CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Notice of Amendments to National Instrument 23-103 *Electronic Trading*

I. Introduction

The Canadian Securities Administrators (CSA or we) have made amendments to National Instrument 23-103 *Electronic Trading* (Instrument or NI 23-103) and its related Companion Policy 23-103 (CP) (together, the Amendments). The Amendments institute a consistent framework for marketplaces and marketplace participants regarding the offer and use of direct electronic access (DEA) to ensure that risks associated with DEA are appropriately managed. The Amendments will change the title of NI 23-103 to *Electronic Trading and Direct Electronic Access to Marketplaces*.

The Amendments have been adopted or are expected to be adopted by each member of the CSA. Provided all necessary ministerial approvals are obtained, the Amendments will come into force on March 1, 2014. We are publishing the text of the Amendments along with a blackline copy that identifies the Amendments concurrently with this Notice. The text of the 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 and finalizing the Amendments and we thank them for sharing their knowledge and expertise. IIROC is also publishing today final amendments to the Universal Market Integrity Rules (UMIR) and dealer member rules that reflect and support the Amendments. More information is found at www.iiroc.ca.

Jurisdictions that are a party to Multilateral Instrument 11-102 *Passport System* (currently all jurisdictions except Ontario) have finalized amendments (Passport Amendments) to that instrument that permit the use of the passport system for aspects of NI 23-103. The Passport Amendments are found at Annex D of this Notice.

II. Background

On April 8, 2011, we published the Instrument for comment. It proposed requirements to regulate electronic trading generally, including the provision of DEA. We finalized the Instrument in June, 2012 but did not include requirements related to DEA as we continued to work with IIROC staff to create a regulatory framework that would treat similar types of third party access to marketplaces similarly, both at the CSA and IIROC level.

We subsequently published proposed amendments to the Instrument and CP related to DEA (2012 Proposed Amendments) on October 25, 2012. The 2012 Proposed Amendments included proposed requirements that would impose obligations on participant dealers[1] who offer DEA to their clients to appropriately manage the participant dealers' risks associated with providing DEA. The 2012 Proposed

[1] A participant dealer is defined in section 1 of the Instrument as "a marketplace participant that is an investment dealer or in Quebec, a foreign approved participant as defined in the Rules of the Montréal Exchange Inc. as amended from time to time".

Amendments, together with IIROC's proposed UMIR and dealer member rule amendments related to third party electronic access to marketplaces, introduced a framework that treats similar forms of marketplace access and the risks that arise from these forms of access in a similar manner.

III. Summary of Written Comments Received by the CSA

We thank all three commenters for their submissions in response to the 2012 Proposed Amendments. A list of those who submitted comments, a summary of the comments and our responses to them are attached at Annex E to this Notice. Copies of the comment letters are posted at www.osc.gov.on.ca.

IV. Substance and Purpose of the Amendments

Developments in technology have not only increased the speed of trading but also have enabled marketplace participants to provide their clients with access to marketplaces more easily. The CSA think that there are risks associated with providing a client with DEA and that to ensure these risks are appropriately managed it is important to institute a consistent framework for marketplaces and marketplace participants relating to the offering and use of DEA.

The only DEA specific rules or policies that are currently in place have been set by marketplaces.[2] These rules and policies can vary between marketplaces and there is no consistent standard of interpretation of these requirements. We think that having a consistent framework for the offering and use of DEA in the Instrument reduces the risk of arbitrage among participant dealers providing DEA and also among marketplaces that have differing DEA standards or requirements.

The CSA have taken the view that 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 marketplace participant identifier (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, a participant dealer may be held responsible for the execution of erroneous trades that occur via DEA under its MPID, even when these trades go beyond its financial capability. As well, a participant dealer may be responsible for the lack of compliance with marketplace or regulatory requirements for DEA orders entered using its MPID.

Therefore, we think that 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 marketplace and the financial system.

