IIROC Notice 10-0298 – Rules Notice – Request for Comments – UMIR – *Proposed Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (November 18, 2010). Under section 8 of National Instrument 23-103, marketplaces are required to prevent the execution of orders exceeding price and volume thresholds set by a regulation services provider. IIROC has issued a request for comments soliciting input on the appropriate approach for marketplace thresholds – see IIROC Notice 12-0162 – Rules Notice – Request for Comments – UMIR – *Request for Comments on Marketplace Thresholds* (May 10, 2012).

[7] IIROC Notice 12-0040, *op. cit*.

[8] Changes to the market-wide circuit breakers in the United States have been approved by the Securities and Exchange Commission ("SEC") to be implemented for a one-year pilot commencing February 4, 2013 - see SEC Release No. 34-67090 (May 31, 2012). IIROC has issued a request for comments soliciting input on the appropriate parameter for triggering market-wide circuit breakers in Canada. See IIROC Notice 11-0359 – Rules Notice – Request for Comments – UMIR – *Request for Comments on Market-wide Circuit Breakers for the Canadian Marketplace* (December 13, 2011).

2. Principles for Regulatory Intervention

In the view of IIROC, the best course of action is for market forces to drive trading activity without regulatory interference. Regulatory intervention is reserved for circumstances when market integrity is at risk and is necessary to maintain fair and orderly markets. Trades will not necessarily be varied or cancelled only to remedy an error of a client or Participant if it does not impair market integrity.[9] Consistent with the uniform support of market integrity in Canada through IIROC's monitoring of all equity markets and the application of a single set of market integrity rules (UMIR), to the extent possible, the circumstances when regulatory intervention is undertaken should be certain and transparent to market participants. In order to provide market participants with regulatory transparency and consistency in accordance with these principles, this Guidance Note outlines the considerations applied in the context of discretionary regulatory intervention by IIROC under Rule 10.9 of UMIR in circumstances when there has been: asymmetric dissemination of material information;[10] an "erroneous" trade or series of trades that impair market integrity;[11] or trades which are not in compliance with UMIR or any Policy.

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9 Under Rule 7.11 of UMIR, a marketplace on which a trade was executed retains the ability to vary or cancel the trade prior to settlement, provided immediate notice is given to IIROC. If IIROC concludes there are no market integrity concerns and agrees with the variation or cancellation, the marketplace will amend the official record of the trade accordingly. Effective March 1, 2013, section 9 of National Instrument 23-103 will establish the circumstances under which a marketplace that has retained a regulation services provider may cancel or vary a trade, namely: with the mutual consent of the parties to the trade and notice to the regulation services provider; as a result of problems or failures with the trading system of the marketplace and with permission obtained from the regulation services provider; or as instructed by its regulation services provider.

10 IIROC administers the "timely disclosure" policies established by the TSX (TSX Company Manual – Part IV – Maintaining a Listing – General Requirements – Part B), TSXV (TSXV Policy 3.3), CNSX (CNSX Policy 5) and Alpha Exchange (Trading Policies, Part V, s. 5.5). The "timely disclosure" policies are imposed on listed issuers by these exchanges as an extension of the statutory disclosure requirements and the disclosure standards recognized under National Policy 51-201– Disclosure Standards. The "timely disclosure" policies require that IIROC, as the regulation services provider for the marketplace, be notified prior to the issuance of a press release containing "material information" (being a material fact or a material change that "would reasonably be expected to have a significant effect on the market price or value" of the security). The prior notification allows IIROC to determine whether a regulatory trading halt would be appropriate prior to the issuance of the press release so as to prevent "asymmetric" dissemination of material information concerning an issuer. The "timely disclosure" policies of each of the exchanges, including the requirement to provide advance notice of the issuance of a material press release to IIROC, apply beyond the hours of trading on each of the marketplaces. IIROC's administration of the "timely disclosure" policies facilitates the dissemination of "material information" by issuers to all market participants simultaneously. In addition, it provides investors who have entered displayed orders (pursuant to Rule 6.3 of UMIR which is designed to support the price discovery mechanism in the relatively illiquid market environment that has traditionally prevailed in Canada), the opportunity to consider the import of the material information and to vary or cancel their orders accordingly prior to the recommencement of trading.

11 IIROC has recognized that diverse types of unintentional errors in order entry may result in "unreasonable" trades. In particular, these trades may occur by the entry of an order that is the result of a "fat finger" error by a client or trader of a dealer such that the order is entered incorrectly with respect to price, volume and/or identification of the security; a malfunctioning algorithmic trading system; the malfunction of the order entry, order management or trading system of an investor, dealer, service provider or marketplace; the incorrect dissemination of order or trade information by the information processor or information vendor; and the failure of orders entered on a marketplace to take account of "special trading rules" issued by the exchange of which a security is listed, dealing with such matters as stock splits or consolidations or record dates for special distributions.

