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IIROC NOTICE

Rules Notice
Request for Comments
UMIR

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12-0162
May 10, 2012

Request for Comments on Marketplace Thresholds

Executive Summary

IIROC is requesting comment on approaches to the establishment and operation of price and volume thresholds or volatility controls by each marketplace in Canada ("Marketplace Thresholds") that would complement initiatives undertaken or proposed by IIROC for controlling short term, unexplained price volatility. This Request for Comments is the first step in the public consultation process that may lead to IIROC making a formal proposal on the establishment of price and volume thresholds to be employed by marketplaces as part of Marketplace Thresholds.

At this time, IIROC is suggesting two guiding principles. First, Marketplace Thresholds should operate to generally preclude the execution of orders at prices that would otherwise, on execution, require regulatory intervention by IIROC on the triggering of a single-stock circuit breaker or the application of IIROC's policies and procedures for the variation and cancellation of trades. Second, the volatility control mechanism used by a marketplace should have the least amount of impact on the market-wide operation of the price discovery mechanism and access to "tradable" liquidity.

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1. Policy Development Process

IIROC has been recognized as a self-regulatory organization by each of the Canadian provincial securities regulatory authorities (the "Recognized 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.

As a regulation services provider, IIROC administers and enforces trading rules for the marketplaces that retain the services of IIROC.[1] IIROC has adopted, and the Recognizing Regulators have approved, UMIR as the market 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 was consulted with respect to the subject of Marketplace Thresholds generally and this Request for Comments in particular. 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.

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[1] Presently, IIROC has been retained to be the regulation services provider for: Alpha Exchange Inc. ("Alpha"), Canadian National Stock Exchange ("CNSX"), Toronto Stock Exchange ("TSX") and TSX Venture Exchange ("TSXV"), each as an "exchange" for the purposes of the Marketplace Operation Instrument ("Exchange"); and for Bloomberg Tradebook Canada Company ("Bloomberg"), Chi-X Canada ATS Limited ("Chi-X"), Instinet Canada Cross Ltd. ("Instinet"), Liquidnet Canada Inc. ("Liquidnet"), Omega ATS Limited ("Omega"), TMX Select ("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 other Exchanges and that presently trades securities listed on the TSX and TSXV.

Comments are requested on all aspects of Marketplace Thresholds, including any matter not addressed in this Request for Comments. Comments should be in writing and delivered by ***August 8, 2012*** to:

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Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "Policy" and sub-heading "Market Proposals/Comments") upon receipt. A summary of the comments contained in each submission will also be included in a future IIROC Notice.

After considering the comments received in response to this Request for Comments, together with any comments of the Recognizing Regulators, and after taking into account developments regarding other measures to curtail marketplace volatility, IIROC will issue for public comment a formal proposal on the establishment of price and volume thresholds to be employed by marketplaces as part of the Marketplace Thresholds. IIROC may propose amendments to UMIR or propose to issue guidance on acceptable parameters. Regardless of the approach IIROC determines to take, any IIROC proposal will be subject to an additional public comment process and to review and approval by the Recognizing Regulators.

2. Background to the Request for Comments

2.1. Controlling Unexplained Price Volatility

Marketplace Thresholds are intended to operate as part of 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]

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

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 or 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 are proposing to augment these requirements in a new national instrument ("Electronic Trading Rule") governing electronic trading by marketplace participants and their clients.[5]
- The second set of controls would be at the marketplace level with each of the marketplaces expected to have effective thresholds in place that would, in the ordinary course, detect "erroneous" or "unreasonable" orders prior to execution.[6]
- The third level of controls is Single-Stock Circuit Breakers, which are designed to halt trading in the event of rapid price movement of at least 10% in a five-minute period.[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]

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[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).

[5] Notice of Proposed National Instrument 23-103 – *Electronic Trading and Direct Electronic Access to Marketplaces*, (2011) 34 OSCB 4133 (April 8, 2011). Under the proposed National Instrument, marketplace participants would have to have appropriate policies, procedures and controls in place that ensure that the risks associated with electronic trading are prevented or managed.

[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 15 of the proposed National Instrument 23-103, marketplaces will be required to prevent the execution of orders exceeding price and volume thresholds set by a regulation services provider.

