Notice

Draft *Regulation 23-103 respecting Electronic Trading and Direct Electronic Access to Marketplaces*

I. INTRODUCTION

The Canadian Securities Administrators (CSA or we) are publishing draft *Regulation 23-103 respecting Electronic Trading and Direct Electronic Access to Marketplaces* (Draft Regulation) and Policy Statement to *Regulation 23-103 respecting Electronic Trading and Direct Electronic Access to Marketplaces* (Draft Policy Statement) for comment. The Draft Regulation introduces provisions governing electronic trading by marketplace participants and their clients. It also introduces specific obligations for direct electronic access (DEA).[1] DEA does not include retail trading whereby clients access accounts through the internet.

The Draft Regulation would also provide a regulatory regime for DEA.

CSA staff have been working closely with staff of the Investment Industry Regulatory Organization of Canada (IIROC) on the development of the Draft Regulation. IIROC staff have shared their knowledge and expertise regarding many of the issues being raised by electronic trading and we thank them for their valuable contribution.

II. DISCUSSION

1. Evolution of the Canadian Market

The Canadian equity market has changed dramatically in recent years. It has moved from a single marketplace environment to multiple marketplaces with exchanges and alternative trading systems (ATSs) trading the same securities. As the markets have evolved, technology has also evolved, increasing the speed, capacity and complexity of how investors trade.

In Canada, electronic trading has been used for many years. The Toronto Stock Exchange was one of the first fully electronic exchanges in the world. Over the past few years, the use of technology has proliferated and the introduction of new marketplaces has driven the need by marketplaces to continuously improve technology by making it faster and more efficient and effective to execute trading strategies. Participants are also using strategies and algorithms that are increasingly complex and demand greater investments in technology and capacity by the participant as well as regulators, vendors and marketplaces.

In addition, technology has enabled marketplace participants to facilitate access by their clients to marketplaces. For example, DEA has enabled clients to use their own systems or algorithms to directly send orders to the marketplaces of their choice. In certain instances this trading goes through the systems of a dealer where pre-trade controls are used while in others, orders do not pass through a dealer's systems and no controls are in place. These DEA clients are usually large, institutional investors with regulatory obligations of their own. However, they may be retail clients that have particular sophistication and resources to be able to manage DEA in accordance with the standards set by a participant dealer.[2]

Market events, such as the May 6, 2010 "flash crash" have illustrated that the speed and complexity of trading require a greater focus on controls designed to mitigate the risks

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[1] Section 1 of the Draft Regulation defines "direct electronic access" as "the access to a marketplace provided to a client of a participant dealer through which the client transmits orders, directly or indirectly, to the marketplace's execution systems under a marketplace participant identifier without re-entry or additional order management, by the participant dealer".

[2] Section 1 of the Draft Regulation defines "participant dealer" as "a marketplace participant that is an investment dealer".

of these technological changes. Globally, regulators are looking at the risks associated with electronic trading, including DEA, and are introducing frameworks to address them (see section III.4 below).

2. Risks of Electronic Trading

As stated, the Canadian market has undergone a very rapid evolution in structure. With the proliferation of the use of complicated technology and strategies, including high frequency trading strategies, comes increased risks to the market. These risks are described below.

(i) Liability Risk

Liability risk relates to the risk to the market where there is uncertainty as to which party will bear the ultimate responsibility of any financial liabilities, regulatory transgressions or market disruptions incurred through electronic trading. Marketplace participants have indicated that there exists uncertainty in some instances regarding ultimate responsibility in relation to trades occurring pursuant to DEA.

As electronic trading gets faster, there is a greater risk of issues occurring that result in liability. For example, systems failures or the execution of erroneous trades may cause losses or situations where parties are manipulating the market using DEA. There is a need to have clarity as to who will be held responsible for ensuring that these risks are appropriately and effectively controlled and monitored.

(ii) Credit Risk

Credit risk is the risk that a marketplace participant, specifically a dealer, will be held financially responsible for trades that are beyond its financial capability, as well as the broader systemic risk that may result if the dealer is unable to cover its financial liabilities.

The speed at which orders are entered into the market by marketplace participants or DEA clients increases the risk that without controls, trades may exceed credit or financial limits. This may occur because marketplace participants or clients cannot keep track of the orders being entered or because erroneous trades are entered and executed because no controls or a lack of proper controls exist to stop them. Systemic risk may arise if a dealer's failure spreads to the market as a whole.

(iii) Market Integrity Risk

Market integrity risk refers to the risk that the integrity of the market and confidence in the market may be diminished if there is a lack of compliance with marketplace and regulatory requirements.

Without the appropriate electronic controls in place, there is a risk of greater violations of regulatory requirements in an environment where trading cannot be monitored manually. This would impact the willingness of investors to participate in the Canadian market.

(iv) Sub-delegation Risk

Sub-delegation risk relates to the risk associated with the practice of a DEA client passing on the use of the marketplace participant identifier of the dealer to another entity (sub-delegatee). The main risks with this practice relate to the ability of a marketplace participant to manage the risks it faces in offering DEA to a particular client. This risk may be triggered by the lack of control in identifying the original sender of an order, the inability to ascertain the suitability of the sub-delegatee to be a DEA user or the inability to have recourse against a client in a jurisdiction that does not share information. Insufficient risk control regarding a sub-delegatee could impair a participant dealer or have an adverse effect on market integrity.