3. Discretionary Regime for Regulatory Intervention

3.1 Factors under UMIR 10.9(2) - "Unreasonable" Trades

The general factors enumerated under Rule 10.9(2) of UMIR provide the basis for IIROC's exercise of discretion to intervene when there is an impact to market integrity caused by "unreasonable" trades. The Market Integrity Official must consider, when determining whether a trade is "unreasonable" in connection with asymmetric dissemination of material information or "erroneous" trades and whether regulatory intervention to vary or cancel any trade is warranted:

- prevailing market conditions;
- the last sale price of the security as displayed in a consolidated market display;
- patterns of trading in the security on the marketplace including volatility, volume and number of transactions;
- whether material information concerning the security is in the process of being disseminated to the public; and
- the extent of the interest of the person for whose account the order is entered in changing the price or quotation for the security.[12]

3.2 Guidelines for Variation and Cancellation of "Unreasonable" Trades

The general factors listed in Rule 10.9(2) of UMIR are supplemented by IIROC's guidelines for determining whether a trade is unreasonable and the appropriate form of regulatory intervention that may be warranted in the circumstances.

3.2.1 Determining Whether a Trade is "Unreasonable"

The additional considerations reviewed by the Market Integrity Official to make a determination as to whether a trade is unreasonable include:

- determining the current fair value for the security (in particular, the last sale price of the security on a consolidated market display) and, in the case of structured products, information on the net asset value, fair value and underlying assets (which if unavailable on a timely basis, may require cancellation of the trade rather than a price variation);

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12 The "extent of the interest of the person" generally refers to an assessment, when the information is reasonably evident, of the intention of the person for whose account the order is entered to change the price or quotation for the security for an improper or manipulative purpose contrary to Rule 2.2 of UMIR, such as to affect portfolio valuation of the account for the person's financial benefit.

- making an initial assumption that market integrity has been impaired if the price difference between the trade that is the subject of the review and the current fair value of the security varies by the greater of:
  - 10% of the price of that security or 10 trading increments,[13] or
  - a higher price threshold depending on market conditions when the trade has been executed during a period of significant market volatility, outside normal trading hours or in a security of limited or very limited liquidity;

as well as consideration of:

- whether the volume or number of trades under review is unusual in the context of the current market or the trading history of the security;
- whether the trade was made in error by a Participant, Access Person or marketplace or as the result of a deliberate trade;
- whether recent events have affected the specific business sector in which the issuer of the particular security is engaged;
- whether the particular security is the subject of a conditional corporate event (such as a take-over bid) and whether the price of the trade reflected that event and the uncertainties surrounding the completion of the event;
- the trading pattern of the security on all marketplaces and foreign organized regulated markets on which the security trades;
- whether, if a security is inter-listed or trades on a foreign organized regulated market, the other market will agree to a similar variation or cancellation, and if not, is there nevertheless a compelling reason to vary or cancel the trade in Canada; and
- whether the parties to the trade will agree to a voluntary variation or cancellation of the trade.

3.2.2 "Trade Rulings" - Variation or Cancellation of "Unreasonable" Trades

The Market Integrity Official must determine whether variation or cancellation of "unreasonable" trades is warranted within the following parameters:

[13] Current fair value of certain exchange-traded funds ("ETFs"), convertible and exchangeable securities, warrants and rights which have an "intrinsic value" based on other listed securities would be determined taking into consideration the historical degree of divergence between the value of the underlying and the market price of the security. If the current fair value of such a security is readily and objectively ascertainable, a trade in the security executed with a price variance of less than 10% or 10 trading increments may nonetheless be found to impair market integrity and be "unreasonable" in the circumstances.

3.2.2.1 *"Erroneous" Trades*

To provide greater certainty in cases of erroneous trades impacting market price, regulatory intervention will generally only be considered (but may not be done) if the price difference between the "erroneous" trade that is the subject of the review and the current fair value of the security varies by the greater of 10% of the price of that security or 10 trading increments. As such, this provides for a "no touch zone" in which there will generally be no regulatory intervention undertaken by IIROC.[14]

Subject to the price threshold being applied as appropriate, if the "erroneous" trade is also determined to be "unreasonable", IIROC will generally vary the execution price rather than cancel,[15] considering the context of the market at the time of the "erroneous" trade as a means to promote fairness and orderly markets. IIROC will only cancel "erroneous" trades in rare cases where there would be no reasonable expectation of execution due to extreme price dislocation.