[7] IIROC Notice 12-0040 – Rules Notice – Guidance Note – UMIR – *Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012). Since the introduction of Single-Stock Circuit Breakers on February 2, 2012, Single-Stock Circuit Breakers have been triggered on two occasions, both of which involved the entry of an order that would have been considered a "fat finger" or "erroneous" order that IIROC would otherwise have expected a marketplace to detect prior to execution had appropriate Marketplace Thresholds been in place at the time.

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.

2.2. Power for Regulatory Halts in Canada

Rule 9.1 of UMIR allows IIROC to impose a trading halt or suspension for regulatory purposes. Such a regulatory halt or suspension may apply to a particular security traded on a marketplace, to a range of securities or to trading of all securities generally. By the terms of Rule 9.1, no order for the purchase or sale of security shall be executed on a marketplace or over-the-counter at any time while the regulatory halt applicable to that security remains in effect. If the regulatory halt has been imposed for reasons other than the issuance of a cease trade order by an applicable securities regulatory authority, a trade may be executed outside of Canada on a foreign organized regulated market[9] if such a trade is permitted by applicable securities legislation.

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[8] Market-wide circuit breakers are currently co-ordinated with the triggering of market-wide circuit breakers in the United States. In light of proposed changes to the market-wide circuit breakers in the United States, 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).

[9] For the purposes of UMIR, a "foreign organized regulated market" means a market outside of Canada:

(a) that is an exchange, quotation or trade reporting system, alternative trading system or similar facility recognized by or registered with a securities regulatory authority that is an ordinary member of the International Organization of Securities Commissions;

(b) on which the entry of orders and the execution or reporting of trades is monitored for compliance with regulatory requirements at the time of entry and execution or reporting by a self-regulatory organization recognized by the securities regulatory authority or by the market if the market has been empowered by the securities regulatory authority to monitor the entry of orders and the execution or reporting of trades on that market for compliance with regulatory requirements; and

(c) that displays and provides timely information to information vendors, information processors or persons providing similar functions respecting the dissemination of data to market participants for that market of at least the price, volume and security identifier of each trade at the time of execution or reporting of the trade on that market,

but, for greater certainty, does not include a facility of a market to which trades executed over-the-counter are reported unless:

(d) the trade is required to be reported and is reported to the market forthwith following execution;

(e) at the time of the report, the trade is monitored for compliance with securities regulatory requirements; and

(f) at the time of the report, timely information respecting the trade is provided to information vendors, information processors or persons providing similar functions respecting the dissemination of data to market participants for that market.

IIROC believes that the circumstances for invoking the regulatory powers under Rule 9.1 of UMIR should be more transparent. To that end, IIROC has issued guidance or requests for comments on the following topics:

- Single-Stock Circuit Breakers;[10]
- Regulatory Intervention for the Cancellation or Variation of Trades ("Unreasonable Trade Policy);[11] and
- Market-wide Circuit Breakers.[12]

None of these mechanisms used or proposed by IIROC is triggered by the "volume" of an order, unless the size of the order would cause or has caused the market price to move to such an extent that there are regulatory concerns for a "fair and orderly" market.

2.3. Existing Marketplace Controls

Several marketplaces currently maintain volatility parameters under which orders entering the marketplace are monitored for the effect that the execution of the order would have on market prices. In the case of TSX, TSXV, TMX Select and CNSX/Pure Trading, if an incoming order for a particular security would, on execution, result in a trade price that would differ from the last sale price on that marketplace for that security by more than an established amount (the "freeze parameter"), trading is "frozen" until the TSX, TSXV, TMX Select or CNSX/Pure can determine if the incoming order is "valid".[13] If the marketplace is able to confirm the validity of the order (either by contacting the person who entered the order or by reviewing the market conditions), the freeze is lifted and the trade proceeds. If the trade is determined to be "invalid" (such as a "clearly erroneous" order), the order is removed and trading resumes. If trading is "frozen" on the TSX, TSXV, TMX Select or CNSX/Pure Trading,

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[10] Guidance has been issued for an "initial implementation phase" covering securities which are constituents of the S&P/TSX Composite Index and Exempt Exchange-traded Funds the assets of which are comprised principally of listed securities. See IIROC Notice 12-0040, op.cit. As outlined in IIROC Notice 12-0041 – Rules Notice – Request for Comments – UMIR – *Summary of Comments Received on Proposed Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012), IIROC will conduct a review and evaluation of Single-Stock Circuit Breakers and to publish the results of that review. The publication would request comment on whether any adjustments should be made to Single-Stock Circuit Breakers and, in particular, whether they should be extended to cover additional securities.

