Dark Order Price Improvement Obligations When Trading Against an Odd-Lot Order

Executive Summary

IIROC proposes amendments to UMIR that are intended to clarify a Dark Order's[1] obligations respecting the requirement to provide a "better price"[2] when executing orders for less than one standard trading unit ("odd-lot order") ("Proposed Amendments").

The Proposed Amendments would confirm that the provision of price improvement by a Dark Order is not required if the order that it executes against is an odd-lot order. The Proposed

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[1]   The UMIR definition of Dark Order is set out on page 4 of this notice.

[2]   Better price is defined in UMIR to mean, in respect of each trade resulting from an order for a particular security:

   a)   in the case of a purchase, a price that is at least one trading increment lower than the best ask price at the time of the entry of the order to a marketplace provided that, if the best bid price is one trading increment lower than the best ask price, the price shall be at least one-half of one trading increment lower; and

   b)   in the case of a sale, a price that is at least one trading increment higher than the best bid price at the time of the entry of the order provided that, if the best ask price is one trading increment higher than the best bid price, the price shall be at least one-half of one trading increment higher.

Amendments would ensure requirements respecting the execution of odd-lot trades are applied in a consistent manner.

The text of the Proposed Amendments is set out in Appendix "A" and a blackline of the changes is set out in Appendix "B". If approved, the Proposed Amendments would be effective upon publication of the Notice of Approval.

How to Submit Comments

Comments are requested on all aspects of the Proposed Amendments, including any matter which they do not specifically address. Comments on the Proposed Amendments should be in writing and delivered by *April 13, 2015* to:

Kevin McCoy
Director, Market Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: kmccoy@iiroc.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Susan Greenglass
Director, Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, Ontario M5H 3S8
Fax: (416) 595-8940
e-mail: marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at www.iiroc.ca.

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1. Discussion of Proposed Amendments

1.1 Summary of Proposed Amendments

The Proposed Amendments, if approved, would confirm the pricing obligations of passive liquidity not displayed in the consolidated market display when trading against an odd-lot order. The Proposed Amendments are comprised of amendments to UMIR 6.6(2) that clarify that an odd-lot order is not required to receive a better price when trading against a Dark Order.

1.2 Dark Order Requirements to Execute at a Better Price When Trading Against an Odd-Lot Order

A Dark Order is defined in UMIR as:

(a)   an order no portion of which is displayed on entry on a marketplace in a consolidated market display; or

(b)   that portion of an order which on entry to a marketplace is not displayed in a consolidated market display if that portion may trade at a price other than the price displayed by that portion of the order included in the consolidated market display

but does not include an order entered on a marketplace as:

(c)   part of an intentional cross;

(d)   a market order that is immediately executed in full on one or more marketplaces at the time of entry;

(e)   a limit order that is immediately executed in full on one or more marketplaces at the time of entry;

(f)   a Basis Order;

(g)   a Call Market Order if that Call Market Order may only trade with other Call Market Orders and the matching of Call Market Orders occurs less frequently than once every minute;

(h)   a Closing Price Order;

(i)   a Market-on-Close Order;

(j)   an Opening Order; or

(k)   a Volume-Weighted Average Price Order.

Pursuant to this definition any resting order eligible to only execute against odd-lot orders would be considered a Dark Order if no portion is displayed on entry on a marketplace in a consolidated market display.

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UMIR 6.6(1) requires that an order for less than 50 standard trading units and with a value of $100,000.00 or less entered on a marketplace that executes against a Dark Order is executed at a "better price". UMIR 6.6(2) provides a list of order types that Dark Orders can execute against without providing a "better price". These order types include an order that is:

- a Basis Order;
- a Call Market Order;
- a Closing Price Order;
- a Market-on-Close Order
- an Opening Order; or
- a Volume-Weighted Average Price Order.

Odd-lot orders are not included in this list. Accordingly, under a technical application of UMIR, an odd-lot order, which is by its nature less than 50 standard trading units, that executes against a Dark Order must be executed at a "better price".