(v) Technology or System Risks

Technology or system risks relate to the possibility for failure of systems or technology and the impact of that failure. The risk arises due to the high degree of connectivity and rapid speed of communication among marketplaces, marketplace participants and DEA client systems required for electronic trading. These inter-connections and the speed at which trading takes place raises concern about the potentially wide-reaching unintended consequences of trading in this type of environment. The potential problems may be due to the impact of systems failures by marketplaces, vendors or clients, lack of capacity, programming errors in algorithms, or erroneous trades. In addition, technology or systems failures that impact the ability of investors to trade or the prices that they receive for execution, introduce the risk of cancellations or variations of trades which would impact investor confidence in the market. This may lead investors, and particularly DEA clients, to trade in other countries.

(vi) Risk of Regulatory Arbitrage

The risk of regulatory arbitrage arises if rules relating to electronic trading and DEA across Canada are not addressed in a manner consistent with global standards and in particular with U.S. Securities and Exchange Commission (SEC) rules in this area (either more restrictive or permissive). If Canadian rules are too stringent, then order flow may migrate to jurisdictions with less restrictive requirements. However, if the Canadian rules are too accommodating, then those that want to avoid rules in other jurisdictions may trade in Canada, increasing the risk to the Canadian market.

3. Current Regulatory Requirements

Currently, there are no rules that apply specifically to electronic trading. There are requirements on marketplaces regarding systems requirements[3] and there are general requirements at the IIROC level for business continuity plans for dealers, as well as the requirements under *Regulation 31-103 respecting Registration Requirements and Exemptions* for a dealer to manage the risks to its business.[4] The only rules in place relating to client trading access are DEA specific rules or policies that are in place at the marketplace level. The main focus of the marketplace DEA rules is to prescribe certain clients that are eligible for DEA (referred to as the "eligible client list"), to require a written agreement between the dealer and the DEA client, to prescribe certain provisions to be included in the written agreement and set out certain system requirements relating to DEA. These rules vary between marketplaces and there is no consistent standard.

III. DESCRIPTION OF THE DRAFT REGULATION

Because of the increased risks to the Canadian market described above, the CSA have determined that a regulatory framework is necessary to ensure that marketplace participants and marketplaces are managing the risks associated with widespread electronic trading including high frequency trading.[5] The result is the development of the Draft Regulation, which includes requirements relating to DEA and is discussed in detail below.

Issues associated with DEA have been previously identified by the CSA. In April 2007, the CSA published for comment amendments to *Regulation 23-101 respecting Trading Rules* (Regulation 23-101) that in part related to addressing issues associated with

[3] Part 12 of *Regulation 21-101 respecting Marketplace Operation* (Regulation 21-101) requires marketplaces, for each of their systems that supports order entry, order routing, execution, trade reporting and trade comparison, to monitor and test systems capacity, review the vulnerability of the systems to threats, establish business continuity plans, perform an annual independent systems review and promptly notify us of any material systems failures.

[4] Subsection 11.1 (b) of Regulation 31-103 requires registered firms to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to manage the risks associated with its business in accordance with prudent business practices.

[5] The Draft Regulation addresses some of the risks of high frequency trading. Other issues, such as the impact of high frequency trading strategies on the market are being examined by some CSA jurisdictions.

direct market access (2007 Draft Amendments). Among other things, the 2007 Draft Amendments clarified the obligations of marketplaces, dealers and dealer-sponsored participants when in a DEA relationship, and introduced requirements such as training for dealer-sponsored participants. These amendments were not taken forward but comments received were reviewed and have been summarized in Appendix A of this Notice. We thank all commenters who took the time to respond to our request for comments.

We are proposing the creation of a new regulation that would expand the scope of the 2007 Draft Amendments to regulate electronic trading generally in addition to the specific topic of DEA. We are of the view that the expanded scope of the Draft Regulation will more effectively aid in addressing areas of concern brought about by electronic trading discussed below.

In addition to reviewing the comments received, as part of the process to develop the Draft Regulation, CSA staff met with numerous marketplaces, marketplace participants and service vendors to better understand the current DEA landscape and the issues related to electronic trading. Staff enquired about a range of topics including the vetting of clients, the types of trade monitoring employed, the use of automated order systems, and whether sub-delegation was permitted or used. The information gathered has helped shape our perspective as to how to address the risks associated with electronic trading and DEA in particular. We would like to thank all of the participants who met with us and provided their views.

1. Requirements Applicable to Marketplace Participants

The Draft Regulation would impose requirements on marketplace participants[6] that electronically access marketplaces (exchanges and ATSs). The purpose of these requirements is to ensure that marketplace participants have the appropriate policies, procedures and controls in place that ensure that the risks described above are prevented or managed. The requirements apply to all electronic trading whether performed by the marketplace participant or by a client that has been granted DEA and who enters orders using a marketplace participant identifier.

(i) Marketplace Participant Controls, Policies and Procedures

The Draft Regulation would require a marketplace participant to establish, maintain and ensure compliance with appropriate risk management and supervisory controls, policies and procedures designed to manage the financial, regulatory and other risks associated with marketplace access or providing DEA to clients.[7]

In establishing the risk management and supervisory controls, policies and procedures, a marketplace participant must:

- ensure all order flow is monitored, including automated pre-trade controls and regular post-trade monitoring that are designed to systematically limit financial exposure and ensure compliance with marketplace and regulatory requirements[8];

- have direct and exclusive control over the controls, policies and procedures[9]; and

- regularly assess and document the adequacy and effectiveness of the controls, policies and procedures.[10]

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[6] Section 1.1 of Regulation 21-101 defines “marketplace participant” as “a member of an exchange, a user of a quotation and trade reporting system, or a subscriber of an ATS”.
[7] Proposed paragraph 3(1)(a).
[8] Proposed subsections 3(2) and 3(3).
[9] Proposed subsection 3(4).
[10] Proposed subsection 3(6).