[11] In order to provide greater public transparency, IIROC has issued proposed guidance on certain of the circumstances in which IIROC may undertake discretionary regulatory intervention under Rule 10.9 of UMIR in order to vary or cancel a trade. See IIROC Notice 10-0331 – Rules Notice – Request for Comments – UMIR – *Proposed Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (December 15, 2010). See also IIROC Notice 12-0112 - Rule Notice – Request for Comments – UMIR - *Proposed Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (March30, 2012) which contains a summary of comments and responses on the original proposal together with a request for comments on the revised draft guidance.

[12] IIROC Notice 11-0359, *op. cit*.

[13] TMX Select operates a similar system of volatility parameters, but the TMX Select parameters also take into account the last sale price of the security on the TSX or TSXV.

this halt in trading is considered a "business halt" and trading in the particular security may continue on other marketplaces.

The shortcoming of the "freeze parameters" is that they may not be triggered if the price movement is caused by the entry of more than one active order, even if the entry of the orders would otherwise be "clearly erroneous", such as in the case of a "runaway" algorithm. The freeze inhibits additional order entry or order change until the freeze is removed. In rapidly moving markets, the market price could move away during the period the freeze is in effect and dealers are not able to manage their orders. On the resumption of trading, orders in the book could be "taken advantage of" if the dealers are unable to change their orders to reflect the current market before other incoming orders trade against them. During the period of the freeze, the liquidity in the book of the marketplace invoking the freeze would be unavailable and order routers may bypass that marketplace and trade on other marketplaces albeit possibly at inferior prices to the liquidity available on the marketplace that imposed the freeze.

TMX Select, TSX, TSXV and CNSX/Pure also employ "bid/ask tick limits" under which market orders and limit orders that would execute outside of an established range are re-priced by the marketplace prior to being entered into the book. This "collar" prevents a single market order or an aggressively priced limit order from trading outside the range which is based on a transparent matrix of different "collars" for securities priced at varying levels. For example, on the TSX and TSXV, a market sell order for a security trading between $1.00 and $5.00 would be assigned a maximum limit price of the existing bid at the time of the entry of the order less $0.25.

Alpha and Chi-X maintain similar programs governing market volatility but, rather than freezing trading, they "reject" the suspect incoming order and trading continues. Unlike the freeze parameters on TMX Select, TSX, TSXV and CNSX/Pure Trading, the reject parameters on Alpha take account of not just the last sale price but also the market price at a point in time prior to the calculation. The reject parameters on Chi-X are determined by multiple price bands calculated as a percentage of value from the last sale price. The price bands vary depending on the price of the security, and any order which would exceed a price band is rejected. If an order is "rejected" by either Alpha or Chi-X, the order may be rerouted to another marketplace trading the particular security. The advantage of reject parameters is that trading continues and it is only the "offending" order that is returned to the dealer for handling. One possible shortcoming of the use of reject parameters comes if the rejected order is simply "rerouted" by a smart order router to the next best available marketplace – an outcome which may simply pass the problem of an erroneous order to another marketplace.

The remaining marketplaces in Canada do not currently maintain or enforce volatility parameters. Omega is a transparent marketplace which may execute "clearly erroneous" trades. Omega has policies to cancel such trades following execution but not to catch the orders on entry. Instinet, Liquidnet and MATCH Now are dark pools and the functionality of

their respective marketplaces reduces or eliminates the need to monitor for clearly erroneous orders (for example, all executions on MATCH Now must occur between the "best bid" and "best ask" on the transparent marketplaces).

2.4. National Instrument 23-103

Section 15 of the proposed National Instrument 23-103 would provide that a "marketplace must prevent the execution of orders for exchange-traded securities exceeding price and volume thresholds". Since all marketplaces trading listed securities and quoted securities in Canada have retained IIROC to be their regulation services provider, the thresholds would be established by IIROC. Until the proposed National Instrument is approved and becomes effective and until IIROC establishes marketplace price and/or size thresholds, each marketplace would be able to continue the use of their existing mechanisms for controlling volatility and detecting "clearly erroneous" orders. A marketplace which does not currently have a mechanism to control volatility would not be required to adopt a mechanism prior to IIROC establishing price and/or size parameters. (See "Policy Development Process" on pages 2 and 3.)

