IIROC NOTICE

Rules Notice
Guidance Note
UMIR

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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[1] or direct electronic access.[2] The Guidance confirms IIROC's position that employing certain trading strategies commonly known as:

- "Layering";

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[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 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.

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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. The manipulative and deceptive trading strategies enumerated in this Rules Notice are not an exhaustive list and there may be other forms of abusive trading practices that contravene UMIR. 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"[3]) 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 ability to monitor all orders, the use of automated pre-trade controls and real-time alert systems as part of the Participant's risk management and supervisory controls which may assist in curtailing potentially abusive trading practices. 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 practices that may be associated with algorithmic or HFT trading including,

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[3] 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.

without limitation, to detect patterns related to layering, spoofing, quote manipulation, quote stuffing and abusive liquidity detection strategies. Participants should consider using an automated compliance system for post-trade review and analysis of orders that have been generated by an automated order system. 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.[4]

4. What are some examples of acceptable 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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[4]   See IIROC Notice 12-0258 – Rules Notice – Guidance Note – *Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (August 20, 2012) at pp. 8-9.

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.[5]

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".[6]

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[5]   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* (February 1, 2011) 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 Notice 2008-003 – *Guidance – Supervision of Algorithmic Trading* (January 18, 2008),

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[6] 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 12-0300 – Rules Notice – Guidance Note – UMIR - *Guidance on "Short Sale" and "Short-Marking Exempt" Order Designations* (October 11, 2012).

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