

## Appendix B

### COST-BENEFIT ANALYSIS

#### Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access To Marketplaces*

##### I. Overview

Trading on Canadian marketplaces has occurred through electronic means, however the Canadian market has evolved substantially in recent years. Technological advancements have increased the complexity of the market and the methods by which market participants can trade or access multiple marketplaces. Trading strategies and speeds have become correspondingly complex. Electronic access to the marketplaces has also been broadly extended with marketplace participants providing direct electronic access (DEA). DEA refers to the process whereby access to a marketplace is provided to clients and these clients transmit orders to the marketplace execution system using the marketplace participant's identifier without additional management by the participant dealer.

Such rapid and complex technological change has resulted in many new risks to the Canadian market. In our view, the regulatory framework for electronic trading must reflect these changes and address these risks. Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* (Proposed Rule) is designed to align regulatory requirements with the current trading environment to ensure effective regulation and mitigation of these risks.

##### II. Costs and Benefits

###### Benefits

The Proposed Rule should benefit all market participants including investors, as well as the market as a whole. It is aimed at reducing the risks of electronic trading and enhancing investor confidence in the market by requiring risk management and supervisory controls, policies and procedures designed to manage the risks of both electronic trading and DEA. These controls, policies and procedures would provide for risk checks and filters of orders before they are entered onto marketplaces by marketplace participants or DEA clients.

Requiring marketplace participants to put in place risk management and supervisory controls, policies and procedures, including filters, should reduce both the systemic risk and the risks to individual dealers. In the absence of a robust system of controls, policies and procedures, the entry of one or more erroneous orders in a rapid manner could leave a dealer with substantial financial liabilities in a very short period of time. This credit risk can translate into broader systemic risk if the dealer is unable to cover these liabilities.

From a regulatory view, in the absence of effective controls, a risk exists that the dealer may also be unaware of the nature of the trading activity taking place using its marketplace participant identifier in a timely manner. The Proposed Rule would thus aid dealers to monitor their own trading as well as that of their clients, and require that the appropriate tools be available to aid in ensuring that activity is in compliance with all regulatory requirements.

Additionally, a lack of controls at the marketplace participant level could expose the entire market to rapid erroneous order flow which could affect the trading activities of a much broader group of participants, and could potentially require the cancellation of trades. Establishing controls, policies and procedures surrounding electronic trading would serve to increase confidence that the market is operating in a fair and orderly manner, by reducing the risks of errant order flow having a significant impact on the trading activities and risks of multiple participants.

The Proposed Rule would put requirements in Canada on a similar level to those in the United States, and would serve to prevent regulatory arbitrage and a migration of risks if Canada is seen as a jurisdiction with significantly less requirements and thus lower costs with respect to mitigation of the risks associated with electronic trading.

The Proposed Rule should also promote fairness by establishing a standard set of rules applicable to all market participants providing DEA, regardless of the marketplace accessed. Some dealers may already have risk systems operational, and by placing this obligation on all participant dealers there will be no competitive or economic advantage to be gained by offering access with no such filters and supervisory controls in place. Additionally, given that no consistent rule framework is currently applied specifically to electronic trading, establishing this set of rules will improve both the integrity and confidence in the market by levelling the playing field and standardizing the obligations so that there are minimum requirements in place applicable for all, no matter where orders are entered.

## **Costs**

### **(i) Technology and maintenance costs**

We recognize that for some participants, the Proposed Rule would likely introduce costs associated with the development and implementation of risk management and supervisory controls, policies and procedures. These costs will vary depending on the level of existing controls in place, the nature of their business and trading strategies, as well as the business models and strategies of any DEA clients. The costs may involve initial outlays as well as ongoing expenses. They will also vary depending on whether a participant chooses to use an in-house system or those provided by a third party.

There may also be costs to the market in the form of minimal additional latency on some order flow. These additional latency costs will again be dependent on the type of trading strategies in use and whether existing controls and risk management filters already exist. This additional latency may not have a major impact on the business of most participants, except for those relying on ultra low latency connections for particular strategies.

Although we acknowledge these costs, we believe that they are proportionate to the benefits provided to the market as a whole as discussed above. The protection of the integrity of the market, the reduction in both dealer and systemic risks, and the increase in the confidence of individual investors make these costs justifiable.

### **(ii) Compliance Costs**

Under the Proposed Rule, marketplace participants would be required to ensure ongoing compliance with the responsibilities imposed. Although some new costs are likely, we expect that many of the compliance requirements would already be in place. As an example we note that currently, all registrants are required under National Instrument 31-103 – *Registration Requirements and Exemptions* (NI 31-103) to manage the risks to their business<sup>1</sup>, and we would expect that they would have established policies and procedures related to marketplace access. Any additional costs of compliance would vary depending on the nature of the business or services provided by the individual marketplace participant.

With respect to DEA, we acknowledge there may be increased costs associated with establishing, maintaining and applying appropriate standards before providing DEA to a client. We believe these costs are justifiable given the protections afforded to the market as a whole through the implementation of the Proposed Rule. Participant dealers who choose to provide DEA to clients should be appropriately vetting potential clients and ensuring standards are met on a continuing basis not only to mitigate financial risk to themselves, but also the systemic risks associated with the activities of their clients.

### **(iii) Costs to Marketplaces**

The Proposed Rule would among other things, impose upon marketplaces the obligation to prevent the execution of orders from exceeding price and volume thresholds. These thresholds would be set by a regulation services provider monitoring the activities of the marketplace and the trading of securities, or by the marketplace itself if it directly monitors the conduct of its members or users and enforces requirements set pursuant to subsection 7.1(1) or 7.3(1) of National Instrument 23-101 *Trading Rules*.<sup>2</sup>

Some marketplaces in Canada already have such systems in place, while others do not. Additional costs will therefore vary depending on the marketplace in question and whether thresholds already exist.

We believe that price protection thresholds are an important layer of protection for the integrity of our market and for investor protection, and thus the costs associated with implementation are justified. Some marketplaces have already taken steps to ensure they have such protections in place, and we believe the requirements in the Proposed Rule will ensure a level playing field exists amongst marketplaces and ensure there is no competitive advantage to be gained by not offering these controls.

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<sup>1</sup> NI 31-103 paragraph 11.1(b) states that “A registered firm must 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.”

<sup>2</sup> Sections 7.1 and 7.3 of National Instrument 23-101 *Trading Rules* state that a recognized exchange or a recognized quotation and trade reporting system may monitor the conduct of its members and enforce the requirements governing its members either directly or indirectly through a regulation services provider.

**Conclusion**

We acknowledge the increase in costs for some market participants associated with the Proposed Rule. In our opinion, the benefits associated with the Proposed Rule are proportionate to these costs. Recent market events have illustrated the risks involved with electronic trading, and appropriate rules or controls to mitigate risks will address these concerns. Further, in establishing requirements related to electronic trading and DEA, the responsibility to ensure the efficiency and protection of our markets will be shared by all participants and there will be no advantages provided to those with less stringent controls and policies in place.