The current mechanisms used by marketplaces to control volatility are described in section 2.3 above. All of the existing mechanisms used by marketplaces are based on "price impact" of the order and do not specifically try to preclude the entry of large orders. As indicated in that section, not all of the marketplaces currently have a version of Marketplace Thresholds. This Request for Comments, which specifically asks whether volume thresholds should be established in addition to price impact thresholds, is the first step in the process for IIROC to establish such parameters..

2.5. Developments in the United States

2.5.1. Single-Stock Circuit Breakers

On May 18 and 19, 2010, the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA") filed proposed rules with the United States Securities and Exchange Commission ("SEC"). The proposed rules reflected a consensus that was achieved among the exchanges and FINRA and were intended to provide for uniform market-wide standards for dealing with individual securities that experience a rapid price movement.

The SEC published the proposed rules for a 10-day public comment period, and approved them on an accelerated basis on June 10, 2010. As of June 11, 2010, markets in the United

States have been participating in a circuit breaker pilot program that initially applied to securities included in the S&P 500 Index.[14]

The single-stock circuit breakers, when triggered, result in a cross-market halt of trading in a security which experiences a 10% price change (up or down) within a 5-minute period. The halt for a period of 5 minutes is intended to give the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion.

The circuit breaker is initiated by the primary listing market, which notifies the other markets and market participants of the imposition of a trading pause by immediately disseminating a special indicator over the consolidated tape. Under the rules, once a listing market issues a trading pause, the other markets are required to pause trading in that security on their markets. FINRA's rule provides that it will similarly pause trading in the over-the-counter market by FINRA members.

After five minutes, the primary listing market reopens trading in the security in accordance with its procedures for doing so. Trading resumes on the other markets and in the over-the-counter market once trading has resumed on the primary listing market. Where there is a significant imbalance on the primary listing market at the end of the five-minute pause, the primary listing market may delay reopening for a further five minutes. However, if the primary listing market has not reopened within ten minutes, the other markets may resume trading. FINRA's rule permits over-the-counter market participants to resume trading only if trading has resumed on at least one exchange.

The primary objective of the U.S. single-stock circuit breaker program is to prevent large swings in index levels resulting from temporary price dislocations among a small group of stocks. If the circuit breaker is effective in curtailing rapid price movements in particular securities, the circuit breakers will limit the possible contagion effect of price movements in particular stocks moving to the broader market. In order to avoid interfering with existing procedures designed to facilitate orderly openings and closings, the single-stock circuit breakers are only in effect from 9:45 a.m. until 3:35 p.m.

2.5.2. Breaking Erroneous Trades

The SEC has also approved rule changes proposed by the national securities exchanges and FINRA in order to clarify the process for breaking erroneous trades.[15] The rules establish

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[14] On September 10, 2010, the SEC approved new rules submitted by the national securities exchanges and FINRA to expand a recently-adopted circuit breaker program to include all stocks in the Russell 1000 Index and certain exchange-traded funds. The SEC also approved new exchange and FINRA rules that clarify the process for breaking erroneous trades. See, for example, SEC Release No. 34-62884, *Order Approving Proposed Rule Changes Relating to Expanding the Pilot Rule for Trading Pauses Due to Extraordinary Market Volatility to the Russell 1000® Index and Specified Exchange Traded Products.*

thresholds for breaking trades when prices diverge from the "reference price," typically the last sale before trading was interrupted. These rules, as amended, are also be in effect on a pilot basis.[16]

For stocks that are subject to single-stock circuit breakers, trades would be broken at the following specified levels:

- for stocks priced $25 or less, trades at least 10% away from the circuit breaker trigger price;
- for stocks priced more than $25 to $50, trades at least 5% away from the circuit breaker trigger price; and
- for stocks priced more than $50, trades at least 3% away from the circuit breaker trigger price.

If circuit breakers are not applicable, the exchanges and FINRA have proposed to break trades at specified levels for events involving multiple stocks depending on how many stocks are involved, namely:

- for events involving between 5 and 20 stocks, trades would be broken that are at least 10% away from the reference price; and
- for events involving more than 20 stocks, trades would be broken that are at least 30% away from the reference price.