In the rare circumstance when a trading error does not impact on the market price of the security but nonetheless negatively impacts market integrity, IIROC's intervention will be limited to trade cancellation. Such intervention may occur if an error is made in security symbol or description and the illiquid nature of the security traded has impacted the ability to settle the trade, or an egregious error as to volume traded occurs which places an issuer at risk.

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14 This threshold for discretionary intervention aligns with the operation of the Single-Stock Circuit Breaker which will be triggered for certain securities in the initial implementation phase in the event of a price increase or decline of at least 10% in a 5-minute period. Trades executed following the trigger of the Single-Stock Circuit Breaker will only be cancelled if the execution price is 15% or more from the reference price. For details on the operation of Single-Stock Circuit Breakers, see IIROC Notice 12-0040, *op. cit.* By comparison, regulatory intervention to vary or cancel a trade under the discretionary regime remains flexible and may occur at price disclocations less than the Single-Stock Circuit Breaker threshold provided that, in general, the "no touch zone" is exceeded. An exception to the application of the "no touch zone" threshold may, however, be made to allow for regulatory intervention at lesser price dislocations in the case of "erroneous" trades in securities such as certain ETFs, convertible and exchangeable securities, warrants and rights which have an "intrinsic value" based on other listed securities and whose current fair value is readily ascertainable and the trade is determined to be "unreasonable" in the circumstances. (See previous footnote for details.)

15 Price variation provides the innocent parties on the other side of the erroneous trade with an execution at the best price that a reasonable investor might have anticipated for that security based on market conditions. The variation of trades, rather than cancellation, also holds the initiator of the "unreasonable" trade responsible for their actions and transfers the trading risk away from the innocent parties on the other side of the trades, who may have hedged or offset their exposure following the trade or missed trading opportunities that would have been available between the time the original trade was executed and its cancellation.

3.2.2.2 Asymmetric Dissemination of Material Information

In administering the "timely disclosure" policies of the exchanges,[16] if IIROC determines that a press release regarding material information about an issuer was published without prior notice to IIROC to permit it to first co-ordinate a regulatory halt in trading, IIROC will cancel all trades deemed to be "unreasonable" taking place in the period between the issuance of the press release and IIROC's imposition of the halt.[17]

3.3 Erroneous Trade Review Process

The Market Integrity Official will render trade rulings as close as possible to the time of the "erroneous" trade which is the subject of review. This is in order to minimize potential disruption to trading and to preclude persons from seeking trade reviews motivated merely by subsequent market movements. Accordingly, IIROC expects that a party to the trade who seeks a trade ruling would communicate their request to IIROC without delay following execution of the trade.[18] In exceptional circumstances, delayed trade ruling requests may be considered from an "innocent" party to the trade but no later than the end of trading on the day following the day on which the trade was made.[19]

Both parties to a trade together may apply to vary or cancel a trade provided the application has been made to IIROC by the end of the trading on the day following the day on which the trade was made or such earlier time as may be established in any Marketplace Rule of the marketplace on which the trade was executed.

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16 See footnote 9 regarding the "timely disclosure" policies of exchanges. Material information disseminated by the issuer would reasonably be expected to have a significant effect on the market price or value of the security. It is important to recognize that a "significant effect" on market price is of lesser magnitude than one which would deem a trade "erroneous". Accordingly, regulatory intervention in trades occurring on asymmetric dissemination of material information is not subject to the application of a pre-determined price threshold as generally with "erroneous trades".

17 IIROC notes that regulatory intervention in trading related to asymmetric dissemination of material information is fairly unique to Canada but serves to protect market integrity and provides a clear and transparent remedy to parties harmed by such activity. The relative certainty and immediacy of this remedy distinguishes it from any remedy that may be available under the statutory regime for civil liability in secondary markets relating to an issuer's failure to implement a trading halt prior to disseminating "material information", which to date is largely untested in Canada.

18 By comparison in the United States, the erroneous trade review process generally must commence within 30 minutes of the trade and be resolved within 30 minutes of the commencement of the review. A decision of the internal appeal committee of the Financial Industry Regulatory Authority, Inc. ("FINRA"), pursuant to an appeal from a determination of a FINRA officer to declare a transaction null and void, is final and binding upon all parties and constitutes final action on the matter in issue. In addition, a FINRA officer's determination not to break a trade is not appealable. See reference in FINRA Rule 11894.

19 See reference in Rule 10.9 (1)(e) of UMIR. However, in rare and egregious circumstances, IIROC may exercise discretion under Rule 10.9(1)(d) to intervene to vary or cancel a trade at any time, including after settlement. Intervention after settlement has only occurred if one party to the trade has taken advantage of an obvious error or if the party did not conduct the trade in an "open and fair" manner. These circumstances have included instances when trades took place at clearly erroneous prices due to pricing error following a corporate action (such as consolidation or stock split) and the circumstances and the execution price did not come to the attention of the party until their receipt of the trade confirmation

Whether the request for a trade ruling is made by a single party or both parties to a trade, delay in making the request may also impact the price threshold for regulatory intervention which would generally be higher the greater the delay. Even without a request, IIROC may contact the parties to a trade following its execution to determine their willingness to agree to a voluntary variation or cancellation of the trade.

