

## Chapter 13

# SRO Notices and Disciplinary Proceedings

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### 13.1.1 CNQ Notice and Request for Comments – Proposed Repeal of CNQ Rule 10-105

CNQ Notice 2005-06  
August 12, 2005

**CANADIAN TRADING AND QUOTATION SYSTEM INC.  
PROPOSED REPEAL OF CNQ RULE 10-105  
NOTICE AND REQUEST FOR COMMENTS**

The Board of Directors of Canadian Trading and Quotation System Ltd. (“CNQ”) has passed a resolution repealing CNQ Rule 10-105 upon Ontario Securities Commission approval following public notice and comment. The text of the resolution is attached to this notice as Appendix “A.” The text of the rule proposed to be repealed is attached to this notice as Appendix “B”.

The Board has determined that the proposed amendments are in the public interest and have authorized them to be published for public notice and comments. Comments should be made no later than 30 days from the date of publication of this notice and should be addressed to:

Canadian Trading and Quotation System Inc.  
BCE Place, 161 Bay Street  
Suite 3850, P.O. Box 207  
Toronto ON  
M5J 2S1

Attention: Mark Faulkner, Director, Listings and Regulation

Fax: 416.572.4160  
E-mail: Mark.Faulkner@cnq.ca

A copy should be provided to the Ontario Securities Commission at the following address:

Capital Markets Branch  
Ontario Securities Commission  
Suite 1903, Box 55  
20 Queen Street West  
Toronto ON  
M5H 3S8

Attention: Cindy Petlock, Manager, Market Regulation

Fax: 416.595.8940  
E-mail: cpetlock@osc.gov.on.ca

### Background

Rule 10 and certain other rules (e.g. Rule 4-108, which prohibits unreasonable mark-ups) were adopted to address concerns about abusive trading practices that occurred in the past on other markets, including the Canadian Dealing Network. In particular, certain dealers registered in Ontario as securities dealers (who were not members of an exchange or of the Investment Dealers Association of Canada) would engage in high-pressure sales tactics with vulnerable investors. These dealers charged excessive mark-ups on sales to customers and then refused to accept orders from those customers to sell out their positions. These were usually done in the context of “pump and dump” or boiler room stock manipulations.

Rule 10-105 has created problems. These include compliance issues (the difficulty in ascertaining that a client has signed off on the statement), reputation issues (creating a false perception among issuers, dealers and investors that CNQ and its listed companies are inherently more risky and prone to manipulation than other markets trading junior issuers) and effectiveness issues (the rule only applies to CNQ Dealers, not to other dealers trading client orders on CNQ through a CNQ Dealer).

## Content of the Rule

Rule 10-105 requires dealers to provide a risk disclosure statement to customers prior to executing the first solicited trade in a CNQ-listed security. The statement describes the differences in regulatory philosophy between CNQ and the TSX and TSX Venture exchanges. It also describes issues that arise in trading any low-priced stock or stock with a small public float. The customer must acknowledge receiving the statement in writing prior to execution of the first solicited trade.

## Effect of the Rule

The rule has created a compliance problem for dealers, as many have no established procedures for tracking whether a particular solicited order is the first solicited order in a CNQ-listed security or whether the customer has received the statement, other than relying on the customer's RR. While provision of risk disclosure statements is also required prior to trading in options, firms have established separate account ranges for option accounts and confirm delivery of the statement as part of account opening procedures. Dealers will not go through the trouble to set up new accounts solely for CNQ trading, and even if they provide the statement to all new customers on account opening, they cannot be certain about existing customers.

CNQ Dealers' compliance practices are varied and indicate confusion as to the scope of the rule.

The risk disclosure statement also creates a perception that the risk of investing in a CNQ-listed issuer is an order of magnitude higher than the Venture Exchange. In fact, the risks are generic to low priced stocks and stocks with smaller floats, even ones listed on the TSX. The rule has also been a barrier to attracting issuers, who fear they will be avoided by investors because of the risk disclosure statement. It has been cited by potential issuers and their financial advisors as a reason not to list on CNQ.

## Rule Not Needed

While the rule is a barrier to competition among marketplaces, it could be justified if it served a valid investor protection purpose. We do not believe this is the case for the following reasons:

### *Limited Applicability*

The rule only applies to the 18 CNQ Dealers, not to all dealers trading client orders on CNQ. We estimate that at least 20 other dealers access the CNQ market by jitting orders through CNQ Dealers. Thus, a significant portion of the constituency the rule is designed to protect does not benefit from it. Furthermore, investors trading low-priced securities on other markets, including NEX and the Canadian Unlisted Board, do not receive any risk disclosure.