2.5.3. "Limit Up-Limit Down" Proposals

The U.S. market has been subject to a single-stock circuit breaker pilot program since SEC approval in June of 2010. These measures were implemented in response to the market events of May 6, 2010. Since the pilot project began, there has been a re-evaluation of the overall effectiveness of the single-stock circuit breaker program, particularly in light of the numerous instances of the circuit breakers triggering due to erroneous trades.

On April 5, 2011, the major U.S. exchanges submitted a proposal to the SEC in an attempt to address these shortcomings.[17] The proposal set forth a plan to establish market-wide limit up-limit down controls in trades of securities covered by the National Market System ("NMS Stocks") and, if approved by the SEC, would replace the existing single-stock circuit breaker program.

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15 SEC Release No. 34-62886, *Order Granting Approval of Proposed Rule Changes Relating to Clearly Erroneous Transactions* at http://www.sec.gov/rules/sro/bats/2010/34-62884.pdf.

16 For a discussion of the approach taken by IIROC to vary or cancel trades pursuant to the Unreasonable Trade Policy, see IIROC Notice 12-0112, op. cit.

17 See File 4-631 – National Market System Plan to Address Extraordinary Market Volatility. The text of the plan is available at: http://www.sec.gov/news/press/2011/2011-84-plan.pdf.

The proposal would prevent trades in NMS Stocks from occurring outside specified price bands, which would be set at a percentage level above and below the arithmetic mean of trades in a particular stock over the preceding 5-minute period. These percentage parameters would be doubled during the opening and closing periods. The percentage parameters as per the initial proposal were as follows:

Class of Securities	Reference Price	Percentage Parameter
Tier 1 NMS Stocks[18]	≥ $1.00	5%
	< $1.00	The lesser of $0.15 or 75%
Tier 2 NMS Stocks[19]	≥ $1.00	10%
	< $1.00	The lesser of $0.15 and 75%

When one side of the market for a particular security is outside the price band, that quote would be identified as non-executable. When the other side of the market reaches the price band the market for that security would enter a limit state. All trading in a security would enter a limit state when the National Best Offer equals the lower limit band or the National Best Bid equals the upper limit band. Trading for a particular NMS Stock would exit a limit state if the entire size of all limit state quotes were executed or cancelled within a 15-second time period. If the market does not exit the limit state within 15 seconds, the primary listing exchange would declare a 5-minute halt.

The U.S. exchanges involved in the original proposal have submitted a response to the comments received on the original proposal and they have proposed changes to the original framework.[20] The most significant of the changes involve revisions to the percentage parameters used to establish the price bands. The new proposed percentage parameters are as follows:

Class of Securities	Reference Price	Percentage Parameter
Tier 1 NMS Stocks	> $3.00	5%
	$1.00 - $3.00	20%
	< $1.00	The lesser of $0.15 or 75%
Tier 2 NMS Stocks	> $3.00	10%
	$1.00 - $3.00	20%
	< $1.00	The lesser of $0.15 and 75%

The limit up-limit-down proposal has yet to receive SEC approval, and in the meantime the single-stock circuit breaker pilot has been extended to July 31, 2012.

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[18] Stocks in the S&P 500 Index or Russell 1000 Index and certain exchange-traded products.

[19] All NMS Stocks other than those in Tier 1.

[20] The response is available at: http://www.nasdaqtrader.com/content/MarketRegulation/LU_LDCommentLetter.pdf.

3. Discussion and Observations

IIROC believes that Single-Stock Circuit Breakers should not become the mechanism for dealing with "clearly erroneous" trades. The Single-Stock Circuit Breaker should remain focused on addressing rapid and significant price movements due to sudden shifts in liquidity for a particular security that impact the continuance of a "fair and orderly" market. The initial responsibility for preventing "clearly erroneous" orders rests with the Participants to prevent the entry of such orders by means of their various order handling procedures and filters in their trading and order management systems. In this regard, the proposed Electronic Trading Rule would require that market participants have appropriate policies, procedures and controls in place to ensure that the risks associated with electronic trading are prevented or managed.[21]

The next line of defense would be the Marketplace Thresholds. Only in rare circumstances should it be necessary for the clearly erroneous order to be caught by the Single-Stock Circuit Breaker or by the application of the Unreasonable Trade Policy, the existing procedures of IIROC for regulatory intervention in the event of significant unexplained price movement for the cancellation or variation of trades.[22]