The policies and procedures must be in written form and the controls, which we expect to be electronic, will have to be described in a narrative form that is documented by the marketplace participant.[11]

These requirements would apply to all electronic trading, including but not limited to DEA and would ensure that all orders for which the marketplace participant is responsible are subject to policies, procedures and controls. We have proposed these requirements because in our view, the risks associated with electronic trading through DEA equally arise when the marketplace participant is entering orders electronically. This will limit the financial, regulatory and other risks associated with electronic trading by clients as well as dealers.

The Draft Regulation sets out a number of specific controls that the marketplace participant must have. It specifically would require controls or requirements that:

- prevent the entry of orders that exceed appropriate pre-determined credit or capital thresholds,
- prevent the entry of erroneous orders in terms of size or price parameters,
- ensure compliance with applicable marketplace and regulatory requirements on a pre- and post-trade basis,
- limit the entry of orders to securities for which the particular marketplace participant or DEA client is authorized to trade,
- restrict access to trading only to persons authorized by the marketplace participant,
- ensure compliance staff of the marketplace participant receive immediate order and trade information,
- enable the marketplace participant to immediately stop or cancel one or more orders entered by the marketplace participant or DEA client,
- enable the marketplace participant to immediately suspend or terminate any DEA granted to a DEA client, and
- ensure that the entry of orders does not interfere with fair and orderly markets.[12]

We note that under the Draft Regulation, a marketplace participant would be able use the technology of a third party when implementing its risk management or supervisory controls, policies and procedures as long as the third party providing such services is independent of any DEA client of the marketplace participant and the marketplace participant is able to directly and exclusively manage the controls, policies and procedures including the setting and adjustment of filter limits.

(ii) Allocation of Control over Controls, Policies and Procedures

The Draft Regulation would require that a marketplace participant maintain direct and exclusive control over its risk management controls, policies and procedures.[13] However, in certain limited situations, we propose to permit a participant dealer to reasonably allocate control over specific risk management and supervisory controls, policies and procedures to another investment dealer that is directing trading to the

[11] Proposed paragraph 3(1)(b).
[12] Proposed subsection 3(3).
[13] Proposed subsection 3(4).

marketplace participant.[14] This is designed to address situations where the investment dealer may be in a better position to manage the risks associated with its trading because of its proximity to and knowledge of its clients. In addition, it can better manage certain responsibilities such as suitability and "know your client" obligations. The allocation of control is subject to a written contract and thorough and ongoing assessment by the participant dealer with respect to the effectiveness of the controls, policies and procedures of the investment dealer. However, allocating control would not excuse the participant dealer from its general obligations under the Draft Regulation.

(iii) Use of Automated Order Systems

The Draft Regulation would impose requirements related to the use of automated order systems.[15] An automated order system is defined as "any system used by a marketplace participant or a client of a marketplace participant to automatically generate orders on a pre-determined basis."[16] Specifically, the Draft Regulation would require that, as part of its risk management and supervisory controls, policies and procedures, a marketplace participant must ensure it has the necessary knowledge and understanding with respect to the automated order systems used by itself or any client. We recognize that much of the detailed information about a client's automated order systems may be considered confidential and proprietary. However this proposed requirement is designed to ensure that the marketplace participant has sufficient information to identify and manage its risks. In addition, automated order systems used by the marketplace participant or its DEA client would need to be appropriately tested before use and regularly tested in accordance with prudent business practices.

As well, the Draft Regulation would require controls that allow the marketplace participant to immediately prevent orders from such systems from reaching a marketplace.[17] This requirement is important so that marketplace participants are able to disable an algorithm or any automated order system that is sending erroneous orders or orders that may interfere with fair and orderly markets.

2. Requirements Specific to DEA

The Draft Regulation would impose a framework around the provision of DEA. The CSA are of the view that it is important to institute a consistent framework across marketplaces and marketplace participants for the offering and use of DEA to ensure that risks are appropriately managed. In addition, having a consistent framework reduces the risk of arbitrage among participant dealers providing DEA and also among marketplaces that have different standards or requirements.

The approach we have taken supports the principle that marketplace participants, including participant dealers, are responsible for all orders entered onto a marketplace using their marketplace participant identifier. If a participant dealer chooses to provide its number to a client, it is the participant dealer's responsibility to ensure that the risks associated with providing that number are adequately managed. To do that, a participant dealer must assess its own risk tolerance and develop policies, procedures and controls that will mitigate the risks that it faces. In addition, the participant dealer should be setting the appropriate minimum standards, assessing the appropriate training and ensuring that due diligence is conducted on each prospective DEA client.

(i) The Provision of DEA

Part of addressing the risks associated with DEA requires participant dealers to conduct due diligence with respect to clients who are to be granted this type of access. This due diligence performed by the participant dealer providing DEA is a critical defence in managing many of the DEA risks outlined earlier and necessitates a thorough vetting of

[14] Proposed section 4.
[15] Proposed section 5.
[16] Proposed section 1.
[17] Proposed paragraph 5(2)(c).

potential clients accessing marketplaces under their marketplace participant identifier. The Draft Regulation establishes that only a participant dealer, defined as a marketplace participant that is an investment dealer, may provide DEA.[18] This is because we consider the provision of DEA to be a trigger for the registration requirements under securities legislation.

