Penson Financial Services Canada
Member of the IIROC and CIPF
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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

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Re: Comment Letter – Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* (the **"Proposed Rule**")

Penson Financial Services Canada Inc. ("**Penson**" or "**we**") appreciates the opportunity to comment on the Canadian Securities Administrators' (the "**CSA**") Proposed Rule. As Canada's largest independent provider of correspondent clearing services, Penson provides direct electronic access ("**DEA**") to Canadian marketplaces to a number of Canadian and U.S. firms. Penson is supportive of the CSA's efforts to develop a Canada-wide regulatory system for electronic trading, including DEA. In particular, we are very supportive of the creation of principled based rules that focus on risk management and supervisory controls, policies and procedures **("RM&SCPP")**.

Outlined below please find our comments to the Proposed Rule for your consideration. To summarize, our comments are primarily focus on two issues. The first is that the Proposed Rule prohibits exempt market dealers ("**EMDs**") from being able to act as DEA clients. We do not agree with this prohibition. Secondly, the Proposed Rule is unclear as to the extent and circumstances that Direct DEA (as defined below) or Naked Access activities would be permitted, if at all.

Terms used in this comment letter which are defined in the Proposed Rule shall have the same meaning as in the Proposed Rule.

1. Defining Direct DEA & Indirect DEA

The Proposed Rule and accompanying notice (the "**Notice**") make reference to two types of DEA currently prevalent in the marketplace.[1] The first is where trades made by a DEA client flow through the systems of the participant dealer (or a third party system) prior to hitting a marketplace ("**Indirect DEA**"). The second is where trades made by a DEA client flow directly to a marketplace without passing through the systems of the participant dealer (or a third party system) ("**Direct DEA**"). Direct DEA is often referred to on the street as "Naked Access".

We have defined the above terms for purposes of clarity. Specific comments relating to Direct DEA and Indirect DEA are set out in section 5 of this comment letter.

2. "Additional Order Management"

The definition of "direct electronic access" includes a carve-out for circumstances where the participant dealer provides "additional order management." We note that the Companion Policy to the Proposed Rule (the "**CP**") provides some colour on this carve-out. However, given the fact that the term "direct electronic access" is a threshold definition which triggers the applicability of much of the Proposed Rule, additional clarity and examples of what the CSA would consider to be sufficient or adequate "additional order management" would provide assistance to marketplace participants.

3. Risk Management and Supervisory Controls, Policies and Procedures

Penson is generally very supportive of the fact that the Proposed Rule emphasizes the importance of RM&SCPP. We appreciate that while the Proposed Rule sets out minimum

[1] For example, the following are references to the concept of direct and indirect DEA in the Proposed Rule and/or Notice: (a) the third paragraph section II.1 of the Notice; (b) the definition of "direct electronic access" in the Proposed Rule; and (c) section 11(3) of the Proposed Rule.

elements of RM&SCPP, it also allows for flexibility and require participant dealers to tailor their RM&SCPP to each specific DEA client, as may be necessary and appropriate in the circumstances.

However, we do have specific comments relating to the requirement provided in section 3(2)(a) of the Proposed Rule that the RM&SCPP must include automated pre-trade controls. These comments are described in section 5 of this comment letter.

4. Exempt Market Dealers

Section 6(2) of the Proposed Rule provides that a participant dealer may not provide DEA to a registrant, unless the registrant is (a) a participant dealer (a marketplace participant that is a registered investment dealer and Investment Industry Regulatory Organization of Canada ("**IIROC**") firm); or (b) a portfolio manager. As indicated in the CP and the Notice, the effect of this provision is to preclude EMDs from being able to act as DEA clients. The rationale expressed by the CSA for this preclusion is that it does not want to facilitate regulatory arbitrage with respect to trading. In the view of the CSA, if a registered dealer wishes to have direct access to marketplaces, then the registered dealer should be an IIROC member and therefore be directly subject to IIROC rules including the Universal Market Integrity Rules ("**UMIR**") if accessing equity marketplaces.

