

IIROC NOTICE

Rules Notice Request for Comments - UMIR

Please distribute internally to:
Legal and Compliance
Trading

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10-0086
March 26, 2010

Proposed Guidance on “Locked” and “Crossed” Markets

Summary

This IIROC Notice requests comments on draft guidance that the Investment Industry Regulatory Organization of Canada (“IIROC”) would propose to issue related to “locked” and “crossed” markets (“Proposed Guidance”). The Proposed Guidance would be issued in the context of a Participant complying with the provisions of National Instrument 23-101 (“Trading Rules”) and Companion Policy 23-101CP concerning locked and crossed orders (“Locked and Crossed Order Provisions”) and with the “best price” and “best execution” obligations under the Universal Market Integrity Rules (“UMIR”).

Policy Development Process

IIROC has been recognized as a self-regulatory organization by each of the Canadian provincial securities regulatory authorities (the “Recognizing 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

¹ Presently, IIROC has been retained to be the regulation services provider for: the Toronto Stock Exchange (“TSX”), TSX Venture Exchange (“TSXV”) and Canadian National Stock Exchange (“CNSX”), each as an “exchange” for the purposes of the Marketplace Operation Instrument (“Exchange”); and for Alpha Trading Systems (“Alpha”), Bloomberg Tradebook Canada Company, Chi-X Canada ATS Limited (“Chi-X”), Liquidnet Canada Inc. (“Liquidnet”), Omega ATS Limited (“Omega”) and TriAct Canada Marketplace LP (the



Regulators have approved, UMIR as the integrity trading rules that will apply in any marketplace that retains IIROC as its regulation services provider.

The Market Rules Advisory Committee of IIROC reviewed the Proposed Guidance. 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.

The text of the Proposed Guidance is set out in Appendix “A”. Comments are requested on all aspects of the Proposed Guidance, including any matter not addressed in the Proposed Guidance. Comments should be in writing and delivered by **May 25, 2010** 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 on the Proposed Guidance received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may make revisions to the Proposed Guidance prior to the issuance of the final Guidance Note. Until that Guidance Note is issued, IIROC would suggest that Participants and Access Persons take the Proposed Guidance into consideration as appropriate.

Background to the Proposed Guidance

In April of 2009, IIROC issued guidance on various aspects of “locked” and “crossed” markets.² That guidance noted that the best price obligation under Rule 5.2 of UMIR required Participants to make reasonable efforts not to “cross” markets. The guidance also noted that the intentional locking of markets was not contrary to UMIR except in a number of specific instances that were described in the guidance. However, that guidance also noted that the Canadian Securities Administrators had proposals outstanding to amend the provisions of National Instrument 23-101 (“Locked and Crossed Order Provisions”) to preclude the intentional locking and crossing of markets and that the guidance issued by IIROC might have to be revised on the adoption of the Locked and Crossed Order Provisions.

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.

² IIROC Notice 09-0105 - Rules Notice– Guidance Note – UMIR – *Guidance on Aspects of “Locked” and “Crossed” Markets* (April 9, 2009).



That Rules Notice was repealed, effective as of January 28, 2010, upon the Locked and Crossed Order Provisions becoming effective.³ The Proposed Guidance would replace the earlier guidance provided by IIROC on “locked” and “crossed” markets and incorporate the requirements of the Locked and Crossed Order Provisions.

Appendix

Appendix “A” sets out the text of the Proposed Guidance respecting “locked” and “crossed” markets.

³ IIROC Notice 10-0032 Rules Notice - Guidance Note – UMIR – *Repeal of Guidance on Aspects of “Locked” and “Crossed” Markets* (February 10, 2010).



