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IIROC NOTICE

Rules Notice
Guidance Note
UMIR

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Guidance on Best Execution and Management of Orders

Summary

This Rules Notice provides guidance to Participants on the management of order flows in the context of the "best execution" obligations under Rule 5.1 of the Universal Market Integrity Rules ("UMIR").[1]

Background

The evolution of the Canadian equity market has significantly affected the way in which orders are executed. Changes in market structure have resulted in a more complex trading environment and give rise to new trading dynamics. These changes include:

- the introduction of multiple marketplaces;
- the increased prevalence of high speed/high frequency electronic trading;
- increased order to trade ratios, and the corresponding increase in message traffic;

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1 Participants should be aware that they also may have obligations regarding the use of order types in the handling of client orders under Rule 3400 – Suitability of the Dealer Member Rules of IIROC. See IIROC Notice 10-0266 – Rules Notice – Request for Comments – Dealer Member Rules – *Plan language rule re-write project – Dealing with clients, Proposed Rules 3400-3900* (October 8, 2010).

- smaller average execution size; and
- the potential for periods of increased market volatility.[2]

In this increasingly fast-paced environment, the way a Participant manages its order flows and routing decisions can materially impact the quality of trade execution. The failure to properly manage order flows can result in unanticipated and undesirable order execution outcomes.

The IIROC review of the events of May 6, 2010[3] found that, in many cases, the triggering of stop loss orders contributed to the significant price declines for many securities on that date. On a less dramatic scale, IIROC continues to see significant and rapid price declines in individual securities as a result of the triggering of multiple stop loss orders entered without limit prices. In a number of the recent cases, the price movement has been dramatic enough to warrant regulatory intervention by IIROC for the variation or cancellation of certain of the trades that have been considered to be "unreasonable". IIROC is of the view that some of these occurrences should have been avoided had limit prices been used upon entry of the stop loss order

Best Execution

Rule 5.1 of UMIR provides that a Participant "shall diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under the circumstances". The "best execution" obligation of a Participant is subject to compliance with "trade-through" protection provisions under Part 6 of National Instrument 23-101 ("Order Protection Rule") and UMIR.[4]

As the Canadian equity market's structure continues to evolve, with multiple venues available for the execution of orders, a Participant must consider the increased market complexity when handling client orders in order to ensure that it continues to comply with its "best execution" requirements. The dynamic nature of the structure of the Canadian equity market gives rise to a Participant having to regularly review the way in which it manages its orders and order flows in order to ensure that its policies, procedures and processes result in the Participant meeting its "best execution" obligations to its clients on an ongoing basis.

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2 For example, see IIROC News Release "IIROC announces results of regulatory review of May 6 trading in Canadian equity marketplaces" (September 9, 2010). The review was undertaken to understand the causes of these sudden price declines and recoveries in Canadian equity marketplaces during the so-called "Flash Crash" on May 6, 2010.

3 Review of the Market Events of May 6, 2010 (September 2010) - http://www.iiroc.ca/English/NewsRoom/Publications/Pages/Other.aspx.

4 In particular, Part 4 of Policy 5.1 - *Subject to Order Protection Rule* provides:

> Notwithstanding any instruction or consent of the client, the provision of "best execution" for a client order is subject to compliance with the "order protection rule" under Part 6 of the Trading Rules by the marketplace on which the order is entered or by the Participant if the Participant has marked the order as a directed action order in accordance with Rule 6.2. Similarly, if a Participant considers a foreign organized regulated market in order to provide a client with "best execution", the Participant must ensure that the condition in subsection (3) of Rule 6.4, if applicable, is satisfied prior to the execution on the foreign organized regulated market.

Rule 7.1 of UMIR requires each Participant to adopt written policies and procedures that "are adequate taking into account the business and affairs of the Participant, to ensure compliance with UMIR", including the "best execution" obligation under Rule 5.1.[5] To a large degree, how a Participant demonstrates that its policies and procedures are reasonably designed to ensure compliance with their best execution obligations is dependant on the size, structure and complexity of the firm. In addition, a Participant that has fully, or in part, automated its order-handling processes should ensure that the technologies employed to manage orders and order flows are designed and calibrated with its "best execution" obligations in mind.

Questions and Answers

The following is a list of the "most frequently asked" questions regarding the use of certain order types in achieving "best execution" in the context of recent developments in Canadian market structure and the response of IIROC to each question:

1. *How should a Participant ensure that order routing decisions comply with their "best execution" obligations and any applicable "trade-through" protection obligations?*[6]

A Participant must regularly review its order routing choices to ensure that such choices continue to satisfy its "best execution" obligations and any applicable "trade-through" protection obligations arising as a result of the use by the Participant of a "Directed Action Order" or the execution of certain trades on a foreign organized regulated market.[7] A Participant may wish to consider:

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5 In particular, Part 4 of Policy 7.1 – *Specific Procedures Respecting Client Priority and Best Execution* provides in part:

A Participant must have policies and procedures in place to "diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under the circumstances." The policies and procedures must:

- outline a process designed to achieve best execution;
- require the Participant, subject to compliance by the Participant with any requirement, to follow the instructions of the client and to consider the investment objectives of the client;
- include the process for taking into account order and trade information from all appropriate marketplaces and foreign organized regulated markets; and
- describe how the Participant evaluates whether "best execution" was obtained.