The Draft Regulation states that DEA can only be provided to a registrant that is a participant dealer (a marketplace participant that is a registered investment dealer and IIROC member) or a portfolio manager. We propose to preclude exempt market dealers from being able to act as DEA clients because in our view, a dealer that wants DEA should not be able to "opt-out" of the application of the Universal Market Integrity Rules (UMIR) and should be an IIROC member. In other words, this exclusion would prevent regulatory arbitrage. This exclusion would not prevent dealers that are not participant dealers from sending orders to executing dealers; it would only preclude them from using DEA. **We ask for specific feedback on this issue.**

We have not specifically proposed to exclude individuals from obtaining DEA access. It is our view that retail investors should not be using DEA and should be routing orders through order-execution accounts that are offered by discount brokers and subject to specific supervision requirements under IIROC dealer member rules.[19] However, there are some circumstances in which individuals are sophisticated and have access to the necessary technology to use DEA (for example, former registered traders or floor brokers). In these circumstances, we would expect that the participant dealer offering DEA would set standards high enough to ensure that the participant dealer is not exposed to undue risk. It may be appropriate for these standards to be higher than those set for institutional investors. All requirements relating to risk management and supervisory controls, policies and procedures would apply. **We would like specific feedback on whether individuals should be permitted DEA or whether DEA should be limited to institutional investors[20] and a limited number of other persons such as former registered traders or floor brokers.**

(ii) Requirements Applicable to Participant Dealers Providing DEA

Minimum Standards

The Draft Regulation would require participant dealers to set appropriate standards that their clients must meet before providing them with DEA.[21] These standards must include that:

- the client has appropriate financial resources,
- the client has knowledge of and proficiency in the use of the order entry system,
- the client has knowledge of and ability to comply with all applicable marketplace and regulatory requirements, and
- the client has adequate arrangements in place to monitor the entry of orders through DEA.[22]

We have not included an "eligible client list" in the Draft Regulation and are of the view that setting minimum standards is more appropriate. This view is consistent with other jurisdictions globally.

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[18] Proposed subsection 6(1).
[19] IIROC Dealer Member Rule 3200.
[20] An institutional investor may include an "institutional customer" as defined under IIROC dealer member rules or an "accredited investor" as defined under Canadian securities legislation.
[21] Proposed subsection 7(1).
[22] Proposed subsection 7(2).

Written Agreement

The Draft Regulation would also require that participant dealers enter into a written agreement with each DEA client.[23] The agreement must provide that:

- the DEA client will comply with marketplace and regulatory requirements,
- the DEA client will comply with product limits or credit or other financial limits specified by the participant dealer,
- the DEA client will maintain all technology security and prevent unauthorized access,
- the DEA client will cooperate with regulatory authorities,
- the participant dealer can reject, vary, correct or cancel orders or can discontinue accepting orders,
- the DEA client will notify the participant dealer if it fails to, or expects to fail to, meet the minimum standards set by the participant dealer,
- when the DEA client is trading for the accounts of its clients, the client orders will flow through the systems of the DEA client, and
- when trading for accounts of its clients, the DEA client will ensure that the client meets the standards set by the participant dealer and that there is a written agreement in place between the DEA client and its client.

These requirements set the minimum that the CSA view as necessary to establish a framework within which DEA should be provided. It has been left open to participant dealers to impose additional terms that they deem necessary to manage the risks associated with DEA.

Training for a DEA Client

Prior to providing DEA to a client, the participant dealer would also need to satisfy itself that the prospective DEA client has adequate knowledge with respect to marketplace and regulatory requirements.[24] In assessing the knowledge level of the client, the participant dealer must determine what, if any, training is required to ensure the management of risks to the participant dealer and the market in general, from providing the client with DEA.

Unlike in the 2007 Draft Amendments, we are not dictating a specific course or courses that a prospective DEA client must take. We are of the view that the participant dealer, in managing its risks, should turn its mind to what level of knowledge is appropriate for a client in order to be granted DEA in the Canadian trading environment. This is consistent with the philosophy that each dealer must assess its own risk tolerance in developing its standards and policies and procedures relating to DEA.

Client Identifiers

In order to identify the specific client behind each trade, the Draft Regulation would also require that each DEA client be assigned a unique identifier that must be associated with every order and would be kept as part of the audit trail.[25] We expect that the participant dealer would work with the various marketplaces to obtain these identifiers, and that each order entered on a marketplace by a DEA client using DEA contains this

[23] Proposed section 8.
[24] Proposed section 9.
[25] Proposed section 10.

identifier. Currently, a number of marketplaces track DEA client trading by using unique client identifiers. This requirement imposes the usage of the identifier on all participant dealers.

In addition, the Draft Regulation would require that the participant dealer provide the unique client identifier to all regulation services providers monitoring trading (currently, IIROC).[26] This facilitates IIROC's ability to monitor trading by DEA clients across multiple participants and multiple marketplaces.

Trading by DEA Clients

Under the Draft Regulation, we have limited the ability of a DEA client to trade using DEA. Generally, a DEA client may only trade for its own account when using DEA provided by a participant dealer.[27] However, certain DEA clients are permitted to trade using DEA for the accounts of their clients. Specifically, these clients are participant dealers, portfolio managers and any entity that is analogous to these categories which is authorized in a foreign jurisdiction that is a signatory to the IOSCO Multilateral Memorandum of Understanding.[28] Finally, we have proposed that a DEA client cannot pass on its DEA to another person.[29]

By proposing that certain DEA clients may trade for the accounts of their clients, we have facilitated certain arrangements currently in place. For example, global dealers often use "hubs" that aggregate orders from various subsidiaries before sending those orders through an affiliate participant dealer. The Draft Regulation would enable foreign affiliates to act as DEA clients, but would require the orders aggregated from other affiliates to pass through their systems before being sent to the participant dealer for execution. What we have prohibited is those foreign affiliates that are not DEA clients from sending orders directly to the participant dealer, with whom they have no contract and no relationship.

