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Borden Ladner Gervais

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Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Service Newfoundland and Labrador
Northwest Territories Office of the Superintendent of Securities
Office of the Yukon Superintendent of Securities
Nunavut Securities Office

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Dear Sir/Mesdames:

**Re: CSA Staff Notice and Consultation 11-348 – Applicability of Canadian Securities
Laws and the Use of Artificial Intelligence Systems in Capital Markets**

We are pleased to provide the members of the Canadian Securities Administrators (the **CSA**) with
comments on *CSA Staff Notice and Consultation 11-348 – Applicability of Canadian Securities Laws
and the Use of Artificial Intelligence Systems in Capital Markets* (the **Notice**) published by the CSA
on December 5, 2024, which examines the applicability of Canadian securities laws to artificial
intelligence (**AI**) systems in capital markets. Following our initial comments, we will respond to
certain of the specific consultation questions set out in the Notice.

We thank you for the opportunity to comment on the Notice. This letter represents the general comments of certain individual members of the Securities and Capital Markets practice group at Borden Ladner Gervais LLP (**BLG**). Our comments are not those of BLG generally or any client of the firm. Our comments are being submitted without prejudice to any position taken or that might be taken in the future by BLG on our own behalf or on behalf of any client.

Where our comments are in response to specific questions posed in the Notice, we have included the text of the question for ease of reference. Capitalized terms used in this letter that are not defined have the meanings attributed to them in the Notice.

Part A – General Comments

We commend the CSA for its thoughtful and proactive efforts to provide clarity and guidance on the application of securities legislation to the rapidly evolving role and use of AI systems in capital markets. The Notice represents a significant step in fostering responsible innovation while maintaining the stability and integrity of Canada's capital markets.

The CSA's commitment to smart, responsive regulation and its efforts to balance innovation with necessary regulatory safeguards is commendable, as it reflects a clear understanding of the potential benefits and risks associated with AI systems and provides valuable guidance for market participants.

Consultative initiatives like this are critical in addressing emerging technologies, building trust, and supporting an adaptable regulatory framework. The Notice provides valuable insights and guidance on compliance with existing laws throughout the AI systems lifecycle. The increasing use of AI in capital markets presents unique opportunities to enhance efficiency, risk management, and decision-making. However, it also introduces concerns related to transparency, systemic risk, and regulatory compliance, which must be carefully managed.

Support for the CSA's Approach

Subject to our specific comments below, we are generally supportive of the CSA's approach and guidance. We appreciate the CSA's attempt to address critical issues such as investor protection, systemic risk, and market transparency, while recognizing the potential efficiencies and competitive advantages AI systems can bring. At a time where Canada's capital markets are in decline and facing significant challenges, a flexible regulatory framework that adapts to technological advancements is required. All regulatory initiatives should be targeted at ensuring that Canada's capital markets remain resilient, competitive and attractive to both domestic and international businesses and investors.

I.   **Overarching Themes Relating to the use of AI systems**

While the Canadian securities regulatory regime is largely principles based, enhancing clarity and specificity in regulatory expectations, particularly in areas such as AI governance, disclosure, and conflict mitigation, would provide market participants with more actionable insights. As AI systems continue to evolve, it is essential for the regulatory approach to remain dynamic and balance innovation with investor protection to foster trust and stability in the capital markets.

The Need for Global Alignment and Continued Engagement

To further enhance the CSA's efforts, we recommend ensuring alignment with global best practices and providing clarity on compliance expectations. It is equally important to develop practical tools to support smaller market participants who may face resource constraints. The CSA's focus on harmonizing regulatory approaches across Canada and at international levels is crucial for fostering regulatory certainty and easing compliance burdens for stakeholders.

