CSA NOTICE AND REQUEST FOR COMMENT

PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 23-103 *ELECTRONIC TRADING*

I. INTRODUCTION

Today the Canadian Securities Administrators (CSA or we) are introducing proposed amendments (Proposed Amendments) to National Instrument 23-103 *Electronic Trading* (NI 23-103) and its related Companion Policy 23-103CP (CP) that would, in part, impose requirements on participant dealers that provide direct electronic access (DEA).[1] The Proposed Amendments are being published for a 90-day public comment period. The text of the Proposed Amendments is contained in Annexes A through C of this Notice and will also be available on the websites of various CSA jurisdictions.

We have worked closely with staff of the Investment Industry Regulatory Organization of Canada (IIROC) in developing the Proposed Amendments and we thank them for sharing their knowledge and expertise. IIROC is also publishing amendments to the Universal Market Integrity Rules (UMIR) and its dealer member rules for comment to reflect and support the Proposed Amendments. More information may be found at www.iiroc.ca.

Jurisdictions that are a party to Multilateral Instrument 11-102 *Passport System* (currently all jurisdictions except Ontario) are also republishing for comment amendments to that instrument that permit the use of the passport system for aspects of NI 23-103. The amendments were published for comment on August 19, 2011. No comments were received. These related amendments are found at Annex D of this Notice.

II. BACKGROUND

On April 8, 2011, we published for comment proposed NI 23-103 and CP (2011 Proposal). The 2011 Proposal included requirements and guidance specifically related to DEA.

On June 28, 2012, the CSA published NI 23-103 and the CP in their final form which have now been adopted by each member of the CSA and will come into effect on March 1, 2013. However, the CSA finalized NI 23-103 and the CP without specific DEA provisions. The CSA delayed the DEA provisions in NI 23-103 to ensure that the CSA requirements related to DEA are consistent with IIROC's proposed amendments on DEA and that similar forms of marketplace access would be subject to similar requirements. The Proposed Amendments cover only DEA and are substantially similar to those that were published in the 2011 Proposal but for a few changes that are described in this Notice. The IIROC proposal applies to not only DEA but situations where dealers route orders to other dealers. We are of the view that the proposed package of IIROC and CSA amendments, taken together, will ensure that similar forms of marketplace access and the risks that arise from these forms of access are treated similarly.

[1] A participant dealer is defined in NI 23-103 as a marketplace participant that is an investment dealer.

III. SUMMARY OF KEY COMMENTS RECEIVED BY THE CSA

We thank all 29 commenters for their submissions in response to the 2011 Proposal. A list of those who submitted comments, a summary of comments related to the DEA-specific provisions contained in the 2011 Proposal and our responses to them are attached at Annex F to this Notice. Copies of the comment letters are posted at www.osc.gov.on.ca. For additional background on the DEA-specific provisions included in the 2011 Proposal, please refer to the CSA notice that was published with the 2011 Proposal.[2]

IV. SUBSTANCE AND PURPOSE OF THE PROPOSED AMENDMENTS

Requirements Specific to Direct Electronic Access

While technology has increased the speed at which trades take place, it has also enabled marketplace participants to facilitate access to marketplaces by their clients, whether large institutions or sophisticated retail clients. Under the Proposed Amendments, DEA exists where a client uses the participant dealer's marketplace participant identifier (MPID) for the purpose of electronically sending orders to a marketplace. This type of access can include a client using the participant dealer's system for automated onward transmission to a marketplace or a client sending the order directly to a marketplace without going through the participant dealer's systems. Under the Proposed Amendments, DEA would not include an order execution service provided pursuant to IIROC rules.[3]

Whether a participant dealer is trading for its own account, for a customer or is providing DEA, the participant dealer is responsible for all trading activity that occurs under its MPID. Allowing the use of complicated technology and strategies, including high frequency trading strategies, through DEA brings increased risks to the participant dealer. For example, the participant dealer may be held financially responsible for the execution of erroneous trades that occur under its MPID, even when these trades go beyond its financial capability. As well, a participant dealer may be responsible for a lack of compliance with marketplace or regulatory requirements for DEA orders entered using its MPID.

Therefore, appropriate controls are needed to manage the financial, regulatory and other risks associated with providing DEA to ensure the integrity of the participant dealer, the marketplaces and the financial system. To address this need, the Proposed Amendments would provide a framework around the provision of DEA so that a participant dealer providing DEA manages these risks appropriately.