The need to proceed expeditiously is particularly heightened when the "erroneous" trade involves a highly-liquid security or a security inter-listed with a foreign organized regulated market. IIROC's ability to intervene in "erroneous" trades deemed unreasonable may be constrained in such cases by external factors generally related to:

- the extent of trading activity in the particular security (or related securities including any listed derivatives) that may have occurred subsequent to the "unreasonable" trade; and
- the ability of IIROC to co-ordinate regulatory intervention with foreign organized regulated markets when the particular security is inter-listed with exchanges outside of Canada.

Given the desirability of consistency with outcomes on other markets trading the same security, IIROC ordinarily seeks to co-ordinate any adjustment in the price of unreasonable trades with the foreign organized regulated market, particularly when a significant volume of trading of the security has occurred on the foreign organized regulated market. To the extent that IIROC is unable to obtain the agreement of the foreign organized regulated market to adjust the prices of "unreasonable" trades, IIROC may be constrained from taking action.

If requested, a review of a trade ruling rendered by the Market Integrity Official is conducted internally by IIROC. This review is undertaken by an executive officer of IIROC as expeditiously as possible with the objective of completing any review prior to the scheduled time of settlement of the contested trade. IIROC's decision on review may then be subject to external review by an overseeing securities regulatory authority.[20]

3.4 Trade Not in Compliance with UMIR

The Market Integrity Official may intervene to cancel a trade resulting from the entry of an order that did not comply with UMIR, causing harm to the innocent party.[21] In particular,

20 See reference in Rule 11.3 of UMIR.

21 IIROC has taken the view that investors, particularly those who have entered displayed orders on marketplaces, should be afforded protection from execution with orders that do not comply with the market integrity rules set out in UMIR. For this reason, IIROC monitors marketplaces for anomalous trading activity identified by system-generated alerts. In order to ensure a fair and orderly marketplace, UMIR also seeks to ensure that intentional price movements are fair and orderly – see Part 2 of UMIR "Abusive Trading".

IIROC may intervene when specific trading rule violations have occurred that are self-evident at the time of the execution of the trade, such as a violation of:

- the client-principal trading requirement under Rule 8.1of UMIR (when a Participant trading with one of its retail clients fails to give the client a better price than the client could obtain on a marketplace or when the Participant does not abide by best execution when trading with its clients such that the price to the client is justified by the condition of the market);
- market stabilization price restrictions under Rule 7.7 of UMIR;
- the requirement not to "abuse" a person with Marketplace Trading Obligations under Part 2 of UMIR;[22] or
- the requirement to move the market in an orderly manner over a period of time when executing a pre-arranged trade or intentional cross under Part 2 of UMIR.

In cases involving more complicated issues such as potential market manipulation (through activities such as wash trades, or establishing artificial prices), the time required for investigation and conclusive determination of breaches of UMIR do not generally lend themselves to real-time regulatory intervention in trading.[23]

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22 On August 26, 2011, IIROC Notice 11-0251 was published announcing the approval of the replacement of the definition of "Market Maker Obligations" with the concept of "Marketplace Trading Obligations" which includes odd lot responsibilities on marketplaces in addition to traditional "market maker" obligations.

23 Trade variation or cancellation has not been viewed as an appropriate remedy for violation of other UMIR provisions when the "innocent" party to the trade did not suffer any harm and should not be disadvantaged by the variation of the price of the trade or the cancellation of the trade. This includes when a Participant enters an order marked as a "directed action order" in accordance with Rule 6.2 of UMIR on a marketplace that trades through better-priced visible orders in breach of the "Order Protection Rule" under Part 6 of National Instrument 23-101 – *Trading Rules*.

If a Market Integrity Official can make a timely determination that a trade resulted from the entry of an order that did not comply with UMIR, there is no pre-determined price threshold that must be met before the Market Integrity Official can cancel the trade. Similarly, there is no pre-determined price threshold that must be met before IIROC can commence regulatory enforcement proceedings in respect of a trade that was not in compliance with UMIR. For example, an intentional attempt to establish an artificial price is detrimental to market integrity regardless of the amount of price movement as the artificial price is not supported by genuine supply and demand. In contrast, an erroneous trade is generally subject to a pre-determined price threshold for regulatory intervention (the "no touch zone") as an objective parameter for when market integrity may be impaired and therefore the trade would be considered "unreasonable".