1.3   *Operation of Current Odd-Lot Facilities*

Toronto Stock Exchange ("TSX")

The TSX currently provides a facility for the execution of odd-lot orders as part of its market-maker program. TSX market-makers are required to provide odd-lot execution at the TSX best bid or offer as part of their market maker obligations. Market-maker odd-lot orders are not considered Dark Orders for the purposes of UMIR as they are created in response to an arriving active odd-lot order and are considered "immediately executable" upon entry[3]. Odd-lot orders that are not immediately tradable are booked into a special terms book that may be viewed by parties having the required access (i.e. access to Level 2 data). Executions of odd-lot orders in the TSX special terms book occur without the provision of a "better price".

TSX Venture Exchange ("TSX-V")

The TSX-V currently provides a facility for the execution of odd-lot orders. TSX-V odd-lot market-makers are required to provide odd-lot execution at the TSX-V best bid or offer as part of its market maker obligations. Market-maker odd-lot orders are not considered Dark Orders for the purposes of UMIR as they are created in response to an arriving active odd-lot order and are considered "immediately executable" upon entry. Odd-lot orders that are not immediately tradable are booked into a special terms book that may be viewed by parties having the required access (i.e. access to Level 2 data). Executions occur without the provision of a "better price".

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[3]   See subsections (d) and (e) of the definition of Dark Order on previous page. The definition excludes orders that are immediately executed in full on one or more marketplaces at the time of entry.

Alpha Exchange ("Alpha")

Alpha currently provides a facility for the execution of odd-lot orders. Alpha odd-lot market-makers are required to provide odd-lot execution at the Alpha best bid or offer[4] as part of its market maker obligations. Market-maker odd-lot orders are not considered Dark Orders for the purposes of UMIR as they are created in response to an arriving active odd-lot order and are considered "immediately executable" upon entry. Odd-lot orders that are not immediately tradable are booked into a special terms book that may be viewed by parties having the required access (i.e. access to Level 2 data). Executions of odd-lot orders are permitted to occur without the provision of a "better price".

The Canadian Securities Exchange ("CSE")

CSE provides an odd-lot facility where, for securities with Market Makers, odd-lots are executed immediately at the NBBO. Odd-lot orders that are not executable are booked into the odd-lot facility where they are eligible to be traded against in full or in part. Orders resting in the odd-lot facility may be viewed by parties having required access (i.e. access to Level 2 data). While booked odd-lot orders may execute at an improved price they are not obligated to execute at a "better price".

CX2

CX2 has published proposed changes that would introduce the trading of odd-lot orders. CX2 will seek out dealers to act as odd-lot market makers. The odd-lots will auto-execute at the NBBO. All odd-lot orders must be marked Immediate-or-Cancel ("IOC"). Any odd-lot order not marked as IOC will be rejected. Any odd-lot order not immediately executable will be canceled. Executions of odd-lot orders would occur without the provision of a "better price".

Omega ATS and LYNX

Both Omega ATS and LYNX offer an odd-lot trading book. When an odd-lot order is received, it checks against the odd-lot book for resting odd-lot order at the submitted price or better. If partially executed or no execution is available, the remaining volume is booked to the odd-lot book. When mixed-lot orders[5] are received, the order is split and the odd-lot portion will either trade, if possible, either fully or partially against resting odd-lot orders. Any unexecuted volume is booked to the odd-lot book. Orders resting in the odd-lot facility may be viewed by parties having required access (i.e. access to Level 2 data). Executions of odd-lot orders occur without the provision of a "better price".

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[4] On November 6, 2014, Alpha Exchange published a [Notice of Proposed Rule Amendments](#). The proposed amendments include a change where odd-lot orders would "auto execute" at the NBBO as opposed to the Alpha BBO.

[5] A mixed lot order is an order that is comprised of at least one standard trading unit and an odd-lot component.

2. Analysis

2.1 Benefits of Liquidity Provision to Facilitate Odd-Lot Order Execution

The consolidated market display includes standard trading units only and excludes odd-lot orders or the odd-lot portion of a mixed-lot order. Only orders representing full standard trading units are able to interact with the liquidity displayed on the consolidated market display. Odd-lot orders, being less than one standard trading unit, cannot trade against the liquidity displayed in the consolidated market display.

