

# Market Integrity Notice

## Guidance

September 21, 2007

No. 2007-019

### Suggested Routing

- Trading
- Legal and Compliance

### Key Topics

- Best Execution
- Best Price Obligation
- Client Order
- Client Priority
- Order Exposure
- Non-Transparent Marketplaces

### UMIR Provisions Referenced

- Rule 5.1 – Best Execution of Client Orders
- Rule 5.2 – Best Price Obligation
- Rule 5.3 – Client Priority
- Rule 6.3 – Exposure of Client Orders

### Market Integrity Notices Referenced

- Market Integrity Notice 2006-017 – Guidance – *Securities Trading on Multiple Marketplaces* (September 1, 2006)
- Market Integrity Notice 2006-020 – Guidance – *Compliance Requirements For Trading On Multiple Marketplaces* (October 30, 2006)
- Market Integrity Notice 2007-015 – Guidance – *Specific Questions Related to Trading on Multiple Marketplaces* (August 10, 2007)

## ENTERING CLIENT ORDERS ON NON-TRANSPARENT MARKETPLACES AND FACILITIES

### Summary

This Market Integrity Notice provides guidance on the application of the best execution, client priority and order exposure requirements of the Universal Market Integrity Rules to the entry of client orders on marketplaces and facilities of marketplaces that do not disseminate information on orders to information vendors.

### Questions / Further Information

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## ENTERING CLIENT ORDERS ON NON-TRANSPARENT MARKETPLACES AND FACILITIES

### Summary

This Market Integrity Notice provides guidance on the application of the best execution, client priority and order exposure requirements of the Universal Market Integrity Rules (“UMIR”) to the entry of client orders on marketplaces and facilities of marketplaces that do not disseminate information on orders to information vendors.

### Background

Part 7 of National Instrument 21-101 - *Marketplace Operation* (the “Marketplace Operation Instrument”) provides that a marketplace that displays orders to any person shall provide accurate and timely information regarding orders to the information processor, if any, or an information vendor. A marketplace need not distribute order information to the information processor or an information vendor if the marketplace does not make details of orders available to persons other than those retained to assist in the operation of the marketplace. As at September 7, 2007, the equity marketplaces that are:

- “transparent” marketplaces which disclose order information are: the Toronto Stock Exchange (“TSX”), the TSX Venture Exchange and CNQ, including Pure Trading; and
- “non-transparent” marketplaces which do not disclose order information are: BlockBook, Liquidnet, and MATCH Now.

In the near future, the TSX intends to enable the “community matching” features of its pre-trade matching facility known as “Alternative Trade eXecution” (“ATX”). Under the “community matching” feature of ATX, a non-transparent “intent” entered by a Participant that participates in ATX may match with intents entered by other Participants or with order flow that is destined for entry in the central limit order book of the TSX. Any “match” in ATX must occur between the best ask price and the best bid price as displayed in a consolidated market display (comprised of all “transparent” marketplaces trading the particular security). The match is reported to the TSX and executed in the central limit order book at a price that is then at or between the best ask price and best bid price. One of the features of ATX allows “intents” from a particular account to be assigned to a “priority allocation group” (“PAG”) that will determine the order in which the intents will match.

None of BlockBook, Liquidnet or MATCH Now provides pre-trade transparency as contemplated by Part 7 of the Marketplace Operation Instrument of any orders entered on their marketplace (through the provision of order information to information vendors for dissemination). BlockBook uses proprietary signalling to indicate to all subscribers the presence of liquidity based on certain parameters. In the case of Liquidnet, subscribers are informed if another subscriber has a matching “indication of liquidity”, following which a one-on-one negotiation of orders may take place. None of BlockBook, Liquidnet or MATCH Now provides a mechanism for orders to be

assigned different priorities for execution outside of the priorities established by the operating model of the respective marketplace.

