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Dear Ms. Dobrowsky and Mr. McCoy:

Re: Proposed changes to procedural requirements applicable to "wash trades"

The Investment Industry Association of Canada (the "IIAC" or "Association") has been approached by a number of members concerned about what appears to be new regulatory expectations regarding the treatment of wash trades.

These new expectations were articulated at the December 4, 2013 CLS meeting, and appear to be confirmed in the Annual Consolidated Compliance Report dated December 9, 2013.

Based on the presentation at the CLS meeting, as well as discussions members have had with IIROC staff, we understand that IIROC will be taking a more stringent approach to

wash trades from both a client perspective, where trades involve direct electronic access, and in respect of trades within firms involving inventories across different divisions. We understand that, contrary to existing practice and previous guidance from IIROC in its Guidance Note 2005-029 dated September 1, 2005, *Entering Orders on Both Sides of the Market*, dealers cannot rely on the exceptions from the general prohibition. The Guidance indicates that in respect of Trades Executed by an Automated Program Trading System, IIROC will provide an exception where a Participant has taken "reasonable steps to ensure that the automated program trading system does not enter orders that may execute as a wash trade on a regular basis. We understand that IIROC is now of the view that members must use the programs and tools currently available through various exchanges and marketplaces in order to comply with this "reasonable steps" requirement. For the reasons outlined below, this is not a practical approach and will not result in compliance without significant unintended consequences.

While we do not object to the underlying regulatory objective behind this new change in IIROC's approach, we have a number of concerns regarding its implementation.

1. **There is currently insufficient technological capability among marketplaces and service providers to support this requirement.**

   Currently the availability of the technology and systems to achieve the objective of significantly reducing the existing level of wash trading is extremely inconsistent among exchanges and ATSs. For example, while Alpha has a reasonably developed system that would achieve the regulatory objectives while minimizing unintended consequences, other exchanges and ATSs either have no such technology, or systems that operate using varying and conflicting parameters that would result in problems including trade-throughs and other violations of order protection rules.

   Given that the order protection rule requires dealers to canvass and be able to execute trades, and portions of trades on all marketplaces, in order to avoid significant execution problems when trades occur on both sides of the market, it is critical that marketplaces employ consistent behaviour with respect to how such trades are dealt with. Currently, the different "anti-wash tags" employed by the different marketplaces operate using different conventions, and promote different outcomes. If a trade is conducted on more than one marketplace, these conflicting conventions and objectives would result in unpredictable outcomes and possible breaches of other regulations including locked and crossed market rules and order protection violations.

   As part of the presentations to CLS, we understand that there is an expectation that wash trades (regardless of whether they were inadvertent, non-related crosses) should be monitored real time and the trades should be taken down same day. If they are detected T+1, then it would be acceptable to collect

information on the trades and file a gatekeeper report on a monthly basis. While we can appreciate that it may be preferable to take down the trade to avoid impacts to last sale, VWAP etc., it is far from certain that all of the marketplaces can handle the call volume that would result from such a policy.

In respect of best practices that would minimize market impact, we recommend that IIROC examine the wash trading processes undertaken by Alpha, under which the trade would not be cancelled, but it would not print.

2. **Dealers' internal divisions have different objectives and algorithms to achieve the objectives.**

   Many firms, particularly larger firms with several different divisions, trade for clients and firm books with different objectives. As such, the firms' divisions often have separate books and trading within the firm for the same securities is not integrated due to the presence of information barriers. The various trading strategies are designed to achieve the best outcome for the groups employing these strategies, and require different algorithms to achieve the intended outcomes. As such, it is not possible to redesign the trading algorithms to line up to prevent unintentional wash trades, as this may have a detrimental market impact on the clients.

3. **We understand that the gatekeeper filing provisions would apply to the reporting of wash trades.**

   It is unclear whether this is intended to be an informational filing or included in an official gatekeeper report. This is problematic, as under UMIR 10.16, gatekeeper reporting is a formal process for reporting rule violations, which has specific timelines and documentation. Given that gatekeeper reports typically form key risk indicators in a compliance program, we agree that if a wash trade could be considered manipulative and deceptive, it would be appropriate to report under this section, however, inadvertent wash trades should not be reported under this section.

   Members are unclear as to the timing of the reporting requirements for wash trades. Certain members recalled that reporting would be required monthly, others indicated that weekly reporting would be required. It is imperative that if gatekeeper provisions apply, the reporting process should be consistent with provisions under UMIR 10.16 and communicated consistently across the entire IIROC membership.

4. **US Approach**

   We note that FINRA published a proposed rule change relating to wash trades in August 2013. The proposal recognizes and specifically excludes transactions that originate from unrelated algorithms or from separate and distinct trading strategies (e.g., separate "desks," aggregation units, or algorithms that are separated by information barriers). The regulation acknowledges that, as a result of such different or competing investment strategies within the same firm, there may be transactions where a single firm is on both sides of the trade. The proposed regulation indicates that these would generally be considered bona fide transactions and would not be considered wash sales for purposes of Rule 5210, provided the trades are not undertaken with fraudulent or manipulative intent.

   http://www.sec.gov/rules/sro/finra/2013/34-70276.pdf

5. **This new regulatory expectation is a significant departure from existing practice and formerly issued guidance, and should be subject to a formal industry comment process**

   A change in IIROC's approach to how wash trades should be handled has much more significant implications than adopting a new trading tag, or implementing established technology. As noted above, given the lack of technological and procedural consistency among marketplaces, and considering the differing trading objectives among firm departments, there are material issues that must be addressed before such a change can be implemented without significant implications for firms and clients.

   In addition, since the communication of the new expectations were limited to the CLS meeting and a brief paragraph without details in the Annual Consolidated Compliance Report, many members are not aware of this potential significant change in regulatory expectations. Given all of these factors, it is appropriate that IIROC undertake a formal industry consultation to ensure that all of the implications are considered and a cost – benefit analysis is undertaken before implementation.

Given the significant potential impact of a change in regulatory expectations relating to wash trades on firms, clients, and the market, we recommend that IIROC identify the nature and scope of the specific market problem that prompted this change in practice. Once the issues and the actual market harm are articulated, IIROC should work with firms, marketplaces and service providers to determine whether a market-wide solution is warranted. If so, all parties should work together to develop the best solution, which

would involve the development of consistent standards among all marketplaces to address the issue, while minimizing market impact. The process should include the formation of a working group, as well as publication of a policy subject to a request for comments.

Thank you for considering our suggestions. Our working group would be pleased to meet with you to discuss any questions you may have.

Yours sincerely,

Susan Copland