We have proposed these limitations because we are of the view that it is inappropriate for DEA clients to sub-delegate their DEA, or allow their clients to trade using DEA and send orders directly to a participant dealer or a marketplace. Doing this exacerbates the risks to the Canadian market and widens the breadth of market access to participants who do not have any incentive or obligation to comply with the regulatory requirements or financial, credit or position limits imposed upon them.

3. Requirements Applicable to Marketplaces

As part of the Draft Regulation, we have proposed requirements on marketplaces relating to electronic trading. Marketplaces, under Regulation 21-101, are already subject to systems requirements.[30] However, the Draft Regulation would impose additional requirements that:

- require marketplaces to provide a marketplace participant with reasonable access to its order and trade information on an immediate basis,

- ensure that marketplace systems can support the use of DEA client identifiers,

- ensure that marketplaces have the ability and authority to terminate all or a portion of the access provided to a marketplace participant or DEA client,

[26] Proposed paragraph 10(2)(a).
[27] Proposed subsection 11(1).
[28] Proposed paragraph 11(2)(c).
[29] Proposed subsection 11(5).
[30] Regulation 21-101, Part 12.

- ensure that marketplaces regularly assess and document whether they require any risk management and supervisory controls, polices and procedures to ensure fair and orderly trading,

- ensure that marketplaces regularly assess and document the adequacy and effectiveness of any risk management and supervisory controls, policies and procedures they implement,

- require that marketplaces prevent the execution of orders outside of thresholds set by the regulation services provider or by a recognized exchange or recognized quotation and trade reporting system that directly monitors the conduct of its members or users and enforces requirements set pursuant to subsection 7.1(1) or 7.3(1) respectively of Regulation 23-101, and

- confirm the process for the cancellation, variation or correction of clearly erroneous trades.

These proposed requirements, along with those in Regulation 21-101, will serve as another level of protection against the risks of electronic trading including DEA, and will serve to supplement the risk management and supervisory controls, policies and procedures required by the marketplace participant.

(i) Order and Trade Information

The Draft Regulation sets out an obligation on marketplaces to provide their participants with reasonable access to their own order and trade information on an immediate basis.[31] We believe this is necessary to enable the marketplace participant to fulfill its obligations with respect to establishing and implementing the risk management and supervisory controls, policies and procedures previously outlined. Specifically, it ensures that the compliance personnel at the participant dealers obtain information regarding DEA client orders and trades so that they can appropriately monitor trading.

(ii) DEA Client Identifiers

As mentioned above, some marketplaces currently require orders from DEA clients to be accompanied by a unique client identifier. This requirement would standardize this practice by requiring all marketplaces, whether an exchange or ATS, to be able to support the use of these identifiers.

(iii) Marketplace Controls Relating to Electronic Trading

The Draft Regulation would require marketplaces to have the ability and the authority to immediately terminate access granted to a marketplace participant or DEA client.[32] This provision is not intended to provide marketplaces with full discretion to terminate without cause. An example of when this would be used is if it is discovered that an algorithm is sending orders in a "loop". This risks the integrity of the participant dealer as well as fair and orderly trading on that marketplace. The existence of this provision is important to ensure that the marketplace can, if necessary, terminate access so that there is no further damage to the quality of the trading on that marketplace or contagion to the rest of the market.

The Draft Regulation would also require that marketplaces assess what risk management and supervisory controls, policies and procedures are required at the marketplace level in addition to those required by their marketplace participants. This is to ensure that marketplaces do not interfere with fair and orderly markets.[33] These controls, policies and procedures should be assessed on a regular basis (at least annually) to ensure

[31] Proposed section 12.
[32] Proposed subsection 14(1).
[33] Section 14 of Draft Policy Statement.

they are adequate and effective.[34] The purpose of this requirement is to ensure that the marketplace is aware of the risk management and supervisory controls required by its participants and assesses whether there are any gaps. Those gaps must be filled by the marketplace by either introducing requirements for its participants or by introducing the controls on its own.

(iv) Marketplace Thresholds

The Draft Regulation would also establish the requirement for marketplaces to prevent the execution of orders beyond certain thresholds determined by a regulation services provider or by a recognized exchange or recognized quotation and trade reporting system that directly monitors the conduct of its members or users and enforces requirements set pursuant to subsection 7.1(1) or 7.3(1) respectively of Regulation 23-101.[35] These marketplace thresholds would be designed to limit the risks associated with erroneous or "fat finger" orders impacting the price of a particular security at the marketplace level, and resulting in a market which is not fair or orderly. This requirement is being proposed as part of the follow-up to the events of May 6, 2010. We are of the view that standardized thresholds across all marketplaces are necessary and that a regulation services provider, where applicable, is in the best position to set those thresholds. We believe that these marketplace thresholds will complement both the IIROC Single Stock Circuit Breaker proposal published in November 2010, and IIROC's existing ability to issue regulatory halts.

(v) Clearly Erroneous Trades

We are of the view that the combination of controls required by the Draft Regulation should prevent many erroneous trades from occurring. However, we have included an additional requirement whereby a marketplace must have the capability to cancel, vary or correct a trade on its own, or where instructed to do so by its regulation services provider.[36] The Draft Regulation would also establish the circumstances under which a marketplace may cancel, vary or correct a trade, if that marketplace has retained a regulation services provider. Specifically, the marketplace may cancel, vary or correct a trade when:

- instructed to do so by its regulation services provider,

- the cancellation, correction or variation is requested by a party to the trade, consent is provided by both parties to the trade and the regulation services provider is notified, or

- the cancellation, correction or variation is necessary to correct a systems issue in executing the trade, and permission to cancel, vary or correct the trade has been obtained from the regulation services provider.