We encourage the CSA to maintain a collaborative and flexible approach as AI systems evolve. Canadian market participants' and other stakeholders' ability to leverage and use AI is likely to be a key element of the competitiveness of the Canadian capital markets and will serve to benefit investors if used properly. Ongoing engagement with market participants, industry experts, and international regulators will be critical to refining the regulatory framework and ensuring its continued relevance. Additionally, prioritizing clarity in the application of existing securities laws to AI systems can help address potential challenges arising from inconsistent interpretations. Incorporating global best practices, such as those being developed by the International Organization of Securities Commissions (**IOSCO**), will further enhance the CSA's role in shaping AI regulation in capital markets.

II.   Recommendations

While the CSA's focus on governance, disclosure, and oversight is a positive step, there are a few areas where further clarity could assist market participants in navigating the evolving regulatory framework to effectively implement AI regulations in capital markets. The following recommendations are aimed at strengthening the CSA's guidance and addressing areas where additional clarity, emphasis, or flexibility could improve the regulatory framework.

1. **Clarification of Compliance Expectations**: We are supportive of greater clarity on compliance expectations, particularly in areas such as governance, disclosure, and conflict mitigation. For example, additional guidance on specific measures to mitigate risks associated with AI in trading and other capital market activities would be beneficial.[1] IOSCO's engagement with firms has highlighted several considerations to mitigate the risks posed by AI and machine learning, including culture, accountability, knowledge/expertise/skills, and operational resilience, which could be applied to Canadian markets.

2. **International Regulatory Alignment**: Aligning guidance with global best practices, such as those being developed by IOSCO and the European Union's *Artificial Intelligence Act*[2] (**EU AI Act**) will help ensure consistency and regulatory certainty. Harmonizing approaches at the provincial, national, and international levels will also ease compliance burdens for stakeholders. While the Notice references collaboration with IOSCO, a more detailed discussion on international regulatory alignment, including how the CSA's approach compares to other major

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[1] IOSCO, "The Use of Artificial Intelligence and Machine Learning by Market Intermediaries and Asset Managers (Final Report)", (September 2021), available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD684.pdf.

[2] Regulation (EU) 2024/1689 of the European Parliament and of the Council of 13 June 2024 laying down harmonised rules on artificial intelligence and amending Regulations (EC) No 300/2008, (EU) No 167/2013, (EU) No 168/2013, (EU) 2018/858, (EU) 2018/1139 and (EU) 2019/2144 and Directives 2014/90/EU, (EU) 2016/797 and (EU) 2020/1828 (Artificial Intelligence Act)*,* available at: http://data.europa.eu/eli/reg/2024/1689/oj.

jurisdictions and its plans for ongoing cross-border collaboration on AI-related issues, would be valuable.

3. **Greater Focus on Risk Mitigation for Systemic Risks**. We urge the CSA to establish clear expectations for market participants regarding the mitigation of systemic risks, particularly in high-impact areas such as trading algorithms, high-frequency trading, and market surveillance. These should include specific measures to enhance accountability in AI decision-making, ensure human oversight, and address algorithmic biases. Additionally, further specification of regulatory expectations for firms utilizing AI in capital markets would help mitigate concerns around market manipulation and excessive volatility. Risk mitigation strategies could involve mandatory stress testing, circuit breakers, and contingency plans for AI-related failures, such as sudden market volatility, unexpected adverse events or system outages,[3] to bolster market stability and integrity.

4. **Third-party AI systems Oversight and Canadian market participants**. In developing expectations and directives with respect to third-party AI systems oversight, we encourage the CSA to be mindful of the fact that a significant proportion of Canadian market participants are small and medium-sized enterprises with limited capacity to effectively oversee and monitor third-party service providers, particularly as they may not have the requisite expertise to critically analyze AI systems and identify potential issues.