(i) Provision of DEA

Under the Proposed Amendments, only a participant dealer, defined as a marketplace participant that is an investment dealer[4], may provide DEA.[5] We have proposed to limit the registrants that may use DEA to a portfolio manager and restricted portfolio manager.[6] The 2011 Proposal allowed DEA to be provided to a participant dealer as well, however, the rules relating to dealer-to-dealer order routing will

[2] (2011) 34 OSCB 4133.
[3] Subsection 1.2(2) of 23-103CP.
[4] Section 1 of NI 23-103.
[5] Subsection 4.2(1) of NI 23-103.
[6] Subsection 4.2(2) of NI 23-103.

be dealt with in the proposed UMIR amendments that IIROC is publishing for comment today. As a result, we have removed this provision from the Proposed Amendments. This is considered to be a significant change from the 2011 Proposal and therefore, we are republishing the provisions of NI 23-103 relating to DEA for comment at this time.

This proposed restriction in the Proposed Amendments would not permit exempt market dealers (EMDs) to use DEA. In our view, dealers should be subject to UMIR if engaging in this type of equity trading.

The 2011 Proposal also proposed that an EMD would be prohibited in the use of DEA. The majority of comments received regarding this provision were not supportive of this proposed prohibition. Commenters cited that many U.S. broker-dealers are registered in Canada as EMDs in order to facilitate part of their business in Canada and that the 2011 Proposal would prevent such U.S. broker-dealers from being a DEA client. Others noted that it is inconsistent to allow unregistered firms or individuals to use DEA yet not allow EMDs to do so.

CSA staff announced in CSA Staff Notice 31-327, published September 2, 2011, that CSA registration staff will examine policy issues relating to firms registered as EMDs that are carrying out brokerage activities (trading securities listed on an exchange in foreign or Canadian markets). CSA Staff Notice 31-327 also stated that in the interim, CSA staff will consider registering these firms in the restricted dealer category with terms and conditions. Subsequently, the CSA published CSA Staff Notice 31-331 as a follow-up to this issue, which introduces IIROC Notice 12-0217 (IIROC Notice). The IIROC Notice proposes that firms registered as EMDs that are conducting brokerage activities become registered as Restricted Dealer member firms and become subject to IIROC oversight.

We therefore continue to think that registered dealers that provide brokerage services similar to those of investment dealers should also be subject to IIROC rules when doing so. Therefore the Proposed Amendments maintain the proposed prohibition on EMDs from using DEA. We note that this restriction would not prevent an EMD from trading, it would only prevent EMDs from trading using DEA.

Some commenters noted that there may be entities that are registered as both a portfolio manager and an EMD. To accommodate for these instances, we have proposed that if a firm is registered as both a portfolio manager and an EMD, it would be eligible for DEA provided that it only uses DEA when acting in its capacity as a portfolio manager and not in its capacity as an EMD. If this firm uses DEA to place trades for its non-advisory clients, then we would consider it to be using DEA in its capacity as an EMD and therefore to be inappropriately using DEA. Similarly, if a foreign dealer is registered as an EMD, it would be eligible for DEA provided that it only uses DEA when acting in its capacity as a foreign dealer and not in its capacity as an EMD for Canadian clients.[7]

The 2011 Proposal did not place any specific limitations on the use of DEA by individuals and we continue to be of the view that certain individuals should not be excluded from obtaining DEA access. While in general we do not think that retail investors should use DEA, there may be circumstances in which sophisticated individuals that have access to the necessary technology and resources, such as former registered traders or floor brokers, can use DEA appropriately. In this type of circumstance and

[7] Subsection 4.2(2) 23-103CP.

if a participant dealer establishes and applies appropriate client standards, we would consider it to be acceptable for individuals to use DEA.[8]

(ii) Minimum Standards for DEA Clients

While DEA clients are usually large, institutional investors with regulatory obligations, some DEA clients, as described above, may also be retail clients that have particular sophistication and resources to be able to manage DEA. A participant dealer must understand its risks in providing DEA and address those risks when establishing its minimum standards for providing DEA to each client. It would also be expected that a participant dealer would ensure that it can adequately manage its DEA business. For example, the participant dealer would need to ensure that it has the necessary staffing, technology and other required resources, as well as the financial ability to withstand the increased risks of providing DEA.