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Guidance on “Locked” and “Crossed” Markets

Summary

This Rules Notice provides guidance on specific questions related to “locked” and “crossed” markets in the context of a Participant complying with the provisions of National Instrument 23-101 (“Trading Rules”) and Companion Policy 23-101CP concerning locked and crossed orders (“Locked and Crossed Order Provisions”) and with the “best price” and “best execution” obligations under the Universal Market Integrity Rules (“UMIR”).⁴

Background

A “locked market” occurs when there are multiple marketplaces trading the same security and a bid (offer) on one marketplace is posted at the same price as an offer (bid) on another marketplace. Had both orders been entered onto the same marketplace the bid and the offer would have matched and a trade would have been executed. There are two ways for a locked market to be unlocked:

⁴ IIROC had previously issued IIROC Notice 09-0105 - Rules Notice – Guidance Note – UMIR – *Guidance on Aspects of “Locked” and “Crossed” Markets* (April 9, 2009). That Rules Notice was repealed, effective as of January 28, 2010, upon the Locked and Crossed Order Provisions becoming effective. See IIROC Notice 10-0032 Rules Notice - Guidance Note – UMIR – *Repeal of Guidance on Aspects of “Locked” and “Crossed” Markets* (February 10, 2010).



- typically, more buyers and sellers appear resulting in subsequent trades and immediate correction; or
- one of the participants involved in the lock removes its order and places the order on another marketplace to immediately execute the trade.

In contrast, a “crossed market” occurs when one participant’s bid (offer) on one marketplace is higher (lower) than another participant’s offer (bid) on a different marketplace. A crossed market condition between marketplaces usually does not last for a long period of time as someone will usually take advantage of the arbitrage opportunity.

With the significant increase in order message traffic in recent years, the prevalence of “locked” and “crossed” markets has increased if for no other reason than the different latencies in the systems of Participants, Access Persons, services providers, data vendors and marketplaces. The volume of order message traffic is expected to continue to expand with increased use of algorithmic trading and dealer sponsored market access. As such, the incidences of “locked” and “crossed” markets that have been unintentionally created will continue to increase.

Effective January 28, 2010, the Trading Rules were amended and among the provisions implemented on that date were the Locked and Crossed Order Provisions.⁵ The amendments introduced section 6.2 of the Trading Rules which provide:

A marketplace participant shall not ***intentionally*** [emphasis added]

- (a) enter on a marketplace a protected order to buy a security at a price that is the same as or higher than the best protected offer; or
- (b) enter on a marketplace a protected order to sell a security at a price that is the same as or lower than the best protected bid.

For the purposes of the Trading Rules, a marketplace participant includes a Participant or Access Person under UMIR.⁶ Rule 2.3 of UMIR provides that a Participant or Access Person shall not enter an order on a marketplace or execute a trade if the Participant or Access Person knows or ought reasonably to know that the entry of the order or the execution of the trade would not comply with a number of requirements including applicable securities legislation.

As such, the entry of an order that does not comply with the Locked and Crossed Order Provisions will constitute a violation of Rule 2.3 and may constitute a violation of other provisions of UMIR.

⁵ See Canadian Securities Administrators Notice, Notice of Technical Corrections to Amendments to National Instrument 23-101 *Trading Rules*, (2009) 32 OSCB 10503. That publication provided notice that the Locked and Crossed Order Provisions were to come into effect on January 28, 2010 and not on February 1, 2011, the implementation date of other amendments to Part 6 of the Trading Rules related to the introduction of “a framework to require all visible, immediately accessible, better-price limit orders to be filled before other limit orders at inferior prices, regardless of the marketplace where the order is entered” (“Order Protection Rule”). When the Order Protection Rule becomes effective on February 1, 2011, the Locked and Crossed Order Provisions will become section 6.5 of the Trading Rules.

⁶ Reference should be made to section 1.1 of the Trading Rules for the definitions of “protected order”, “protected bid” and “protected offer”.



In accordance with the requirements of Policy 7.1 of UMIR, each Participant is expected to review its policies and procedures to ensure that they are adequate, taking into account the business and affairs of the Participant to ensure compliance with the Locked and Crossed Order Provisions and the guidance set out in this Rules Notice. Each Participant is also expected to periodically review a sample of orders and trades to test the adequacy of its policies and procedures. IIROC has discussed this Rules Notice with staff of the Canadian Securities Administrators. The guidance in this Rule Notice is intended to supplement and complement the provisions of Companion Policy 23-101CP.