### *Applicability of Other Rules*

Securities law and IDA rules provide a comprehensive investor protection regime. Repealing the risk disclosure statement will not change this. In particular, dealers have suitability and "know your client" obligations imposed on them by virtue of those rules. Some investors have refused to sign the statement because they erroneously believed they were waiving the protection of those rules. Some brokers may also be of the view that providing the statement eliminates the need to perform a suitability assessment.

### *Regulatory Framework*

CNQ is a regulated market subject to the same OSC oversight as the TSX. The IDA and Market Regulation Services Inc., which perform member and market regulation for the other exchanges, perform the same services for CNQ to the same standards. The regulatory framework and oversight provided by an exchange is the reason why the United States Securities and Exchange Commission exempted all US exchange-listed securities from its penny stock rule (see Exchange Act Rules 15c-1 to -9).

The problems in the CDN market that were at the root of the decision to require risk disclosure were largely attributable to the abusive trading practices of certain securities dealers. These dealers were not members of any self-regulatory organization and were not subject to comprehensive sales practice rules and compliance checks. The problem was not that the existing regulatory framework was insufficient to offer clients protection. It was. The problem was that the securities dealers were not subject to those rules.

This was exacerbated by the regulatory framework. CDN had no discretion to refuse a registered dealer access to its market, and had limited discretion to refuse an issuer quotation. It had no discretion to refuse to allow trade reporting apart from halting the issue. It also operated a pure dealer market lacking transparency where trades were negotiated over the telephone and reported to the market some time later, and where bids and offers were not firm.

The Ontario Securities Commission solved the first problem by taking aggressive enforcement action against the securities dealers, putting them out of business. In addition, it adopted Rule 31-507, which requires all brokers and securities dealers to be

members of an SRO. All CNQ Dealers must be members in good standing of the IDA, subject to its full panoply of sales practice rules and its oversight.

As for the second problem, CNQ has minimum standards that allow it to refuse to accept issuers or dealers whose past or present conduct give rise to concerns about market integrity or investor protection. CNQ has turned down issuer applications on this basis. CNQ can expel traders or dealers and suspend or delist issuers that do not comply with its rules.

#### *Company Regulation*

One of the purposes of the rule was to bring to investors' attention the difference between CNQ's approach to listed company regulation and that of the other exchanges. In fact, it overemphasizes this difference. CNQ has rules governing original and continued listing that are in many respects similar to those of the other exchanges. Probably the biggest difference is that CNQ will not, other than for fundamental changes, require shareholder approval of transactions over and above requirements of corporate and securities law. In practice, shareholder approval is routinely granted, often in writing by holders of a majority of the outstanding shares; until recently, shareholders of TSX-listed companies could grant "blanket" approvals for future arm's length private placements that would not constitute a change of control. We believe that our enhanced disclosure requirements, which allow shareholders to see notices of proposed transactions posted on the CNQ website, provides equivalent protection.

#### *Quality of the CNQ Marketplace*

Although its entry-level listing standards are lower in some respects than the TSX Venture's, the market is not sufficiently different that a risk disclosure statement is warranted in one but not the other. All but one listed issue have a market maker; all but a few have at least two and many have three or more. Unlike the CDN market, where bids and offers were akin to expressions of interest that were not executable without negotiation, bids and offers in the CNQ system can be hit or taken electronically. Recent rule changes have increased the number of orders that non market-making dealers may enter directly.

Automation of the CNQ market facilitates real-time and after-the-fact market monitoring and surveillance.

Market makers are present on one side of approximately half of trades on CNQ, accounting for about 25% of buying and selling activity. This is a significant addition to natural liquidity, and is much greater than was contemplated when the rule was drafted.

Price continuity has also been good. With 92% of trades occurring within 5 cents of the previous trade, it is apparent that the CNQ model is effective at limiting trade-to-trade price volatility.

#### *No Evidence of Abuses*

Finally, no systemic abuses have come to pass after 2 years of operation. Ongoing monitoring by Regulation Services and CNQ's Market Operations staff have uncovered isolated possible rule violations, but no pattern of trading that would suggest a greater potential for market manipulation than on the other exchanges.

#### **Consultation**

No formal consultations were undertaken with respect to the proposed rule.

#### **Alternatives Considered**

No alternatives were considered.

#### **Rules of Other Jurisdictions**

We are not aware of any other marketplace that has an equivalent rule or of any jurisdiction that has an equivalent rule for exchange-traded securities. Penny stock rules in the United States (see Exchange Act Rules 15g-1 to -9) do not apply to securities traded on a national securities exchange.

#### **Conclusion**

The requirement to provide a risk disclosure statement puts a regulatory burden on CNQ Dealers and puts CNQ at a competitive disadvantage, neither of which is justified by the end result. At best it provides disclosure to only a limited number of participants in one of three Canadian marketplaces that trade low-priced securities. It creates confusion and compliance problems for dealers and is a disincentive in attracting both listings and dealers to CNQ. Repealing the rule will not give rise to the abuses seen before because of the body of securities law and SRO rules, including "know your client" and suitability rules, that protect investors much more effectively than this rule could.