Additionally, the marketplace must have reasonable policies and procedures that clearly outline the processes by which that marketplace will cancel, correct or vary a trade, and these policies and procedures must be publicly available. [37]

4. Other Jurisdictions

In developing the Draft Regulation, we have closely reviewed a number of international initiatives such as Rule 15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, adopted by the SEC in November 2010[38], the final report prepared by the International Organization of Securities Commissions' (IOSCO) Standing

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34 Proposed subsection 14(2).
35 Proposed section 15.
36 Proposed section 16.
37 Proposed subsection 16(3).
38 Published at: http://www.sec.gov/rules/final/2010/34-63241.pdf

Committee, *Principles for Direct Electronic Access to Markets* published in August 2010[39] (IOSCO DEA Report), the Australian Securities and Investments Commission (ASIC) *Consultation Paper 145: Australian Equity Market Structure: Proposals*[40], and the European Commission *Review of the Markets in Financial Instruments Directive* (MiFID) published in December of 2010.[41]

The IOSCO DEA Report sets out principles intended to be used as guidance for jurisdictions that allow or are considering allowing the use of DEA. They include minimum financial standards for DEA clients, the establishment of a legally binding agreement between the marketplace participant providing market access and the DEA client, and the existence of effective controls to manage the risks associated with electronic trading at both the marketplace and marketplace participant level. The requirements in the Draft Regulation are in line with the principles established by IOSCO.

In the U.S., Rule 15c3-5 requires brokers or dealers with access to trading on a marketplace including those providing DEA, to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of this business activity. This rule effectively prohibits broker-dealers from providing unfiltered access to any marketplace.

In Australia, the ASIC Consultation Paper 145 is similar to the Draft Regulation in that it would require a market participant providing DEA to ensure that clients meet minimum standards with respect to financial resources, and proficiency with regulatory requirements and the use of systems. Additionally, there are similarities surrounding the use of automated order systems, in that they both establish requirements for participants and participant dealers to ensure that the use of such systems do not interfere with fair and orderly trading, and that all automated order systems used by the participant or a client of the participant are appropriately tested and that the nature of the systems are appropriately understood.

The European Commission's review of MiFID proposes requirements for automated trading, defined as "trading involving the use of computer algorithms to determine any or all aspects of the execution of the trade such as the timing, quantity and price".[42] The review suggests the introduction of requirements for firms involved in automated trading to have robust risk controls to mitigate potential trading system errors, and that regulators be notified of what computer algorithms are employed, including explanations of their purpose and how they function. With respect to DEA, the review recommends that firms which provide "sponsored access" to automated traders would also have in place robust risk controls and filters "to detect errors or attempts to misuse facilities".

IV. AUTHORITY FOR THE DRAFT REGULATION

In those jurisdictions in which the Draft Regulation is to be adopted, the securities legislation provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the Draft Regulation.

V. COMMENTS AND QUESTIONS

We invite all interested parties to make written submissions with respect to the draft *Regulation 23-103 respecting Electronic Trading and Direct Electronic Access to Marketplaces*.

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[39] Published at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD332.pdf

[40] Published at: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp-145.pdf/$file/cp-145.pdf

[41] Published at: http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf

[42] Published at: http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf at page 15.

Please address your comments to all of the CSA member commissions on or before July 8, 2011, as indicated below:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Superintendent of Securities, Department of Justice, Government of Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut
Superintendent of Securities, Consumer, Corporate and Insurance Services, Office of the Attorney General, Prince Edward Island
Saskatchewan Financial Services Commission
Superintendent of Securities, Government Services of Newfoundland and Labrador
Ontario Securities Commission

M[e] Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
e-mail : consultation-en-cours@lautorite.qc.ca

and

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

We cannot keep submissions confidential because securities legislation in certain provinces requires that a summary of the written comments received during the comment period be published.

Questions may be referred to any of:

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April 8, 2011

Appendix A

Summary of public comments on draft amendments to *Regulation 21-101 respecting Marketplace Operation* and *Regulation 23-101 respecting Trading Rules* regarding direct market access and Canadian Securities Administrators responses

Comments	***CSA Responses***
Definition of Dealer-Sponsored Access One commenter pointed out that the use of the terms "electronic connection" and "access its order routing system" in the definition of "dealer sponsored access" can be broadly interpreted to include almost any order that is electronically transmitted to a dealer and if taken literally, could include orders where there may be no trader intervention but is clearly not a case of direct access to a marketplace i.e. algorithmic trades, program trades and list based trades. This commenter believes that it is important to clarify that any direct market access (DMA) requirements would only be intended to cover sponsored trading access by non-participating organizations where there was no possible intervention by the sponsoring participating organization.	The Draft Regulation is designed to expand the scope of the 2007 Draft Amendments to regulate electronic trading generally in addition to specifically addressing DEA. We believe many of the risks can be applied to both.
Question 24: Should DMA clients be subject to the same requirements as subscribers before being permitted access on a marketplace?	
Comments	***CSA Responses***
The majority of commenters do not believe that DMA clients should be subject to the same requirements as subscribers. Many feel that ultimate responsibility for DMA clients should remain with subscribers. Reasons cited for this position include that: (i) it is the subscribers who are best suited to contractually impose standards on their DMA clients and monitor and oversee the trading activity of their DMA clients; (ii) imposing additional requirements on the end client would result in unnecessary duplication of cost and effort and would create confusion over who is ultimately responsible for ensuring compliance with various rules; and (iii) the proposed requirement would reduce DMA activity on Canadian markets and motivate DMA clients to trade inter-listed securities in foreign marketplaces which in turn would harm Canadian markets.	The Draft Regulation represents a change in approach to the 2007 Draft Amendments. The Draft Regulation would hold marketplace participants responsible for managing the risks associated with electronic trading, whether these orders are their own or those of a DEA client. We propose that a participant dealer providing DEA must establish appropriate standards, and assess whether each client meets these standards prior to granting DEA. The Draft Regulation would allow the participant dealer to reasonably allocate specific risk management and supervisory controls to a DEA client who is an investment dealer. This allocation would be set out in a written agreement, so there should be no confusion as to who is ultimately responsible.