The Proposed Amendments prescribe that before granting DEA to a client, a participant dealer must first establish, maintain and apply appropriate standards for providing DEA and assess and document whether each client meets these standards.[9] One of the first steps to addressing the financial and regulatory risks associated with DEA would require a participant dealer to conduct due diligence with respect to clients who are to be granted this type of access. This due diligence is key in managing the risks associated with providing DEA and would necessitate a thorough vetting of potential clients accessing marketplaces under its MPID.

A participant dealer's DEA standards would need to include that the client has:

- sufficient financial resources to meet any financial obligations that may result from the use of DEA by that client,
- reasonable knowledge of and proficiency in the use of the order entry system,
- knowledge of and the ability to comply with all applicable marketplace and regulatory requirements, and
- reasonable arrangements to monitor the entry of orders through DEA.[10]

We would consider the above standards to be the minimum necessary for a participant dealer to properly manage its risks, however the participant dealer should assess and determine whether it needs any additional standards given its business model and the nature of each prospective DEA client. For example, standards that may apply to an institutional client may differ from those that apply to an individual.

Unlike the current rules at the marketplace level related to DEA, the Proposed Amendments would not set out an "eligible client list" that imposes specific financial standards for DEA clients. The CSA is of the view that a participant dealer should have the flexibility to determine the specific levels of the minimum standards in order to accommodate its business model and appetite for risk. This is in keeping with global standards related to DEA.

[8] Subsection 4.2(3) 23-103CP.
[9] Subsection 4.3(1) of NI 23-103.
[10] Subsection 4.3(2) of NI 23-103.

In order to ensure that the established minimum DEA client standards are maintained, the Proposed Amendments would oblige a participant dealer to confirm at least annually with each DEA client as to whether it continues to meet the DEA client standards established by the participant dealer.[11] Obtaining a written annual certification by the DEA client may be one way to meet this requirement.

(iii) Written Agreement

In addition to the minimum DEA client standards, the CSA think that certain requirements for the provision of DEA should be a part of every DEA arrangement in order to appropriately address the risks that DEA can pose to the Canadian market. Therefore, the Proposed Amendments would require that before providing DEA, a participant dealer must have a written agreement with each DEA client that specifies that:

- the DEA client will comply with marketplace and regulatory requirements,
- the DEA client will comply with the product limits and credit or other financial limits specified by the participant dealer,
- the DEA client will take all reasonable steps to prevent unauthorized access to the technology that facilitates the DEA,
- the DEA client will fully cooperate with marketplaces or regulation services providers in connection with any investigation or proceeding with respect to the trading conducted pursuant to the DEA provided,
- the DEA client will immediately inform the participant dealer if it fails or expects not to meet the standards set by the participant dealer,
- when the DEA client is trading for the accounts of its clients, the DEA client will take all reasonable steps to ensure that its client orders will flow through the systems of the DEA client and will be subject to reasonable risk management and supervisory controls, policies and procedures,
- the DEA client will inform the participant dealer in writing of all individuals acting on the DEA client's behalf that it has authorized to use its DEA client identifier, and
- the participant dealer has the authority, without prior notice, to reject, vary, correct or cancel orders and discontinue accepting orders.[12]

While these requirements are expected to address many of the risks associated with providing DEA, a participant dealer may add provisions to the written agreement it thinks are necessary to manage its specific risks.

(iv) Training of a DEA Client

A participant dealer would also need to be satisfied that a prospective DEA client has reasonable knowledge of marketplace and regulatory requirements before providing DEA.[13] This proposed requirement is meant to specifically address the market integrity risk that providing DEA can pose to the participant dealer. The participant dealer must therefore determine, what, if any, training its client

[11] Subsection 4.3(3) of NI 23-103.
[12] Section 4.4 of NI 23-103.
[13] Subsection 4.5(1) of NI 23-103.

requires to ensure that the client understands the applicable marketplace and regulatory requirements and how trading on the marketplace system occurs to help mitigate this risk. We are not proposing any specific type of training to be provided; however, depending on the client and the trading it plans to do, the participant dealer may require it to take the same types of courses as is required for an approved participant under UMIR.