5. **Registrants – Firms and Individuals.** To the extent that the CSA is of the view that the use of certain AI systems by registrants requires disclosure, we believe registrants should be able to use their professional judgement in determining the level of such disclosure, commensurate with the role and risks of the AI system in question to the services being provided to investors. To assist registrants in making this determination, the CSA should consider the introduction of illustrative examples, or a tiered disclosure framework based on AI's materiality to business operations. The CSA might also consider testing disclosure approaches with their behavioural insight teams to calibrate investor understanding of a very technical, complex issue with a registrant meeting its disclosure obligations. For firms using AI, the CSA may expect that at least certain registered individuals will possess AI-related knowledge and expertise, as well as the proficiency and relevant investment management experience required under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. We encourage the CSA to consider the impact this expectation may have on the CSA's registration processes, including with respect to labour supply and the process for reviewing and approving applications for registration. Consideration should also be given to whether there is appropriate training readily available for the registrant community and whether AI expertise is a proficiency that can be obtained in a timely manner. The inclusion of AI-related education in proficiency courses should be encouraged.

6. **Non-Investment Fund Reporting Issuers (Non-IF Issuers).** While the CSA's disclosure recommendations for Non-IF Issuers are welcome, practical challenges remain. Non-IF Issuers may struggle with uncertainty regarding the extent of AI-related disclosure required. To address this, the CSA should consider the introduction of illustrative examples, or a tiered disclosure

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[3] National Institute of Standards and Technology (NIST), "Artificial Intelligence Risk Management Framework (AI RMF 1.0)", (January 2023), available at: https://doi.org/10.6028/NIST.AI.100-1.

framework based on AI's materiality to business operations. Without such clarity, there is a risk of over-disclosure (leading to unnecessary compliance burdens) or under-disclosure (raising investor protection concerns). Any additional disclosure requirements should be balanced with investor needs and efforts to encourage a robust and competitive Canadian capital market.

7. **AI Regulatory Sandbox.** We encourage the CSA to consider establishing an AI regulatory sandbox, allowing market participants to test AI applications in a controlled environment. As AI adoption accelerates, a more adaptive regulatory approach, including periodic AI-specific compliance reviews and collaboration with global regulators, will be necessary to maintain market integrity and investor protection.

8. **CSA's Use of AI.** Given heightened disclosure expectations with respect to the development and use of AI systems, the CSA should ensure that it is staffed with individuals who understand AI and its application in various areas, including to registered firms and registrable functions. We also encourage the CSA to disclose the ways in which the members of the CSA are using AI in their regulation of capital markets, for example, disclosure of whether AI is being used in issue-oriented continuous disclosure reviews.

Overall, we believe that the Notice provides a strong foundation for addressing AI systems in Canadian capital markets. The technology-neutral approach, emphasis on existing regulatory frameworks, and focus on key issues such as governance, explainability, and disclosure is commendable. The measures outlined in the Notice, combined with the insights gathered from this consultation, will undoubtedly contribute to the continued stability and success of Canada's capital markets.

Part B – Response to CSA Questions

Question 1: *Are there use cases for AI systems that you believe cannot be accommodated without new or amended rules, or targeted exemptions from current rules? Please be specific as to the changes you consider necessary.*

We acknowledge that while many AI use cases can function within existing regulatory frameworks, certain applications may require new or updated rules or targeted exemptions to address the unique challenges AI systems present in ensuring compliance with securities laws. Key areas that may require tailored regulatory updates include:

- **Explainability Requirements:** AI models, particularly deep learning systems used in high-frequency trading, portfolio management, and algorithmic decision-making, often lack transparency. Clearer guidelines on explainability, such as requiring firms to document decision-making processes, provide detailed model risk assessments (including how AI models work, the data they use, and how risks are evaluated), and maintain audit trails to ensure accountability, could help address this. Updating governance standards to define human oversight roles in AI-driven trading and investment decisions may also be necessary.

- **AI-Related Disclosure Standards:** Firms using AI systems for trading, investment management, or financial reporting may need enhanced disclosure to ensure market integrity and investor protection. These obligations could include disclosures on AI-related risks, operational failures, governance frameworks, and the extent of AI's role in investment

decisions. Updated AI guidance in the Companion Policies to certain instruments, such as National Instrument 51-102 *Continuous Disclosure Obligations*, National Instrument 41-101 *General Prospectus Requirements* (and the other prospectus Instruments), and National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (and its related Forms), could ensure issuers disclose material AI reliance and associated risks.