If a Participant or Access Person believes that a marketplace participant is entering orders on marketplaces in contravention of the guidance provided in this Rules Notice, the Participant or Access Person is encouraged to bring this situation to the attention of IIROC by contacting Market Surveillance in:

- Toronto at 416.646.7220 in respect of orders for securities listed on the Toronto Stock Exchange or CNSX; and
- Vancouver at 604.643.6505 in respect of orders for securities listed on the TSX Venture Exchange.

Questions and Answers

The following are questions relating to the obligations of a Participant under UMIR in the context of a “locked” or “crossed” market and IIROC’s response to each question:

1. *Is the entry of any order that results in a “locked market” a violation of a Participant’s or Access Person’s obligations under the Locked and Crossed Order Provisions or UMIR?*

Not necessarily. Companion Policy 23-101CP recognizes that locked or crossed markets may occur unintentionally and several examples of “unintentional” locks are set out in the Companion Policy.⁷ IIROC will measure compliance with the

⁷ See subsection (2) of section 6.2 of Companion Policy 23-101CP which provides:

Section 6.2 of the Instrument prohibits a marketplace participant from intentionally locking or crossing a market. This would occur, for example, when a marketplace participant enter a locking or crossing order on a particular marketplace or marketplaces to avoid fees charged by a marketplace or to take advantage of rebates offered by a particular marketplace. There are situations where a locked or crossed market may occur unintentionally and provides for the following examples:

- (a) the locking or crossing order was displayed at a time when the marketplace displaying the locked or crossed order was experiencing a failure, malfunction or material delay of its systems, equipment or ability to disseminate marketplace data;
- (b) the locking or crossing order was displayed at a time when a protected bid was higher than a protected offer;
- (c) the locking or crossing order was posted after all displayed liquidity was executed and a reserve order generated a new visible bid above the displayed offer or offer below the displayed bid.

When the Order Protection Rule becomes effective on February 1, 2011, the examples of unintentionally locking and crossing that are set out in what is then subsection (2) of section 6.5 of Companion Policy 23-101CP will be expanded to include the following example: “when a marketplace participant routes multiple directed-action orders that are marked immediate-or-cancel to a variety of marketplaces and because of latency issues, a locked or crossed market results”.



requirements based on the information which a Participant or Access Person has or should have had at the time of the entry of the order on a marketplace.

IIROC recognizes that “locked” or “crossed” markets may be created unintentionally as a result of:

- “race conditions” when competing orders are entered on protected marketplaces at essentially the same time with neither party having knowledge of the other order at the time of entry;
- ordinary differences in processing times and latencies between the systems of the Participant or Access Person, the various marketplaces, service providers, the information processor and information vendors;
- a failure, malfunction or material delay in the systems of a Participant or Access Person, marketplace, service provider, information processor or information vendor;
- the use of a “bypass order” by a Participant or Access Person (generally in connection with the “best price” obligations of the Participant to orders on other protected marketplaces) that has the effect of initially “bypassing” hidden liquidity at better prices and that hidden liquidity emerges immediately after the execution of the bypass order;
- marketplaces having different mechanisms to “restart” trading following a halt in trading for either regulatory or business purposes; and
- the execution of Opening Orders or Market-on-Close on a particular protected marketplace when trading is on-going (in the case of Opening Orders) or continues (in the case of Market-on-Close Orders) on at least one other protected marketplace.

In addition, it will not be considered to be an intentional “lock” of markets when securities legislation requires that the order be entered on or executed on a particular marketplace. For example, an order may be entered on a particular marketplace when an order is already displayed on another marketplace on the other side of the market at the same price, if the securities being sold are subject to resale restrictions in the United States are sold in Canada on a “designated offshore securities market” under Rule 904 of Regulation S of the *Securities Act of 1933*.⁸ However, the requirement to execute the order on a particular marketplace or class of marketplace would not permit the intentional entry of an order that would have the effect of “crossing” the markets.