(v) DEA Client Identifiers

In order to allow regulators to identify DEA trading more readily and determine the specific client behind each trade more easily, the Proposed Amendments would require that a participant dealer assign each DEA client a unique identifier that must be associated with every order it sends using DEA.[14] We would expect the participant dealer to work with the various marketplaces to assign these identifiers and ensure that each order entered on a marketplace by a DEA client using DEA includes this identifier. This practice is currently being followed on certain marketplaces and the CSA believe that mandating this practice across all marketplaces would assist the CSA, exchanges conducting their own market regulation, and regulation services providers in carrying out their regulatory functions.

(vi) Trading by DEA Clients

Due to the risks associated with providing DEA, the CSA think that DEA clients should not pass on their DEA access to their clients. Allowing such behaviour would exacerbate the risks DEA poses to the Canadian market and may widen the breadth of market access to participants who do not have any incentive or obligation to comply with the regulatory requirements or any financial, credit or position limits imposed by participant dealers. Therefore, the Proposed Amendments would prohibit a DEA client from providing its DEA to another person or company.[15]

To contain the use of DEA and thereby limit the risks it poses to a marketplace participant and the market as a whole, the Proposed Amendments would generally only allow a DEA client to trade for its own account. However, certain DEA clients, specifically those that are portfolio managers, restricted portfolio managers and any entity that is registered in a category analogous to the portfolio manager or restricted portfolio manager category in a foreign jurisdiction that is a signatory to the IOSCO Multilateral Memorandum of Understanding would be allowed to trade using DEA for the accounts of their clients.[16]

V. SUMMARY OF CHANGES TO THE DEA RELATED PROVISIONS

After considering the comments received and in order to complement the IIROC proposed amendments related to marketplace access, we have made some changes to the DEA related provisions included in the 2011 Proposal. The Proposed Amendments that we are publishing today reflects those changes.

This section describes the key changes made to the proposed DEA related provisions since the 2011 Proposal.

[14] Section 4.6 of NI 23-103.
[15] Subsection 4.7(1) of NI 23-103.
[16] Subsection 4.7(2) of NI 23-103.

(i) Definition of Direct Electronic Access

We have revised the proposed definition of direct electronic access to more clearly state that it includes the transmission of an order using a person or company's marketplace participant identifier through the person or company's systems for automatic onward transmission to a marketplace or directly to the marketplace without being electronically transmitted through the person or company's systems.

(ii) Application of Requirements Applicable to Participant Dealer Providing Direct Electronic Access

A new proposed provision would not apply the proposed requirements applicable to a participant dealer providing DEA if the participant dealer complies with similar requirements established by a regulation services provider, a recognized exchange that directly monitors the conduct of its members and enforces requirements set under subsection 7.1(1) of NI 23-101 or a recognized quotation and trade reporting system that directly monitors the conduct of its users and enforces requirements set under subsection 7.3(1) of NI 23-101. **Since the Proposed Amendments cover the trading of all securities and set the minimum requirements that must be complied with by all participant dealers, we request feedback on whether there should be an exemption from Part 2.1 of NI 23-103 provided to a participant dealer if it complies with similar requirements established by a recognized exchange or quotation and trade reporting system that directly monitors the conduct of its members and enforces requirements. Similarly, solely with respect to standardized derivatives, should there be an exemption provided to a participant dealer if it complies with similar requirements established by a regulation services provider or a recognized exchange or quotation and trade reporting system that directly monitors the conduct of its members and enforces requirements?**

(iii) Provision of Direct Electronic Access to Registrants

The 2011 Proposal permitted a participant dealer to provide direct electronic access to registrants that were participant dealers or portfolio managers. In order to complement the proposed IIROC amendments related to marketplace access, the Proposed Amendments would not allow participant dealers to provide DEA to other participant dealers, as this is dealt with under the IIROC amendments. Another change is that the Proposed Amendments would allow participant dealers to provide direct electronic access to restricted portfolio managers. We view the risks of providing DEA to a restricted portfolio manager or a portfolio manager to be similar.

(iv) Written Agreement

The Proposed Amendments include a new provision in the written agreement between a participant dealer providing DEA and its DEA client. This new obligation would require a DEA client to inform the participant dealer, in writing, of all individuals acting on the DEA client's behalf that it has authorized to use the DEA client identifier to the participant dealer and to update this list as necessary.

(v) Form of DEA Client Identifier

The Proposed Amendments would introduce a new requirement related to the DEA client identifier. Specifically, the DEA client identifier would need to be assigned in the form and manner required by a

regulation services provider, or a recognized exchange or recognized quotation and trade reporting system that directly monitors the conduct of its participants.