- **Regulatory Alignment and Compliance:** AI systems present new opportunities for regulatory compliance, market surveillance, and investment advisory services, but existing regulations were designed for human-driven processes. Targeted amendments, exemptions, or additional guidance may be necessary to address AI complexities while reducing unnecessary burdens on market participants. Establishing regulatory sandboxes to allow market participants to test AI compliance solutions in a controlled environment before full-scale implementation, while also updating market surveillance tools to leverage AI for detecting market manipulation or fraud, would ensure more effective regulation and oversight without the immediate application of all regulatory requirements.

While current regulations provide a solid foundation, AI's rapid influence warrants ongoing two-way discourse between regulators and market participants. A principles-based approach focusing on explainability, disclosure, and investor protection would help AI use cases align with market integrity. With thoughtful regulatory adjustments, the CSA can support the safe and effective integration of AI in Canada's capital markets.

Question 9: *Should market participants be subject to any additional rules relating to the use of third-party products or services that rely on AI systems? Once such a third-party product or service is in use by a market participant, should the third-party provider be subject to requirements, and if so, based on what factors?*

Market participants should continue to be held to the same standards regardless of whether they are using third-party AI products or services. As such, market participants will have to work to ensure that AI products and services are evaluated with respect to their track record, adequacy of risk management practices, data security, regulatory compliance standards, etc. in order to mitigate liability risks. Market participants should be aware of their liability under securities regulations and that their use of AI will not alleviate them of such liability. In other words, market participants will bear responsibility for any AI output that they rely on and/or use in their regulated activities.

As noted above, to the extent that AI use presents a material risk to a market participant's business, disclosure of the use of AI and the related risks is warranted.

Question 10: *Does the increased use of AI systems in capital markets exacerbate existing vulnerabilities/systemic risks or create new ones? If so, please outline them. Are market participants adopting specific measures to mitigate against systemic risks? Should there be new or amended rules to account for these systemic risks? If so, please provide details.*

Examples of systemic risks could include the following:

- *AI systems working in a coordinated fashion to bring about a desired outcome, such as creating periods of market volatility in order to maximize profits;*

- *Widespread use of AI systems relying on the same, or limited numbers of, vendors to function (e.g., cloud or data providers), which could lead to financial stability risks resulting from a significant error or a failure with one large vendor;*

- *A herding effect where there is broad adoption of a single AI system or where several AI systems make similar investment or trading decisions, intentionally or unintentionally, due, for example, to similar design and data sources. This could lead to magnified market moves, including detrimental ones if a flawed AI system is widely used or is used by a sizable market participant;*

- *Widespread systemic biases in outputs of AI systems that affect efficient functioning and fairness of capital markets.*

While there are significant benefits to the use of AI, the increased use of AI systems in capital markets may exacerbate existing vulnerabilities and introduce new systemic risks. These risks stem from the scale, interconnectedness, and opacity of AI systems, which can amplify market disruptions, create new vulnerabilities, and lead to unintended consequences. Key concerns include herding effects, vendor concentration, market manipulation, systemic biases, and cyber risks. To mitigate these risks, regulators may need to consider new or amended rules to ensure market integrity and stability. However, any such efforts should be balanced by a regulatory approach that fosters innovation, market efficiency and competitiveness of Canadian capital markets.

Conclusion

Overall, we believe that the Notice provides a strong foundation for addressing AI systems in Canadian capital markets. The technology-neutral approach, emphasis on existing regulatory frameworks, and focus on key issues such as governance, explainability, and disclosure is commendable. The measures outlined in the Notice, combined with the insights gathered from this consultation, will undoubtedly contribute to the continued stability and success of Canada's capital markets.

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Thank you for the opportunity to comment on the Notice. Please do not hesitate to contact any of the undersigned if you have any questions with respect to our comments above or wish to discuss.

Sincerely,

Laura Levine   **Melissa Ghislanzoni**   **Yemisi Afolabi**
Partner   Counsel   Associate