Two commenters noted that the U.S. does not have similar regulations for DMA clients regarding access to marketplaces.	We do not believe the Draft Regulation is significantly more restrictive than other jurisdictions, such that trading would shift to foreign marketplaces. The U.S. Rule 15c3-5 establishes a framework similar to the Draft Regulation.
One commenter suggested that through each DMA client obtaining a unique trader ID, RS would be able to monitor DMA client account activity across participants and marketplaces and that this should address regulatory concerns regarding DMA trading. As well, this commenter also believes that the ability of the marketplace to revoke a DMA client's access trading privileges is sufficient to obtain compliance with RS investigations from DMA clients and that contracts between RS and DMA clients are not necessary.	The CSA are of the view that through the proposed participant dealer requirement to assign each DEA client a DEA client identifier and ensure that this identifier appears on each DEA order, the regulation services provider will be able to effectively monitor DEA activity.
One commenter cited that they strongly opposed requiring DMA clients to enter into an agreement with the regulation services provider or subjecting DMA clients to other regulations beyond general market integrity rules on the following: just and equitable principles, prohibition of manipulative or deceptive trading methods and improper orders and trades. To follow a similar approach in the U.S., this commenter suggested that the onus of ensuring compliance with applicable market integrity rules and providing user training should be placed on the sponsor, which can be clarified contractually through user agreements between the sponsor and the user as appropriate. A couple of commenters mentioned that a DMA client may not be in a position to ensure that their orders are ultimately routed and marked correctly since these orders must first pass through the participating organization's systems and they cannot be responsible for any technical rule violations caused by systems issues at the sponsoring firm. A few commenters were supportive of DMA clients having the same requirements as all other participants.	The Draft Regulation would not require contracts between the regulation services provider and the DEA client. The participant dealer must provide each DEA client identifier and associated client name to the regulation services provider.
One commenter was of the view that only properly registered participants and approved ATS subscribers should have direct access to the marketplace in order to ensure efficient and orderly markets.	The Draft Regulation sets out that participant dealers may not provide DEA to a registrant other than a participant dealer or portfolio manager.

Training Some commenters mentioned that the training requirement for DMA clients should be relevant and that the current Canadian Securities Institute's Trader Training Course is not appropriate as it is often out of date and covers more material than is relevant for DMA clients. Two commenters suggested that the current TSX and TSX Venture DMA rules that require the dealer to provide training and updates is an appropriate way to ensure clients are trained. One commenter suggested that the regulators could set a higher standard and provide clearer expectations of the material to be covered by required training programs and provide assistance with issuing notices and regulatory updates designed for DMA clients. One commenter not in support of having DMA clients take a standardized trader training course contended that this requirement would serve as an impediment, especially if each jurisdiction imposed a specific trader training course requirement for access to local marketplaces in that jurisdiction. This commenter suggested that if a training course requirement is imposed there should be an exemption for foreign DMA clients. Another commenter indicated that training to attain such high a level of trading proficiency is not justified for the amount of trading that they presently engage in.	The Draft Regulation does not establish specific requirements or minimum levels of education required for DEA clients. It would place an obligation on the participant dealer to satisfy itself that a client has adequate knowledge of applicable marketplace and regulatory requirements and the standards established by the participant dealer.
Question 25: Should the requirements regarding dealer-sponsored participants apply when the products traded are fixed income securities? Derivatives? Why or why not?	
Comments	***CSA Responses***
The majority of commenters that responded to this question believe that the requirements regarding dealer-sponsored participants should not apply to over-the-counter products such as fixed income and derivative products. Some reasons cited for this view include: that there is no central order book with price transparency; the structure of non-exchange listed fixed income and derivative products is fundamentally different than equities; and the perceived regulatory burden could potentially discourage usage by dealer-sponsored participants at a time when transparency and the use of electronic means of trading in the OTC markets is still developing in Canada. One commenter also	The Draft Regulation applies to all securities traded on a marketplace as defined in *Regulation 21-101 respecting Marketplace Operation* (Regulation 21-101). Consideration will be given in the future as to whether it should apply to electronic trading in other products.

stated that this proposed requirement could stifle innovation in these marketplaces and put Canadian markets at a competitive disadvantage compared to the U.S. as there are no similar regulatory requirements in that marketplace. One commenter believes that all assets and all markets should be subject to the same requirements.	
Question 26: Would your view about the jurisdiction of a regulation services provider (such as RS for ATS subscribers or an exchange for DMA clients) depend on whether it was limited to certain circumstances? For example, if for violations relating to manipulation and fraud, would the securities commissions be the applicable regulatory authorities for enforcement purposes?	
Comments	***CSA Responses***
Many commenters do not feel that it is appropriate for RS to have jurisdiction over DMA clients. Some commenters cited concerns that treating U.S. broker-dealers who are DMA clients as Access Persons may cause these clients to stop trading on Canadian marketplaces which could reduce liquidity and result in wider spreads on Canadian marketplaces. One commenter submitted that introducing an expansive new regime in Canada that gives a Canadian regulator jurisdiction over U.S. clients of Canadian dealers would send a message that is contrary to the goal of free trade in securities and may impact the SEC's possible proposal on mutual recognition with Canada. One commenter stated that the contractual relationship between a DMA client and RS effectively creates a new requirement for clients to be registered with RS and that it should be recognized that in certain circumstances clients may not be permitted to sign a contract with an SRO. This commenter also noted that the process and administration relating to these contracts must be clearly defined as many times a DMA client will have multiple brokers and the employees may have access to some marketplaces with one dealer and potentially different access with another dealer. One commenter suggested that RS should have jurisdiction over DMA clients for the purposes of UMIR 2.2 and that RS should contact the sponsoring registered Participant for all other matters relating to DMA clients.	The CSA do not propose to extend the jurisdiction of the regulation services provider to all DEA clients at this time.