IIROC believes that at least one of the mechanisms for controlling volatility should operate either to preclude or to detect and deal with "significant, rapid and unexplained" price declines. On the other hand, IIROCs preference is that market forces drive trading activity without interference provided there is a fair and orderly market. If material information has been properly disclosed to market participants, the price discovery mechanism should be allowed to work and the market price of the security may move rapidly to a new level, but such movement is explained by the market's evaluation of the material news or information. One of the downsides of the "limit up-limit down" approach is that the mechanism not only catches "erroneous" orders but may restrict the ability of the price of a security to move to its proper level based on a functioning price discovery mechanism. This restriction means that trades will in fact be occurring at what might otherwise be considered "artificial" prices not justified by true supply and demand.[23]

IIROC's position that the price discovery mechanism should not be unduly restricted is demonstrated by the identification of certain circumstances when a Single-Stock Circuit Breaker will not be triggered even though there may be the requisite movement in market prices over the specified period of time. In particular, a Single-Stock Circuit Breaker will not

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[21] Proposed National Instrument 23-103, Parts 1 and 2.

[22] See IIROC Notice 12-0112, op. cit.

[23] The "limit up-limit down" mechanism was originally employed in the derivatives markets to ensure that the price of the derivatives did not "decouple" from the value of the underlying securities or indices on which the derivatives were based.

be invoked for a particular security under any of the following circumstances that may take place during the trading day:

- after the "general" circuit breakers have been triggered (as the invocation of the general circuit breaker indicates that there is a prevailing market sentiment which is not related to liquidity issues for that particular security);
- after a Single-Stock Circuit Breaker has been invoked for that security (as the previous invocation of the circuit breaker should have acted as a warning to the market that there may be liquidity issues with that particular security and that market participants should be monitoring trading developments in the security); and
- after the imposition of a "regulatory halt" in the trading of that security, particularly when the halt has been imposed to permit the dissemination of "material news" (as the market should be allowed to react to the news provided that the news has been properly disseminated in accordance with applicable securities legislation and marketplace requirements).

Similarly, Single-Stock Circuit Breakers will only be active between the hours of 9:50 a.m. and 3:30 p.m. Trading in the first twenty minutes following the regular opening and for the last thirty minutes before the close of regular trading would not be subject to a halt under a Single-Stock Circuit Breaker as IIROC was of the view that these periods of natural volatility should be excluded from the application of circuit breakers in order to avoid the unnecessary triggering of a Single-Stock Circuit Breaker due to overnight developments that should not give rise to a trading halt, including foreign market movements, issuer news releases, geo-political developments, anticipated spikes in demand and/or supply or index events. During these periods when the Single-Stock Circuit Breaker is not active, existing measures designed to facilitate orderly openings and closings - including the ability of a Market Integrity Official to impose a regulatory halt - will continue to apply. The question that arises is whether Marketplace Thresholds should also be allowed to be more flexible during these periods of natural volatility.

While uniform Marketplace Thresholds have the benefit of being easily understood by market participants, this objective should be balanced against the degree of flexibility that marketplaces require in adopting volatility parameters that are appropriate for the type of trading undertaken on its market. In these circumstances, each marketplace should be transparent as to the type of volatility parameters employed and the levels at which they are triggered.

4. Suggested Guiding Principles for Marketplace Thresholds

IIROC proposes for comment the following framework for evaluating whether a particular mechanism for controlling price volatility by precluding execution of certain orders is effective and can be appropriately integrated into the multi-tiered approach for the control of price volatility:

1. In the ordinary course, Marketplace Thresholds should preclude the execution of an order that would otherwise trigger regulatory intervention in the form of a Single-Stock Circuit Breaker or a trade variation or cancellation under the Unreasonable Trade Policy.

2. The application of Marketplace Thresholds should not exacerbate price volatility during periods of rapid market volatility by:

   (a) removing access to liquidity that would otherwise execute at "acceptable" prices; or

   (b) redirecting "unacceptable" orders to other marketplaces.