6 Canadian Securities Administrators Notice, Notice of Amendments to National Instrument 21-101 *Marketplace Operation* and National Instrument 23-101 *Trading Rules*, (2009) 32 OSCB 9401. In particular, reference should be made to Part 6 of the Trading Rules ("Order Protection Rule") which became effective February 1, 2011. See also IIROC Notice 11-0036 – Rules Notice – Notice of Approval – UMIR – *Provisions Respecting the Implementation of the Order Protection Rule* (January 28, 2011). In particular, reference should be made to Part 6 of Policy 7.1 – *Specific Provision Respecting Trade-throughs* which became effective February 1, 2011. Under that provision, a Participant must have policies and procedures in place that are reasonably designed to ensure compliance with the Order Protection Rule if the Participant uses a "Directed Action Order" as provided for under the Order Protection Rule or with the conditions in Rule 6.4 of UMIR if the Participant executes certain orders on a foreign organized regulated market.

7 An Introducing Broker who is a member of an exchange, user of a quotation and trade reporting system or a subscriber to an alternative trading system is also a Participant for the purposes of UMIR with "best execution" obligations under Rule 5.1 of UMIR. An Introducing Broker who is not a Participant is subject to similar best execution requirements under applicable securities law, particularly Part 4 of National Instrument 23-101. The Introducing Broker is expected to adopt policies and procedures to ensure compliance with its "best

- maintaining a written order routing methodology or table; and
- the establishment of a formal process, such as a committee that regularly reviews the methodology that determines order routing choices.

The Participant is expected also to review the policies and procedures that inform their order routing decisions in conjunction with:

- the launch of a new marketplace;[8] and
- a significant change to trading functionality offered by any of the existing marketplaces.[9]

2. *How should orders be managed when not all marketplaces are open and available for trading?*

In Canada, different marketplaces operate different opening mechanisms (i.e. an opening auction or a "shot-gun" open) and open at different times. A Participant's policies and procedures relating to the Participant's "best execution" obligations should address the handling of orders when not all marketplaces are open and available for trading (which includes prior to the opening and after the close of marketplaces during so-called "traditional exchange hours" of 9:30 a.m. to 4:00 p.m. or when certain marketplaces may be unavailable for trading for systems or technical reasons). Specifically, a Participant's procedures must address the handling of "immediately tradable" orders received when not all marketplaces are open and available for trading.

IIROC has previously issued guidance[10] in response to the question: "How should an 'immediately tradable' order from a client be handled if not all of the marketplaces are open at the time the order is received?" This previously issued guidance provided that how an immediately tradable client order received outside of traditional trading hours is handled by a Participant will depend on the policies adopted by the Participant as communicated to its clients. For example, the policy may provide that a Participant that receives a market order after 4:00 p.m. and before 9:30 a.m. the next trading day may consider trading opportunities on any visible marketplace that is then open for trading or the Participant may "hold" the order until all marketplaces or the principal or the primary market is open for trading.

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execution" obligations. The Introducing Broker must be satisfied that the manner in which its orders are managed by the Executing Dealer is consistent with the policies and procedures of the Introducing Dealer regarding "best execution".

8 It is the practice of IIROC to issue an IIROC Notice under the category of "Marketplace Notice" prior to the launch of a new marketplace. These notices are available on the IIROC website at www.iiroc.ca.

9 See *Summary Comparison of Current Equity Marketplaces* available on the IIROC website at www.iiroc.ca.

10 See Market Integrity Notice 2008-010 – *Guidance – Complying with "Best Price" Obligations* (May 16, 2008).

3. *What should a Participant consider when deciding where to "book" an order if multiple marketplaces open for trading at the same time?*

The policies and procedures adopted by the Participant should consider the "opening mechanism" adopted by each of the marketplaces and the impact of that mechanism on the probability of execution and the "quality" of that execution. Some marketplaces may offer an "opening auction market" which continually displays indicated prices prior to opening for trading. Other marketplaces may offer a simple "shot gun" opening. While "Opening Orders" are exempt from the Order Protection Rule,[11] a Participant must nonetheless comply with its "best execution" obligations with respect to its handling of "Opening Orders". Each Participant must regularly monitor the quality of the executions obtained for "Opening Orders" to be able to determine that the marketplace chosen as the location for entering Opening Orders generally offers "best execution" for that particular security. Participants must recognize that different marketplaces may offer the most liquidity at the opening of trading for particular securities and, as such, their policies and procedures for obtaining "best execution" for Opening Orders must take account of this fact.