If a Market Integrity Official of IIROC determines that a Participant or Access Person has entered an order which locks or crosses the market in circumstances which are contrary

⁸ Previously only the Toronto Stock Exchange and TSX Venture Exchange qualified as a “designated offshore securities market”. Reference should be made to Market Integrity Notice 2006-006 – *Guidance – Sale of Securities Subject to Certain United States Securities Laws* (February 16, 2006). On March 8, 2010, CNSX Markets Inc. announced that CNSX and Pure Trading had “designated offshore securities market” status from the United States Securities and Exchange Commission.



to the Locked and Crossed Order Provisions or UMIR, IIROC may require the Participant or Access Person to take steps to “unlock” or “uncross” the market.

2. *Is a Participant required to move a properly “booked” order on one marketplace to another marketplace to trade with an order that was subsequently entered on that other marketplace where the latter order caused a “locked market”?*

No. A Participant is **not** required to “migrate” a resting order on a marketplace to another marketplace to trade with an order that resulted in a “locked market”. Insofar as a Participant has not “bid-through” or “offered-through” an order on another marketplace when entering an order on the “resting” marketplace, a Participant, under its “best price” obligations, is under no obligation to move its resting order to another marketplace to trade with an order entered after the “booked” order was entered. For greater certainty, if an order is entered on a marketplace at a price which at the time of entry would not be executable against better-priced orders visible on a protected marketplace, the Participant is in compliance with “best price” and “best execution” obligations.

Nonetheless, a Participant may decide to “migrate” a client order to the other marketplace to increase the probability of execution. In making such a decision under the “best execution” obligation of the Participant, the Participant would have to give due consideration to the possible loss of priority if the existing order is moved and the likelihood of full execution should the order be moved to that other marketplace. The circumstances under which a Participant would move an order to another marketplace are based on the “best execution” policies and procedures adopted by the Participant.

IIROC expects that the policies and procedures adopted by a Participant to achieve “best execution” will set out the circumstances under which properly “booked” client orders will “migrate” and that the Participant will inform its clients of such policy and its implications. In the view of IIROC, the adoption of such policy and its communication to clients will reduce the likelihood of client confusion with respect to the question of “when and where” client orders will trade.⁹

3. *May an order to purchase a security be entered on a marketplace if an order to sell the same security at the same price has been entered on another marketplace by the same person or group of persons?*

No. Not only is the market being intentionally locked contrary to the Locked and Crossed Order Provisions but Rule 2.2 of UMIR prohibits a Participant or Access Person from entering an order on a marketplace if the Participant or Access Person knows or ought reasonably to know that the entry of the order will create, or could reasonably

⁹ In many ways, the expectations of IIROC are comparable to what IIROC expects in the handling of a client “Good-Till -Cancelled Order” that has been booked on a marketplace that either opens later or closes earlier than other marketplaces trading the same security.



be expected to create, a false or misleading appearance of trading activity in or interest in the purchase or sale of the security. If the orders for purchase and sale had been entered on the same marketplace, the orders would have executed and the resulting trade would be considered a “wash trade”. In the view of IIROC, a Participant or Access Person that enters an order on one marketplace for the purchase of a security and enters another order for the sale of the same security at the same price on another marketplace for the benefit of the same person or group of persons has engaged in a manipulative and deceptive activity contrary to Rule 2.2.¹⁰

4. Are all “rebate arbitrage” strategies acceptable?

No. Under a “make-or-take” trading fee model, a marketplace rewards persons who post limit orders on its marketplace by paying a “make” or “liquidity providing” rebate fee. Conversely, a marketplace charges a “take” fee for an order that interacts with the posted limit orders. The marketplace generally profits from the spread on the price it pays for liquidity and charges for orders that trade with such liquidity. Currently, each marketplace may establish the fees it pays or charges for orders that either “make” or “take” liquidity.¹¹

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, Rule 2.2 of UMIR prohibits a Participant or Access Person from entering an order on a marketplace if the Participant or Access Person knows or ought reasonably to know that the entry of the order will create or could reasonably be expected to create a false or misleading appearance of trading activity in or interest in the purchase or sale of the security. 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.