The Amendments introduce requirements to assist a marketplace participant in managing these risks appropriately. As well, the Amendments will further enhance the integrity of our markets by requiring specific controls to be in place to reduce the risk of violations of regulatory requirements through DEA trading and to better identify DEA trading. For example, the Amendments will help ensure that DEA trading is only conducted by clients that have a reasonable knowledge of applicable marketplace and regulatory requirements. In addition, the Amendments will allow DEA trading to be more readily tracked by regulators through the use of DEA client identifiers.

Below is a summary of the main requirements imposed by the Amendments.

---

[2] We note that marketplaces must revoke their rules or policies related to direct electronic access upon implementation of the Amendments.

(i) Provision of DEA

The Amendments allow only a participant dealer (i.e. a marketplace participant that is an investment dealer or in Québec, a foreign approved participant) to provide DEA.[3]

As well, a participant dealer may not provide DEA to a client that is acting and registered as a dealer with a securities regulatory authority.[4] We have specifically excluded investment dealers and foreign approved participants from receiving DEA as clients in the definition of "direct electronic access" because we think dealer-to-dealer arrangements (known as "routing arrangements" under UMIR) will be better dealt with in IIROC or, in the case of foreign approved participants, Montréal Exchange Inc. (Montréal Exchange), rules that specifically address these types of arrangements.

It is the CSA's view that a client acting and registered as a dealer with a securities regulatory authority must not be provided with DEA because we think that dealers that are not investment dealers should not have low latency electronic access to marketplaces since they are not subject to IIROC or Montréal Exchange rules related to dealer-to-dealer arrangements.

The requirement under subsection 4.2(2) will not prevent a client that is acting and registered as a dealer from using methods other than DEA to trade.

For an entity registered both as a dealer and an adviser, we note that it would be eligible for DEA provided that it only uses DEA when acting in its capacity as an adviser and not in its capacity as a dealer. If this entity uses DEA to place orders for its non-advisory clients, then we would consider it to be using DEA in its capacity as a dealer and therefore to be inappropriately using DEA. Similarly, if a foreign dealer is registered as a dealer, 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 dealer for Canadian clients.[5]

The Amendments also address the issue of the use of DEA by individuals. DEA, especially when used in conjunction with complex trading strategies and algorithms, requires a high level of trading knowledge to be used appropriately. While we do not think that that most individuals possess this level of trading knowledge, there may be circumstances in which sophisticated individuals who 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 if a participant dealer establishes and applies appropriate DEA client standards, we would consider it to be acceptable for individuals to use DEA.

(ii) Minimum Standards for DEA Clients

DEA clients may be large, institutional investors with regulatory obligations while others may be retail clients that have particular sophistication and resources to be able to manage DEA trading.

We think that a participant dealer must understand its risks in providing DEA and address those risks when establishing its minimum standards for providing DEA. We also expect a participant dealer to ensure that it can adequately manage its DEA business, such as having the necessary staffing, technology

[3] Subsection 4.2(1) of NI 23-103.
[4] Subsection 4.2(2) of NI 23-103.
[5] Subsection 4.2(2) of 23-103CP.

and other required resources, as well as having the financial ability to withstand the increased risks of providing DEA.

Therefore, the Amendments require 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 potential DEA client meets these standards.[6] An important step in addressing the financial and regulatory risks associated with providing DEA is a participant dealer conducting due diligence on its prospective DEA clients. A thorough vetting of each DEA client will help a participant dealer ensure that the client meets the necessary standards and will help prevent the participant dealer from being unduly exposed when providing DEA. A participant dealer may conclude that it is not appropriate to offer DEA to a potential DEA client.

A participant dealer's DEA standards must include that the client has:

- sufficient resources to meet any financial obligations that may result from the use of DEA by that client,
- reasonable arrangements in place to ensure all individuals using DEA on behalf of the client have reasonable knowledge of and proficiency in the use of the order entry system,
- reasonable knowledge of and the ability to comply with all applicable marketplace and regulatory requirements, and
- reasonable arrangements in place to monitor the entry of orders through DEA.[7]

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

The Amendments do not set out an "eligible client list" that imposes specific financial standards upon DEA clients as found in the current DEA rules and policies at the marketplace level. We think 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 approach is in keeping with global standards related to DEA.