**APPENDIX "A"**

BE IT RESOLVED that:

1. Rule 10-105 and the accompanying note relating to risk disclosure statements is repealed.
2. This resolution is to be effective immediately upon Ontario Securities Commission approval following public notice and comment.

PASSED this 24<sup>th</sup> day of February, 2005, to be effective upon Ontario Securities Commission approval following public notice and comment.

"Ian Bandeen"  
Chairman

"Timothy Baikie"  
Secretary

**APPENDIX "B"**

***The text of the rule proposed to be repealed is as follows:***

**10-105** — When recommending the first trade with a client in a security of a CNQ Issuer, a CNQ Dealer or the registered representative shall provide a written risk disclosure statement to the client containing the disclosure required by CNQ and the client shall acknowledge receipt of the risk disclosure statement in writing prior to the execution of the first order.

**Note: CNQ Dealers shall use the following risk disclosure statement:**

**Trading on CNQ**

There are some important things to consider before investing in an issuer listed on CNQ. First, although CNQ has minimum standards that issuers must meet in order to be eligible for listing, these are lower than the standards for issuers listed on other stock exchanges. They should be considered speculative and investors in CNQ issuers should have a tolerance for higher-risk investments. There are no minimum financial requirements for eligibility for continued listing.

The CNQ standards and rules governing issuers can be found on the [www.cnq.ca](http://www.cnq.ca) website by clicking on "Issuer Info" and following the link to "Policies and Procedures."

Second, although CNQ has rules governing share issuances and major transactions by listed issuers, these rules may be less restrictive than another stock exchange's. CNQ will not generally review or "approve" a transaction in advance or require shareholder approval (unless the transaction constitutes a "fundamental change" under CNQ's issuer policies). Existing shareholders may suffer equity or voting dilution as a result of corporate transactions and may not be able to vote on those transactions.

Third, CNQ issuers must post enhanced disclosure on the CNQ website. This disclosure can be found on the [www.cnq.ca](http://www.cnq.ca) website by clicking on "Issuer Info" and "Disclosure Hall." Posting is entirely the issuer's responsibility and CNQ does not assume any responsibility for the timeliness, accuracy or completeness of those postings. CNQ will perform periodic reviews of issuers' disclosure record to determine compliance with applicable securities legislation and CNQ rules.

Fourth, CNQ issuers may have smaller floats of freely-tradeable stock than exchange-listed issuers. CNQ denotes certain issuers as "thin float" issuers at the time of listing, but floats on other issuers may also be smaller than for exchange-listed stocks.

If a stock has a small float, it is likely to have a larger spread (the difference between the bid, or the highest price at which someone is currently willing to buy and the offer, or the lowest price at which someone is willing to sell) and be less actively traded. An investor who wishes to buy or sell immediately will have to pay the spread, which could be very large relative to the price of the stock.

For example, assume ABC Co. has a bid of \$0.20 and an offer of \$0.25. An investor wishing to buy immediately would have to buy at \$0.25, which is a price 25% higher than the bid. Assuming the market stayed the same, if the investor wished to sell the security immediately, it would be sold at \$0.20 for a 20% loss. A security may have to go up considerably in value for an investor to make a profit after paying the spread and commissions.

An investor could minimize the price of paying the spread by entering a limit order (in the example above, a buy order of \$0.245 or less). However, the less active a stock is, the longer it will normally take for that order to be executed, and it may not be executed at all.

Stocks with small floats also tend to be more volatile as a relatively small order can push the price up or down because there are not enough offsetting orders in the book. The stock may overreact to corporate announcements of material information, going up (or down) in price sharply and then coming back. It is also easier for one person or a group of persons to control a large portion of the float, which could allow them to manipulate the price at which the security is bought and sold, which is against the rules governing trading on CNQ.

If a stock with a small float has only one market maker, it is likely that the market maker will establish the spread, as it will often be the only party willing to buy or sell at a particular point in time. If a stock with a small float does not have a market maker, at times there may be no bid or offer, in which case it will not be possible to trade the stock immediately.

Fifth, CNQ securities may be susceptible to hype. Beware of anyone touting a security as a "sure thing" or "sure to go up" or suggesting that they know information about the issuer that has not been made public. Be particularly wary if the person is not associated with a CNQ dealer. CNQ dealers are prohibited from making misrepresentations in order to induce someone to buy, sell or hold a security of a CNQ issuer, and are prohibited from using high pressure sales tactics. They also must tell you when

recommending a trade if their firm is the only market maker in the security (which means they may have established the market), if the firm will trade for its own account with your order (i.e. buy from or sell to you from their inventory of the stock) or if the stock has no market maker.