5. Is it a violation of UMIR to enter an order on a marketplace that “bids-through” or “offers-through” an order on another marketplace even if the order that “bids-through” or “offers-through” does not “trade”?

¹⁰ Reference should also be made to Part 3 of the Trading Rules which sets out activities by a client that may be considered manipulation and fraud.

¹¹ Fees established by a marketplace must comply with the access requirements in National Instrument 21-101. See section 5.1 of National Instrument 21-101 and section 7.1 of Companion Policy 21-101CP for provisions related to exchanges and quotation and trade reporting systems and section 6.13 of National Instrument 21-101 and section 8.2 of Companion Policy 21-101 CP for provisions related to alternative trading systems.



Yes. Such behaviour is not in compliance with the Locked and Crossed Order Provisions.¹² In addition, IIROC is of the view that a Participant who intentionally “bids-through” (enters a purchase order that is booked on a marketplace at a price which is higher than an offer to sell that security on another protected marketplace) or “offers-through” (enters a sell order that is booked on a marketplace at a price which is lower than a bid to purchase that security on another protected marketplace) is in a breach of Rule 2.1 of UMIR governing just and equitable principles of trade since such orders will result in a “crossed market”. Furthermore, if the Participant is entering a client order when “bidding-through” or “offering-through”, the Participant may be in violation of the “best execution” requirements under Rule 5.1 to diligently pursue the execution of the client order on the most advantageous execution terms reasonably available under the circumstances. To the extent that the order that “bid-through” or “offered-through” trades on a marketplace, the Participant will not be considered to have taken reasonable efforts to execute the order at the best available price as required by Rule 5.2 of UMIR.

6. During a “crossed” market, may a Participant or Access Person execute against the order that has caused a “crossed” market or the order that was “bid-through” or “offered-through”?

Yes. The entry of an order that is a “bid-through” or “offer-through” will result in a “crossed” market. If the Participant or Access Person has not taken reasonable efforts to avoid the “bid-through” or “offer-through”, the Participant or Access Person will have violated UMIR. However, IIROC also recognizes that, with the significant increases in order message traffic, the incidence of “crossed” markets will also increase without any breach of UMIR having occurred. Once markets are “crossed”, IIROC is of the view that the entry of a subsequent order that has the effect of “uncrossing”, or contributing to the uncrossing of, the markets is permitted for the purposes of UMIR.¹³ For example, if a security is offered on a protected marketplace at \$10 and a bid at \$11 is entered on another protected marketplace, the entry of the bid at \$11 is a “bid-through” and has violated the requirements of UMIR. A Participant or Access Person that subsequently trades with the offer at \$10 or the bid at \$11 has not violated its “best price” obligation provided there are no offers below \$10 or bids above \$11 on any other protected marketplace. Trading to take advantage of opportunities presented by “crossed” markets fits the UMIR definition of activities permitted by an arbitrage account.

7. If markets are “locked”, may a Participant or Access Person intentionally enter an order that would have the effect of increasing the volume displayed at the bid or the ask price?

¹² See section 6.2 of Companion Policy 23-101CP.

¹³ The entry of an order that contributes to the “uncrossing” of markets will also be allowed under the Order Protection Rule when it becomes effective on February 1, 2011.



No. Once a Participant or Access Person is aware that the market is locked, the intentional entry of any limit order on a protected marketplace at the price at which the lock has occurred will be considered to not in compliance with the Locked and Crossed Order Provisions.

8. What happens if a Participant or Access Person uses an order type or order router functionality that is designed to “reprice” orders and the repricing locks the market?