5. Specific Questions

While comment is requested on all aspects of controlling price volatility in the Canadian marketplace, IIROC specifically requests comment on the following questions:

1. As a result of recent experience in the U. S. with "erroneous trades" triggering Single-Stock Circuit Breakers, a number of commentators in the U. S. have suggested that standardized "limit up-limit down" volatility parameters be implemented at the market centre level. If adopted in the U.S., would there be a need for similar or "uniform" Marketplace Thresholds in the context of the Canadian market? In particular, would "uniform" Marketplace Thresholds be able to adequately take account of differences in trading patterns between large- and small-capitalization issuers on Canadian marketplaces?

2. Should all marketplaces be required to adopt a form of "Marketplace Thresholds"? Should a marketplace that is not a "protected marketplace" be exempted if executions on that marketplace cannot occur outside of the spread between the "best bid price" and "best ask price"?[24]

[24] Under Rule 1.1 of UMIR "protected marketplace" means a marketplace that:

(a) disseminates order data in real-time and electronically to the information processor or one or more information vendors in accordance with the Marketplace Operation Instrument;

(b) permits dealers to have access to trading in the capacity as agent;

(c) provides fully-automated electronic order entry; and

(d) provides fully-automated order matching and trade execution.

3. If marketplaces are allowed to adopt their own version of Marketplace Thresholds, are the "Suggested Guiding Principles" (set out in section 4 of this notice) appropriate? Are there are additional principles which should be considered?

4. If marketplaces are allowed to adopt their own version of Marketplace Thresholds, should:

   (a) "freeze parameters" be required to provide for order cancellation during the period of the freeze (such that liquidity does not get "trapped" on a marketplace or "taken advantage of" on the lifting of the freeze in a rapidly moving market)?

   (b) "freeze parameters" be required to provide for order entry during the period of the freeze (so that any additional liquidity would have an opportunity to enter and stabilize prices)?

   (c) "freeze parameters" be limited as to how long they may be in effect for a particular security (to provide greater certainty to marketplace participants)?

   (d) "rejected orders" be required to carry a message as to the reason for rejection so that the order could not be automatically re-routed to another marketplace without intervention from the Participant or Access Person who entered the order?

5. How should "directed action orders" be treated under Marketplace Thresholds? [25] Should the obligation to ensure that the order is "acceptable" (e.g. the execution price would be below the volatility parameters of the marketplace on which the order is entered and below the threshold for regulatory intervention by IIROC) be borne by the party that marked the order as a "directed action order" (whether that be the Participant or Access Person that entered the order or the marketplace that marked and re-routed the order pursuant to the Order Protection Rule)?

6. What types of orders should be covered by Marketplace Thresholds? Should they cover all orders:

   - entered on a marketplace;

[25] On February 1, 2011, amendments to National Instrument 23-101 regarding the Order Protection Rule were implemented. Marketplaces must have policies and procedures in place reasonably designed to prevent trade-throughs. Consideration should be given to the inter-play between Marketplace Thresholds and the directed action orders contemplated by the Order Protection Rule. A directed action order is an order designated by the Participant or Access Person entering the order on a marketplace and acts as an instruction to the marketplace to immediately execute the order without reference to orders which may be displayed on other marketplaces. In these circumstances, the Participant or Access Person assumes the responsibility not to trade-through better-priced orders. If a marketplace were to apply its volatility parameters to a directed action order, the outcome would likely be the occurrence of a trade-through. If marketplaces were to suspend their volatility parameters for orders entered as directed action orders, the Participants and Access Persons who intend to use directed action orders must ensure their policies and procedures are adequate to prevent the entry of clearly erroneous orders that are designated as directed action orders.

- that on execution would establish the "last sale price" (thereby excluding: Basis Orders; Call Market Orders; Closing Price Orders; certain Special Terms Orders and Volume-Weighted Average Price Orders); or
- that would establish the "best ask price" or "best bid price" (thereby excluding orders that do not establish the "last sale price" together with Opening Orders and Market-on-Close Orders)?

7. The proposed National Instrument 23-103 contemplates that a regulation services provider may establish both "price and volume thresholds". If an order would have a significant impact on the market price beyond the threshold established by IIROC, Marketplace Thresholds would be expected to preclude the execution of the order. If an order would not have a significant impact on the market price on execution, should Marketplace Thresholds limit or preclude the ability of such order to trade simply because of the size of the order?

8. Should Marketplace Thresholds be more flexible during periods of "natural volatility" (e.g. in the twenty minutes following the regular opening and for the last thirty minutes before the close of regular trading, being the periods when the Single-Stock Circuit Breaker would not be triggered)?