For a summary comparison of the basic features of each marketplace, reference should be made to the chart available through the RS homepage at [www.rs.ca](http://www.rs.ca) under the heading “Markets We Regulate”. For more detailed guidance on the application of UMIR to trading on multiple marketplaces, reference should be made to:

- Market Integrity Notice 2006-017 – *Guidance – Securities Trading on Multiple Marketplaces* (September 1, 2006);
- Market Integrity Notice 2006-020 – *Guidance – Compliance Requirements For Trading On Multiple Marketplaces* (October 30, 2006); and
- Market Integrity Notice 2007-015 – *Guidance – Specific Questions Related to Trading on Multiple Marketplaces* (August 10, 2007).

## Questions and Answers

The following are the most frequently asked questions regarding the obligations of a Participant when entering a client order on a non-transparent marketplace or facility and the responses of RS to each:

### **1. May “small” client orders that are subject to the Order Exposure Rule be entered on a non-transparent marketplace or facility?**

Rule 6.3 of UMIR requires, subject to certain enumerated exceptions, that client orders to purchase or sell 50 standard trading units or less of a security be immediately entered on a marketplace. As such, the obligation applies to a client order to purchase or sell:

- 5,000 or less units of a security trading at \$1.00 or more per unit;
- 25,000 or less units of a security trading at \$0.10 or more per unit and less than \$1.00 per unit; and
- 50,000 or less units of a security trading at less than \$0.10 per unit.

The purpose of the rule is to ensure that client orders are exposed to the market. The exposure of such client orders contributes to the operating of the price discovery mechanism to establish the “best bid price” and “best ask price” used in various UMIR provisions including the best price obligation.

The policy objectives behind Rule 6.3 are not met if the client order is entered on a marketplace that does not provide information on the order to an information vendor for inclusion in a consolidated market display. Effective March 9, 2007, Rule 6.3 was amended to require the entry of the client order that is subject to the exposure requirements of that Rule on a marketplace that discloses order information in a consolidated market display.

In the view of RS, client orders which are routed to a non-transparent marketplace or facility to determine if liquidity is available on that marketplace or facility at prices that are the same or better than displayed in a consolidated market display would comply with the requirements of Rule 6.3 provided any unexecuted portion of the client order was then immediately entered on a marketplace that did provide order transparency.

**2. Are there circumstances when the “best execution” obligation would require a Participant to consider a “non-transparent” marketplace or facility?**

Rule 5.1 of UMIR requires a Participant to diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions. RS is of the view that a Participant in discharging its best execution obligation should consider possible liquidity on marketplaces that do not provide transparency of orders in a consolidated market display, such as BlockBook and MATCH Now, if:

- the displayed volume in the consolidated market display is not adequate to fully execute the client order on advantageous terms for the client; **and**
- the non-transparent marketplace has demonstrated that there is a reasonable likelihood that the marketplace will have liquidity for the specific security.

As access to Liquidnet is limited to institutions other than dealers, a Participant would not have an obligation to consider Liquidnet or any other marketplace to which the Participant could not otherwise, directly or indirectly, obtain access to trade as agent.

**3. What “best price” obligation is owed if a client order executes on a non-transparent marketplace at a price that is inferior to an order displayed on a transparent marketplace?**

Under Rule 5.2, a Participant has an obligation to make reasonable efforts to fill better-priced orders on a marketplace before executing a trade at an inferior price on another marketplace or a foreign market. In the view of RS, the “best ask price” and “best bid price” can only be determined by reference to orders on marketplaces that provide pre-trade transparency. In order for a Participant to demonstrate that it had made “reasonable efforts” to execute a client order at the best price, RS expects the Participant will deal with “better-priced” orders on another marketplace if that marketplace:

- disseminates order data in real-time and electronically through one or more information vendors;
- permits dealers to have access to trading in the capacity as agent;
- provides fully-automated electronic order entry; and
- provides fully-automated order matching and trade execution.

Of the current marketplaces, only CNQ (including Pure Trading), TSX and TSXV meet all four conditions. BlockBook, Liquidnet and MATCH Now are “non-transparent” marketplaces that do not disseminate order data.