Both the Locked and Crossed Order Provisions and UMIR preclude a Participant or Access Person from intentionally “locking” the market. In the view of IIROC, the Participant or Access Person bears the responsibility if its use of an order type or order router functionality which “reprices” orders which results in their order being repriced to a level that creates a locked market. If the repricing leads to a locked market, or increases the volume of orders displayed at the locked price, the Participant or Access Person will be considered to have intentionally locked the market. Furthermore, the Participant or Access Person bears this responsibility even in circumstances where the actual repricing of the order is being undertaken by a third party such as a service provider or a marketplace.

9. May a client instruct the entry of an order that has the effect of creating or continuing a “locked” or “crossed” market?

No. Although in the ordinary course, the Participant’s “best execution” obligation would require that it follow its client’s instructions with respect to the handling of an order, compliance with the “best execution” obligation is subject to compliance with applicable regulatory requirements. In light of this, if the client prefers that their order be executed on a particular marketplace, the client may consent to the order being withheld from entry on a marketplace until such time as the prevailing market prices would permit the entry of the order without locking or crossing the market.

10. May a client electronically enter an order that has the effect of creating or continuing a “locked” or “crossed” market?

No. The Participant has the obligation to ensure that orders entered electronically by a client (either with direct market access to a marketplace¹⁴ or with a connection to the order management system of the Participant) does not intentionally lock or cross the market.

IIROC recognizes that not all Participants that provide direct market access to clients may currently have this ability. IIROC expects that such Participants will immediately

¹⁴ See Market Integrity Notice 2007-010 – Guidance – *Compliance Requirements for Dealer-Sponsored Access Trading* (April 20, 2007).



take steps to modify their systems or their procedures for the handling of orders from clients with direct market access in such a way as to permit the Participant to comply with its obligations. IIROC expects that each Participant will have made the necessary modifications within 90 days following the date of this Rules Notice.

11. *May the policies and procedures adopted by a Participant allow it to exclude from consideration protected orders displayed on a particular marketplace?*

No. The policies and procedures adopted by a Participant to ensure against the intentional locking or crossing of markets must provide that the Participant take account of all protected orders. For example, a Participant may have established a practice of trading on marketplaces that disclose the identifier of the Participant in the order and trade information disseminated by that marketplace. In that case, the policies and procedures adopted to ensure compliance with the Locked and Crossed Market Order Provisions must take account of protected orders displayed by a marketplace that does not disclose Participant identifiers. The Participant would be able to withhold the entry of an order until it could be entered on a preferred marketplace without locking or crossing the market. However, in these circumstances, if the order to be entered is a client order subject to Rule 6.3 of UMIR dealing with the immediate exposure on a transparent marketplace of orders for 50 standard trading units or less, the Participant must have the specific instruction of the client to withhold the order from entry on a marketplace until such time as the prevailing market prices would permit the entry of the order on a marketplace that discloses the identifier of Participants without locking or crossing the market.

12. *Is there an exception from the prohibition on intentionally “locking” or “crossing” markets available for persons with market making obligations?*

No. Even if a person with market making obligations on a particular marketplace has agreed to maintain a two-sided market with a specified “spread” between the best bid price and best ask price on that marketplace, the market maker may not intentionally enter orders that have the effect of creating, or adding to, a “locked” or “crossed” market.

13. *Are there restrictions on the limit price at which various specialty orders may be entered?*

No. For example, an Opening Order entered on a particular marketplace may be entered with a bid price that is at or above the best ask price then displayed on a marketplace which is open for trading or with an ask price that is at or below the best bid price then displayed on a marketplace which is open for trading. In these circumstances, the person entering the order does not know what the prevailing



market price will be at the time the particular marketplace opens for trading and therefore has not “intentionally” locked or crossed the market. The same holds for orders which are entered to trade at a calculated price or a price that will be established at a future point in time (such as Closing Price Orders, Market-on-Close Orders, Call Market Orders and Volume Weighted Average Price Orders). A Closing Price Order may be entered on a marketplace to trade at the closing sale price of that security on that marketplace on that trading day even though, in the case of an order to buy, the closing price may be at or above the best ask price then displayed on another marketplace or, in the case of an order to sell, the closing price may be at or below the best bid price then displayed on another marketplace.

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