In order to ensure that the established minimum DEA client standards are maintained, the Amendments require a participant dealer to annually assess, confirm and document that each DEA client continues to meet these standards.[8]

(iii) Written Agreement

In addition to minimum DEA client standards, we think that certain requirements for the provision of DEA should be part of every DEA arrangement to make sure that the risks of providing DEA are appropriately addressed. Therefore, the Amendments 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,

---

[6] Subsection 4.3(1) of NI 23-103.
[7] Subsection 4.3(2) of NI 23-103.
[8] Subsection 4.3(3) of NI 23-103.

- 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 co-operate in connection with any investigation or proceeding by marketplaces or regulation services providers 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 another person or company, it will ensure that the orders of the other person or company are transmitted 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 immediately provide the participant dealer in writing with the names of all personnel acting on the DEA client's behalf that it has authorized to enter an order using DEA, and
- the participant dealer has the authority, without prior notice, to reject, cancel or discontinue accepting orders and to vary or correct an order to comply with a marketplace or regulatory requirement.[9]

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

(iv) Training of DEA Clients

In order to address the market integrity risk that providing DEA can pose to a participant dealer, the Amendments require a participant dealer to be satisfied that a prospective DEA client has reasonable knowledge of marketplace and regulatory requirements as well as the DEA client standards the participant dealer has established before providing DEA to that client.[10] The participant dealer must determine what, if any, training a prospective DEA client requires to ensure the client has the requisite knowledge. Therefore, while no specific type of training is mandated by the Amendments, depending on the client and the trading it plans to do, the participant dealer may determine that a DEA client must take the same types of courses as is required for an approved participant under UMIR.

As well, in order to ensure that a DEA client is kept up to date with respect to applicable marketplace and regulatory requirements, a participant dealer must ensure that a DEA client receives any relevant amendments to these requirements.[11]

(v) DEA Client Identifier

The Amendments require a participant dealer to ensure that a DEA client is assigned a unique DEA client identifier that will be associated with every order the client sends using DEA.[12] In addition to this

[9] Section 4.4 of NI 23-103.
[10] Subsection 4.5(1) of NI 23-103.
[11] Subsection 4.5(2) of NI 23-103.
[12] Subsection 4.6(1) of NI 23-103.

requirement, the Amendments prohibit a marketplace from permitting its participants to provide DEA unless the marketplace's systems support the use of DEA client identifiers.[13]

These provisions will allow regulators to identify DEA trading more readily and to more easily determine the specific DEA client behind each trade. We note that DEA client identifiers are currently being used on certain Canadian marketplaces and are of the view that mandating this practice across all marketplaces will help regulators to carry out their functions more effectively.

(vi) Trading by DEA Clients

In order to appropriately manage the risks of providing DEA, we do not think that DEA clients should pass on or provide their DEA access to another person or company. The CSA think that this "sub-delegation" of DEA would exacerbate the risks that DEA poses to the Canadian market by widening 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 Amendments prohibit a DEA client from providing its DEA to another person or company other than the personnel it has authorized under subparagraph 4.4(a)(vii) of the Instrument.[14]

In order to contain the use of DEA and limit the risks it poses to the participant dealer, the Amendments generally only allow a DEA client to trade for its own account. However, certain DEA clients may trade for the account of another person or company using DEA. Specifically, a person or company that: (i) is registered or exempted from registration as an adviser under securities legislation or (ii) carries on business in a foreign jurisdiction, is permitted to trade for the account of another person or company in that jurisdiction using DEA and is regulated in the foreign jurisdiction by a signatory to the IOSCO Multilateral Memorandum of Understanding, may trade for the account of another person or company using DEA.[15]

(vii) Application of Part 2.1 of the Instrument

The IIROC UMIR and dealer member rule amendments are intended to provide a comprehensive framework to regulate various forms of third-party electronic access to marketplaces provided by their participants and to complement the Amendments.