Since the “better-priced” orders are determined from information in a consolidated market display, a Participant owes an obligation only to the “visible” portion of a “better-priced” order on another marketplace. If a marketplace has visible orders but the marketplace is not open for trading at that time, a Participant does not owe a “best price” obligation to such orders. A Participant may trade at any time taking into account all visible orders on marketplaces then open for trading. This obligation will apply to special trading facilities of a marketplace which conducts trading before or after “regular” trading hours if orders in such special facility are visible.

Since neither ATX nor MATCH Now will provide pre-trade transparency, UMIR would not require a Participant to determine if a “better-priced” order existed on ATX or MATCH Now prior to executing on another marketplace. However, both ATX and MATCH Now have been structured to provide price improvement over the “best ask price” and the “best bid price” at the time of execution on MATCH Now and at the time of “match” on ATX. (When a “match” on ATX is executed as a trade on the TSX, the price must be at or between the “best ask price” and the “best bid price”.) As such, no order executing on MATCH Now or matching on ATX would owe a “best price obligation” to an order on another marketplace.

**4. What are the “client priority” obligations if a marketplace or facility permits orders to be assigned different priorities for execution?**

For Participants who participate in the ATX facility of the TSX, each particular account which is eligible to enter an “intent” will be assigned to a PAG that will be “hard-coded” into ATX and which will not be subject to trade-by-trade allocations or changes by traders. Under Rule 5.3, a Participant may have to provide priority to a client order received prior to the entry of a principal order or non-client orders at the same or an inferior price to that of the client order. “Client priority” would be required if the Participant, based on the information known or reasonably available to the person or persons originating or entering the principal order or non-client order, knows or should have known that the principal order or non-client order will execute or have a reasonable likelihood of executing in priority to a client order received by the Participant prior to the entry of the principal order or non-client order:

- for the same security;
- at the same or an inferior price; and
- on the same side of the market.

If a client order is to be entered into ATX as an “intent”, the client would have to specifically consent to receiving a PAG rating which is lower than those used for principal or non-client orders. In the view of RS, such consent would have to be

“informed”, in other words, the client would have to understand the implications for the execution of their order.

It is the intention of RS, as part of its trade desk review, to review the assignment of PAGs or priority for execution to ensure that client priority has been provided or that informed consent has been obtained from clients in the event a client has been assigned a lower PAG or priority for execution than that used by principal or non-client accounts.

**5. *If a marketplace or facility permits orders to be assigned different priorities for execution, do all client orders have to be assigned the same level of priority?***

The client priority rules under UMIR do not preclude the possibility that different PAGs or priority for execution may be assigned to different groups of clients. However, as noted above, a client assigned a lower PAG or lower priority for execution would be expected to have provided an informed consent with respect to such assignment. As part of its trade desk review, RS would intend to review the evidence of the informed consent in the event a client is assigned a PAG or priority for execution lower than that assigned to other clients. In all cases, the Participant would remain subject to Rule 5.1 with respect to its “best execution” obligation for each client order.

**6. *Is an “intent” entered into ATX considered to be an “order” for the purpose of UMIR?***

While the rules of the TSX refer to “active intents” and “passive intents” entered into the ATX facility (principally to avoid confusion with respect to orders entered into the central limit order book of the TSX), these “intents” are a firm indication of a willingness to buy or sell a security that may be executed. As such, an “intent” entered into the ATX facility is considered an “order” for the purposes of Marketplace Operation Instrument and UMIR (and a client order entered on ATX as an “intent” will be monitored by RS and subject to review as part of a trade desk review undertaken by RS of a Participant).

Nonetheless, ATX is a “matching facility” rather than a marketplace. Any match of an order or active intent with a passive intent in ATX does not constitute a trade. The match only becomes a trade when executed in the trading engine of the TSX. As such, the critical point in time for the purposes of the application of certain UMIR provisions dealing with “trades” will be at the execution of the trade in the central limit order book of the TSX.

### **Questions / Further Information**

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