The same considerations will apply to the handling by a Participant of a "Market-on-Close Order" when multiple marketplaces offer market-on-close or call market facilities to execute the closing trades at the end of the trading day.

4. *What are the obligations of a Participant who uses a third party vendor for order routing?*

A Participant who uses a third party vendor for order routing should be familiar with the operation of the router and the configurability available. The configuration of the order router should support the Participant's policies and procedures with respect to its "best execution" obligations as well as any "trade-through" protection obligation imposed on the Participant. On a regular basis, the Participant should review the operation and performance of the order router to ensure that the order router continues to be compatible with the policies and procedures of the Participant.

5. *How should a Participant handle "stop loss" orders in fast moving markets?*

A stop loss order without any limit on the price of execution will, once the market has reached the pre-determined trigger price, be entered on a marketplace as a market order. The execution outcome is, to a large extent, dependant on the methods and technology used by a Participant to manage these order types. Stop loss orders may be triggered by short term price movements. If a Participant's order management procedures (as they

[11] An "Opening Order" will be considered as a "calculated-price order" for the purposes of the exception provided in section 6.2(e)(ii) of the Order Protection Rule.

relate to triggered stop loss market orders) give priority to "immediacy of execution" over "price of execution", the resulting executions may occur at unanticipated prices. Furthermore, the execution of stop loss orders can exacerbate a selloff trend by increasing the liquidity imbalance given that stop loss orders tend to cluster at or around certain trigger prices.

Participants are reminded that they continue to have "best execution" obligations when managing stop loss orders. Participants who use technology solutions for the management of stop loss orders must ensure that their "best execution" obligations are considered in the technology design such that orders are not being entered on marketplaces that would execute at "clearly erroneous" prices. Participants are encouraged to require limit prices on stop loss orders. This recommendation is particularly applicable to those Participants who have automated the handling of stop loss orders and the technology has a limited ability to prevent unintended execution outcomes.

IIROC recommends that each Participant ensure that clients who use stop loss orders are aware of:

- the risks inherent in the use of stop loss market orders in fast moving markets; and
- the general procedures of the Participant for the handling of a stop loss order that has been "triggered".

6. *What should a Participant tell a client with respect to the use of "market" orders?*

Many of the problems associated with the use of stop loss market orders also apply to the entry of any market order, particularly during periods of significant market volatility. With a market order, there is no control over what the best available price will be at the moment the trade is executed and the corresponding cost of the transaction. In cases of extreme market volatility or liquidity imbalance, the market price can quickly drop below or rise above the price that was quoted at the time the order was entered and a market order may trade at a price which is significantly different from the expected execution price or range of prices. During times of very high market activity, there may be delays in message traffic with quotes lagging behind actual prices that continue to change on marketplaces in real time. The size of any quote may change rapidly, affecting the likelihood of a quoted price being available in whole or in part.

In contrast, a limit order provides control over the execution price but also reduces the certainty of execution. It is possible a limit order will not be executed, missing the opportunity to buy or sell the stock altogether in a fast moving market. Aggressively priced limit orders, when a buy limit order has a higher price than the prevailing market and a sell limit order has a lower price than the prevailing market, will trade much like a market order but the order will not "chase" the market price and potentially execute at a price which is outside the range which is acceptable to the investor.

IIROC recommends that each Participant ensure that clients who use market orders are informed of the advantages and disadvantages of the use of such order types in various market conditions.

7. What obligations under UMIR does a Participant have to a "discount client" with respect to the order type selected for use by a client?

While suitability obligations are generally not applicable to an Execution-Only Account,[12] Participants retain a "best execution" obligation with respect to orders from a client with an Execution-Only Account. A Participant should take reasonable steps to ensure that such clients are provided with adequate information on how certain order types, such as market orders and–stop loss market orders, function and the associated execution risks in the current equity market structure.

A Participant supporting electronic order entry from "Execution-Only Accounts" may wish to consider implementing a warning on the order entry screen when a client enters an order with a higher risk of unintended execution outcomes, such as a stop loss order with no limit. Participants are encouraged to require that clients with Execution-Only accounts provide limit prices on all stop loss orders.

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[12] Participants should be aware that they also may have obligations regarding the use of order types in the handling of client orders under the proposed Rule 3400 – *Suitability* of the Dealer Member Rules of IIROC. See IIROC Notice 10-0266 – Rules Notice – Request for Comments – Dealer Member Rules – *Plan language rule re-write project – Dealing with clients, Proposed Rules 3400-3900* (October 8, 2010).