To avoid duplication with respect to DEA, section 4.1 of the Instrument exempts a participant dealer from complying with the requirements in Part 2.1 if it complies with requirements that are similar to those in Part 2.1 and have been established by a regulation services provider, or a recognized exchange or a recognized quotation and trade reporting system (QTRS) that directly monitors the conduct of its participants. We think that if the risks associated with providing and using DEA are similarly covered under the rules of a regulation services provider, or a recognized exchange or QTRS that performs its own regulation, then the requirements in Part 2.1 of the Instrument are not needed.

However, if a participant dealer is providing DEA access to a client and is not subject to similar requirements, it would still need to adhere to the requirements in Part 2.1. For example, a marketplace participant that is a member of the Montréal Exchange and provides DEA but is not subject to the UMIR

[13] Section 9.1 of NI 23-103.
[14] Subsection 4.7(4) of NI 23-103.
[15] Subsection 4.7(1) of NI 23-103.

requirements related to DEA would need to follow the requirements in Part 2.1 until the Montréal Exchange implements requirements similar to those in Part 2.1.

V. Summary of Changes to the 2012 Proposed Amendments

While the Amendments are substantially similar to the 2012 Proposed Amendments, this section describes the non-material changes the CSA have made to the proposed amendments published for comment on October 25, 2012.

(i) Definition of DEA

We have revised the definition of DEA to exclude investment dealers and in Quebec, foreign approved participants, from its terms. This definition is now more consistent with the concept of DEA as outlined in UMIR and the change was made to address a comment that asked both the CSA and IIROC proposals to be as similar as possible to avoid confusion. We note that the granting of access to marketplaces by participant dealers to investment dealers or foreign approved participants of the Montréal Exchange is to be governed either by the rules of IIROC or soon to be proposed rules by the Montréal Exchange.

(ii) Definition of Participant Dealer

We have revised the definition of participant dealer to clarify that in Québec, this term includes foreign approved participants as that term is defined in the Rules of the Montréal Exchange from time to time.

(iii) Provision of DEA

Subsection 4.2(2) of the Instrument does not allow DEA to be provided to a person or company that is acting and registered as a dealer with a securities regulatory authority. The initial provision proposed that DEA could only be provided to registrants that were either portfolio managers or restricted portfolio managers. We received a comment that the proposed provision would benefit from greater clarity by specifying the entities that may not receive DEA. We agree with this comment and have revised the wording to clarify that a client acting and registered as a dealer may not be provided with DEA from a participant dealer. This provision would apply to a client registered as a mutual fund dealer, scholarship plan dealer, exempt market dealer and a restricted dealer.[16] The revised wording is also meant to clarify that a participant dealer may provide DEA to any other client that satisfies the criteria of sections 4.3, 4.4 and 4.5 of the Instrument, including banks and trust companies.

We think that, in order to prevent regulatory arbitrage, a client registered in a category of dealer, other than "investment dealer", should not have this type of electronic access to marketplaces through a participant dealer since such a client is not subject to IIROC rules.

(iv) Standards for DEA clients

Under subsection 4.3(1) of NI 23-103, a participant dealer must not provide DEA to a client unless it has established, maintains and applies standards that are reasonably designed to manage, in accordance with prudent business practices, the participant dealer's risks associated with providing DEA. Changes to the wording of this subsection were made to align it with the standard in paragraph 3(1)(a) of the Instrument that requires marketplace participants to establish, maintain and ensure compliance with risk management

[16] We note that investment dealers are outside the definition of DEA.

and supervisory controls, policies and procedures that are reasonably designed to manage, in accordance with prudent business practices, the risks associated with marketplace access or providing clients with access to a marketplace.

We also added in subsection 4.3(3) of NI 23-103, that a participant dealer must assess and document as well as confirm on an annual basis that a DEA client continues to meet the standards established by the participant dealer. This change clarifies what actions the participant dealer must take during this annual confirmation.