Two commenters asserted that the provincial securities regulator is the appropriate body to regulate DMA clients and other non-Investment Dealer Association or non-exchange members. One commenter, while hesitant to impose a regulation services agreement to be signed by each DMA customer, stated such agreements should be limited to a brief statement of general principles and not be open to negotiation as to its content in order to avoid applying different standards of regulation to different market participants. A few commenters believe that all participants should be subject to the same regulations by the same regulators to ensure consistency. One commenter contended that the current regulatory jurisdiction is too fragmented and called for RS to be the primary regulatory authority for all levels of market trading infractions and over any party with access to marketplaces.	
Question 27: Could the proposed amendments lead dealer-sponsored participants to choose alternative ways to access the market such as using more traditional access (for example, by telephone), using foreign markets (for inter-listed securities) or creating multiple levels of DMA (for example, a DMA client providing access to other persons)?	
Comments	***CSA Responses***
A large majority of commenters that responded to this question believe that the proposed amendments could lead DMA clients to circumvent dealers and find alternative ways to access Canadian markets. A few commenters noted that foreign dealers in particular may choose not to trade in Canada if they are required to be subject to another local regulatory regime. One commenter noted while the proposed amendments do not contemplate disclosure of information relating to trading strategies or working of orders, that requirements of this nature would have the effect of directing order flow away from Canadian markets. One commenter submitted that foreign clients must use a registered participant in Canada.	The Draft Regulation would place the responsibility for DEA client orders on the participant dealer. The CSA do not believe that the Draft Regulation would lead DEA clients to find alternative methods to access the Canadian market. Additionally, we note that the Draft Regulation would not establish DEA requirements which are significantly different from those in other jurisdictions, and do not believe foreign dealers will choose not to trade in Canada as a result. The Draft Regulation sets out requirements for the use of automated order systems, such that any marketplace participant must ensure it has the necessary knowledge and understanding of any automated order system employed in order to identify and manage risks associated with the use of the system. The CSA recognize that some of the information regarding client automated order systems would be considered proprietary, however we would expect in these cases that a participant dealer would obtain sufficient knowledge to manage its own risks.

Question 28: Should there be an exemption for foreign clients who are dealer-sponsored participants from the requirements to enter into an agreement with the exchange or regulations services provider? If so, why and under what circumstances?	
Comments	***CSA Responses***
The majority of commenters that responded to this question are not supportive of an exemption for foreign clients who are dealer-sponsored participants from the requirements to enter into an agreement with the exchange or regulations services provider. Many commenters re-iterated their position that a direct agreement between DMA clients and RS is not warranted and that this would pose a significant barrier for foreign dealers and clients to access our markets. One commenter contended that foreign DMA clients will stop trading in Canada if they are required to execute an agreement with a foreign regulator. One commenter suggested that foreign and domestic DMA clients should not be subject to other regulations beyond the following trading rules: just and equitable principles, prohibition of manipulative or deceptive trading methods and improper orders and trades. This commenter stated that the DMA sponsor or ATS should be responsible for all other regulatory and compliance requirements. A number of commenters believe that all market participants should be treated equally and there should not be any advantage to any participant.	The Draft Regulation would not require foreign clients to enter into an agreement with the exchange or regulation services provider.
Question 29: Please provide the advantages and disadvantages of a new category of member of an exchange that would have direct access to exchanges without the involvement of a dealer (assuming clearing and settlement could continue to be through a participant of the clearing agency).	
Comments	***CSA Responses***
The overwhelming majority of commenters that responded to this question are not supportive of a new category of a member of an exchange. A few commenters are concerned that a member of an exchange that is not subject to the gatekeeper oversight that dealers currently provide could compromise overall market integrity unless subject to the same level of oversight by RS as a traditional dealer. One commenter is supportive of exchanges	The Draft Regulation does not propose a new category of registration.

determining member eligibility criteria in their sole discretion and creating classes within their membership in the event that they want to provide different types of services to different types of members as long as a requisite level of access and functionality is provided to all members.	

Please note: public comments to Questions 1 to 14 and 19 to 23 and the corresponding CSA responses were published on October 17, 2008 in the Bulletin of the Autorité des marchés financiers, Vol. 5, no 41. Comments to Questions 15 to 18 and the corresponding CSA responses were published on June 20, 2008 in the Bulletin of the Autorité des marchés financiers, Vol. 5, no 24.

	Commenters
1.	Canadian Security Traders Association Inc.
2.	Investment Industry Association of Canada
3.	Raymond James Ltd.
4.	RBC Asset Management Inc.
5.	RBC Dominion Securities Inc.
6.	TD Asset Management
7.	TMX Group
8.	Perimeter Markets Inc.
9.	Scotia Capital
10.	Highstreet Asset Management
11.	CPP Investment Board
12.	Merrill Lynch
13.	TD Newcrest
14.	Bloomberg Tradebook Canada