Currently, marketplaces are designed such that odd-lot orders may only trade on facilities specifically designed to provide odd-lot execution. Given that odd-lot orders are unable to trade against displayed liquidity, the provision of odd-lot liquidity on such facilities, whether through a market-maker obligation or otherwise, is critical to ensure that odd-lots are able to execute. Without such liquidity provision, the execution of an odd-lot order would be difficult. IIROC believes that a requirement to provide a "better price" when executing against an active odd-lot order is not balanced with the contribution that passive liquidity facilitating the execution of odd-lot orders brings to investors.

2.2 Consolidated Market Display

National Instrument 21-101 Marketplace Operation ("NI 21-101") requires that a marketplace that displays orders of exchange-traded securities to a person or company provide accurate and timely information regarding orders for the exchange-traded securities displayed by the marketplace to an information processor ("IP"). Part 5.1 (3) of Companion Policy 21-101 ("CP 21-101") clarifies that the CSA do not consider special terms orders that are not immediately executable or that trade in special terms books to be orders that must be provided to an IP. While "special terms order" is not defined in NI 21-101, the UMIR definition of special terms order includes an order for the purchase or sale of a security for less than one standard trading unit.

In UMIR, "consolidated market display" is defined as information on orders or trades from each marketplace on which a particular security trades that has been processed by an IP in accordance with Part 14 of NI 21-101. The IP only processes orders and trades provided by the marketplace in accordance with Part 7 or 8 of NI 21-101. As noted above, "special terms orders" are not required to be provided to the IP for processing.

In practice, odd-lot orders are not processed by the IP and do not contribute to the consolidated market display. The consolidated market display is limited to standard trading units only.

2.3　Treatment of Odd-Lot Orders in other UMIR Provisions

"Disclosed Volume"

In UMIR, "disclosed volume" means the aggregate of the number of units of a security relating to each order for that security entered on a protected marketplace and displayed in a consolidated market display. This definition excludes, among other order types, the volume of Special Terms Orders (which include odd-lot orders).

"Best Ask Price" and "Best Bid Price"

The UMIR definitions of both "best ask price" and "best bid price" consider the highest/lowest prices displayed in a consolidated market display, but specifically exclude, among other types of orders, Special Terms Orders (which include odd-lot orders).

"Last Sale Price"

The UMIR definition of "last sale price" means the last sale of at least one standard trading unit of a particular security displayed in a consolidated market display but does not include the price of a sale resulting from an order that is, among other things, a Special Terms Order (which includes an odd-lot order) unless the Special Terms Order has executed with an order or orders other than a Special Terms Order.

Trade Cancellation and Variation

IIROC confirmed in the 2013 annual compliance report that IIROC would no longer intervene in the execution of odd-lot orders at unreasonable prices.[6] The annual compliance report noted:

> *"Odd lot executions do not impact the last sale price, volume-weighted average price (VWAP), closing price or other common benchmarks and market integrity is not impaired by the existence of unreasonable or erroneous odd lot trades."*

2.4　Treatment of Odd-Lot Orders in the United States

Rule 610 of Regulation NMS ("Reg NMS") provides the framework for the fair access to quotations of NMS securities by all national securities exchanges and national securities associations. Rule 611 of Reg NMS requires that all trading centers establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations in NMS stocks. The U.S Securities and Exchange Commission ("SEC") previously issued guidance that clarified that the provision of Reg NMS

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[6]   The discontinuing of intervention respecting odd-lot trades at unreasonable or erroneous prices was also set out in IIROC Notice 13-0297 – Rules Notice – Technical - *Variation and Cancellation of Odd Lot Trades* (December 10, 2013).

Rule 610 (Access to quotations) and Reg NMS Rule 611 (Order Protection Rule) do not apply to odd-lot orders. The SEC noted in its guidance[7] that:

> *"Rule 610 and Rule 611 do not apply to odd-lot orders or to the odd-lot portions of mixed-lot orders. Rule 600(b)(8) defines "bid" or "offer" as the bid price or offer price for one or more round lots of an NMS security. This definition is embedded in the definition of "quotation" in Rule 600(b)(62), as well as the definition of "protected bid" or "protected offer" in Rule 600(b)(57). Consequently, trading centers are permitted to establish their own rules for handling odd-lot orders and the odd-lot portions of mixed-lot orders. For example, although trading centers are not required to handle odd-lot orders or the odd-lot portions of mixed-lot orders in accordance with the requirements for automated quotations set forth in Rule 600(b)(3), they are free to incorporate such requirements in their rules if they wish to do so."*

Pursuant to Reg NMS the execution of an odd-lot order may trade through the protected quote resulting in an execution at a worse price than the displayed quote. Markets in the United States that accept odd-lot orders have adopted their own procedures for the handling of odd-lot orders which generally provide for the execution of odd-lot orders at the quote.