(v) Written Agreement

Subsection 4.4(b) requires that a written agreement between the participant dealer and the DEA client provide that a participant dealer is authorized to reject or cancel any order or discontinue accepting orders from the DEA client without prior notice. The proposed provision also required that a participant dealer be authorized to vary or correct any order. We revised this proposed requirement so that a participant dealer need only be authorized to vary or correct an order to comply with a marketplace or regulatory requirement. This change addresses the concern that a DEA client may be uncomfortable with authorizing a participant dealer to vary or correct an order without notice and therefore change the DEA client's risk portfolio without the DEA client's knowledge. We note that this authorization is the minimum required by the CSA and that a participant dealer may impose more stringent requirements pertaining to its authorization that it thinks are necessary to appropriately manage its risks in providing DEA.

(vi) DEA Client Identifier

The 2012 Proposed Amendments included a requirement for a participant dealer to assign a DEA client identifier upon providing DEA to a DEA client. To ensure consistency with the UMIR amendments related to third party access, we have modified this requirement so that participant dealers must ensure the client is assigned a DEA client identifier. We expect that the current method of assigning DEA client identifiers used by the regulation services provider will continue to be used into the foreseeable future. However, the revised wording can accommodate any future changes to this process while ensuring that a client will only trade using DEA once it has received a unique DEA client identifier.

(vii) Trading by DEA Clients

Section 4.7 requires that if a DEA client is using DEA and trading for the account of another person or company, the orders of the other person or company must be transmitted through the systems of the DEA client before being entered on a marketplace through a participant dealer.

We received comments that the prohibition against providing DEA to a DEA client trading for the account of another person or company in subsection 4.7(1) did not correspond to the permissions in subsection 4.7(2) that referred to "clients". To rectify this inconsistency, we have modified the wording to use "person or company" throughout this section of the Instrument.

We also received comments that the wording between the UMIR amendments related to DEA should be as similar as possible to the provisions found in the Instrument. We modified some of the language in this section to conform to the language used in the corresponding UMIR amendments.

Finally, wording in subsection 4.7(1) has been modified to replace the term "is registered in a category analogous" to a portfolio manager or restricted portfolio manager with "carries on business" to address a concern that it may be difficult to determine whether a registration category in a foreign jurisdiction is

analogous to the CSA's portfolio manager or restricted portfolio manager category. We think that the revised wording of "carries on business" will enable participant dealers to more readily identify DEA clients that are eligible to trade for the account of another person or company.

VI. Contents of Annexes

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

VII. Questions

The Amendments are available on certain websites of CSA members, including:

www.lautorite.qc.ca
www.albertasecurities.ca
www.bcsc.ca
www.osc.gov.on.ca

Please refer your questions to any of the following:

Sonali GuptaBhaya Ontario Securities Commission 416-593-2331 sguptabhaya@osc.gov.on.ca	Tracey Stern Ontario Securities Commission 416-593-8167 tstern@osc.gov.on.ca
Paul Romain Ontario Securities Commission 416-204-8991 promain@osc.gov.on.ca	Serge Boisvert Autorité des marchés financiers 514-395-0337 ext. 4358 serge.boisvert@lautorite.qc.ca
Élaine Lanouette Autorité des marchés financiers 514-395-0337 ext. 4321 elaine.lanouette@lautorite.qc.ca	Meg Tassie British Columbia Securities Commission 604-899-6819 mtassie@bcsc.bc.ca
Shane Altbaum Alberta Securities Commission 403-355-4475 shane.altbaum@asc.ca	Lawrence Truong Alberta Securities Commission 403-297-2427 lawrence.truong@asc.ca

VIII. Local Matters

In Ontario, the Amendments to the Instrument and other required materials were delivered to the Minister of Finance on July 4, 2013. The Minister may approve or reject the Amendments or return them for further consideration. If the Minister approves the Amendments or does not take any further action by September 3, 2013, the Amendments will come into force on March 1, 2014.

In Québec, the Amendments will be delivered to the Minister of Finance for approval. The Amendments will come into force on the date of publication in the *Gazette officielle du Québec* or on any later date specified in the Amendments.

July 4, 2013