(vi) Provision of DEA Client Identifier to Marketplaces

As well, the Proposed Amendments would require a participant dealer that assigns a DEA client identifier to immediately provide the DEA client identifier to each marketplace to which the DEA client has direct electronic access through the participant dealer. Added guidance in the CP explains that the CSA do not expect a DEA client's name to be disclosed to a marketplace, merely the DEA client identifier which will allow a marketplace to more readily identify DEA flow.

(vii) Clarification re Maintaining Technology Facilitating Direct Electronic Access in a Secure Manner

We have proposed a clarification in the CP that all reasonable steps required to be taken to prevent unauthorized access to the technology facilitating DEA are to be commensurate with the risks posed by the type of technology and systems that are being used.

(viii) Authorization of Employees Using DEA Client Identifier

We have added proposed guidance to the CP explaining that a DEA client must formally authorize individuals that will be using the DEA client identifier when trading for the DEA client.

(ix) Training of DEA Clients

The Proposed Amendments also include proposed guidance in the CP that explains when, after DEA has been granted, a re-assessment of the DEA client's knowledge of applicable marketplace and regulatory requirements would be considered necessary and what the participant dealer could do to address deficiencies in the DEA client's knowledge.

(x) Use of DEA by Entities Registered as an EMD and as a Portfolio Manager or Restricted Portfolio Manager

The proposed guidance in the CP would include a clarification about an EMD's use of DEA if it is also registered as a portfolio manager or restricted portfolio manager. The guidance also clarifies when a foreign dealer that is also registered as an EMD is eligible for DEA.

V. ANTICIPATED COSTS AND BENEFITS OF THE PROPOSED AMENDMENTS

For the Ontario Securities Commission's cost-benefit analysis of the Proposed Amendments, please see Annex E – *Cost-Benefit Analysis – Proposed Amendments to National Instrument 23-103 Electronic Trading*.

VI. AUTHORITY FOR THE PROPOSED INSTRUMENT

In Saskatchewan, the Financial and Consumer Affairs Authority of Saskatchewan (the Commission) has the power to adopt the proposed Instruments, as the Commission regulation, pursuant to following provisions of *The Securities Act, 1988* (Saskatchewan) (the Act):

Sub-clause 154(1)(f) of the Act authorizes regulations prescribing requirements respecting the disclosure or furnishing of information to customers and clients, prospective customers and clients, other registrants, the public or the Commission by registrants and directors, partners, officers, representatives, employees and security holders of registrants;

Sub-clause 154(1)(h) of the Act authorizes regulations prescribing requirements respecting books, records and other documents that market participants shall keep, including the form in which and the period for which the books, records and other documents shall be kept;

Sub-clause 154(1)(i) of the Act authorizes regulating the listing and trading of securities or exchange contracts, including prescribing requirements for keeping records and reporting trades and quotations;

Sub-clause 154(1)(l) of the Act authorizes regulating trading or advising in securities or exchange contracts to prevent trading or advising that is fraudulent, manipulative, deceptive or unfairly detrimental to investors; and

Sub-clause 154(1)(hh.1)(ii) of the Act respecting the media, format, preparation, form, content, execution, certification, dissemination and other use, filing and review of all documents required pursuant to or governed by this Act, and the regulations and all documents determined by the regulations to be ancillary to the documents.

VII. REQUEST FOR COMMENTS

We invite all interested parties to make written submissions with respect to the Proposed Amendments.

Please submit your comments in writing on or before January 23, 2013. If you are not sending your comment by email, send a CD containing the submission (in Microsoft Word format).

Please address your submission to all of the CSA as follows:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Saskatchewan Financial Services Commission
Securities Commission of Newfoundland and Labrador

Deliver your comments **only** to the addresses below. Your comments will be distributed to the other the participating CSA members.

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

and

M^{e} Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
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We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of written comments received during the comment period.

The text of the Proposed Amendments is being published concurrently with this Notice.

VIII. CONTENTS OF ANNEXES

Annex A – Amending Instrument for NI 23-103
Annex B – Blackline of NI 23-103 indicating the Proposed Amendments
Annex C – Blackline of 23-103CP indicating the Proposed Amendments
Annex D – Passport System Amendments
Annex E – Cost-Benefit Analysis
Annex F – Comment Summary and CSA Responses

IX. QUESTIONS

Please refer your questions to any of the following:

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