> *New York Stock Exchange ("NYSE")*

On July 27, 2010, the SEC approved rule amendments respecting the handling of odd-lot orders on the NYSE. When sufficient odd-lot interest is received that can be aggregated to round lots, the round lots are posted to the exchange and are included in the protected quote. The designated market maker is no longer the counterparty to odd-lot trades, and only has obligations for unmatched odd-lot interest at the opening, the re-opening following a halt and at the close. There is no requirement that the odd-lot executions occur at a price better than the protected quote. Odd-lot orders that cannot be aggregated to round lots are booked on the exchange at their limit prices and are not displayed in the exchange quote.

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[7]   See question 7.03 of "Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS" (http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm)

3. Impacts of the Proposed Amendments

3.1 Participant Impacts

IIROC does not believe that the Proposed Amendments will impact Participants.

3.2 Marketplace Impacts

IIROC does not believe that the Proposed Amendments will impact marketplaces, as the Proposed Amendments support current and proposed odd-lot execution facilities.

4. Implementation Plan

If approved, the Proposed Amendments would become effective upon publication of the Notice of Approval.

5. Policy Development Process

5.1 Regulatory Purpose

The Proposed Amendments would add consistency to the treatment of odd-lot order execution across all marketplaces and support liquidity provision to facilitate the execution of such orders which is beneficial to investors, including retail investors.

The Proposed Amendments do not impose any burden or constraint on competition. They do not impose costs or restrictions on the activities of market participants.

5.2 Regulatory Process

The Board of Directors of IIROC ("Board") has determined the Proposed Amendments to be in the public interest and on January 28, 2015 approved them for public comment. The Market Rules Advisory Committee of IIROC considered this matter as proposed in concept by IIROC.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Canadian provincial securities regulatory authorities ("Recognizing Regulators"), IIROC may recommend that revisions be made to the proposed amendments. If the revisions are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the proposed amendments as revised will be subject to approval by the Recognizing Regulators. If the revisions are material, the proposed amendments as revised will be submitted to the Board for approval for republication.

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Appendix A – Proposed UMIR Amendments

The Universal Market Integrity Rules are hereby amended as follows:

1.   Subsection (2) of Rule 6.6 is amended by:
    (a)   deleting "or" at the end of subclause (e);

    (b)   deleting "." and adding "; or" at the end of subclause (f); and

    (c)   adding the following subclause:
        (g)   for less than one standard trading unit.

Appendix B – Text of UMIR to Reflect Proposed UMIR Amendments Respecting Odd-Lot Price Improvement

Text of Provision Following Adoption of the Proposed UMIR Amendments	Text of Current Provisions Marked to Reflect Adoption of the Proposed UMIR Amendments

6.6   Provision of Price Improvement by a Dark Order
 	
(2) Subsection (1) does not apply if the order entered by the Participant or Access Person is:
 	
    (a)   a Basis Order;
    (b)   a Call Market Order;
    (c)   a Closing Price Order;
    (d)   a Market-on-Close Order;
    (e)   an Opening Order;
    (f)   a Volume-Weighted Average Price Order; or
    (g)   for less than one standard trading unit.
	6.6 Provision of Price Improvement by a Dark Order
	
	(2) Subsection (1) does not apply if the order entered by the Participant or Access Person is:
	
	    (a) a Basis Order;
	    (b) a Call Market Order;
	    (c) a Closing Price Order;
	    (d) a Market-on-Close Order;
	    (e) an Opening Order; ~~or~~
	    (f) a Volume-Weighted Average Price Order~~.~~; or
	    (g) for less than one standard trading unit.

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