As described in detail below, we do not agree with this position.

(a) Non-Registrants as Potential DEA Clients

As indicated above, section 6(2) of the Proposed Rule limits DEA access to registrants who are participant dealers or portfolio managers. The term "registrant" is defined under the *Securities Act* (Ontario) (the "**OSA**") to mean a person or company registered or required to be registered under the OSA[2].

The Proposed Rule does not provide any restriction on firms that are not registrants from becoming DEA clients. As such, potential DEA clients may include the following classes of firms:

(i) Canadian firms that are exempt from registration (e.g., proprietary trading firms exempt by virtue of the "trade through a registered dealer exemption" set out in section 8.5 of National Instrument 31-103 *Registration Requirements and Exemptions* ("**NI 31-103**"));

[2] All other provinces and jurisdictions in Canada have similar or identical definitions of the term "registrant".

(ii) certain Canadian firms that would otherwise be required to register as EMDs, but who qualify for the "Northwest Exemption" (local relief orders made available in certain Northwestern Canadian jurisdictions, including Alberta, British Columbia, Manitoba, the Northwest territories, Nunavut and the Yukon Territory); and

(iii) any foreign firm (regardless of whether it is registered or not in its home jurisdiction)[3].

It is peculiar that the CSA would be comfortable with allowing the above classes of entities to be potential DEA clients, but not EMDs. We note that none of the above classes of firms would be in a better position to understand Canadian marketplace and regulatory requirements (including UMIR) than would EMDs. On this point, we also note that part of the rationale for creating the EMD category of registration in NI 31-103 (in contrast with its predecessor category of registration, the "limited market dealer") was to impose substantive regulatory requirements in the areas of proficiency, capital and insurance on EMDs. As such, EMDs, unlike the classes of firms identified above, will have familiarity with Canadian regulatory requirements and will have met a minimum level of proficiency.

(b) Other Issues

We would also like to highlight some additional concerns we have with prohibiting EMDs from being DEA clients.

(i) *Regulatory Oversight*. Under the current regulatory regime, Canadian regulators have considerably stronger nexus to EMDs than any of the above classes of firms. The CSA currently conducts regular compliance reviews and audits of EMDs. As such, Canadian regulators would be able to closely review all trading activities and the RM&SCPP of an EMD that engaged in DEA activities as a DEA client. This would not be the case with the classes of firms identified above as the CSA does not generally review or audit unregistered or foreign based firms.

[3] It should be noted that, as a technical matter, most Canadian participant dealers would limit DEA access to foreign firms in accordance with applicable securities laws and regulations in the home jurisdictions of such foreign firms. For example, a Canadian participant dealer providing DEA access to a U.S. based client would normally trip the U.S. broker-dealer registration requirements. However, Rule 15a-6 under the *Exchange Act* provides an exemption to participant dealers so long as, among other things, the U.S. client is registered as a broker or dealer in the U.S. Accordingly, as a practical matter, and as is presently the case, most Canadian participant dealers would continue to limit DEA to U.S. firms who are registered broker-dealers.

(ii) *Disharmony*. The Proposed Rule would result in increased disharmony between firms who carry on exempt market dealer activities across Canada. As described in section 4(a)(ii) above, those firms carrying on exempt market dealer activities in the "Northwestern" jurisdiction would be eligible to be DEA clients, while those outside the Northwestern jurisdictions would not.

(iii) *Proprietary Trading*. As noted in section 4(a)(i) above, to the extent that a Canadian firm engaged solely in proprietary trading, such firm would be eligible to be a DEA client under the Proposed Rule because it would not meet the definition of "registrant". However, if an EMD engaged in the same activity (proprietary trading), the EMD would be prohibited from being a DEA client with respect to such proprietary trading activities. In other words, under the Proposed Rule, an unregistered proprietary trading firm has greater latitude to conduct proprietary trading activities than does a registered EMD, notwithstanding the fact that the EMD has substantive regulatory requirements and is subject to reviews and audits by Canadian regulators. In fact, EMDs are worse off due to their registration.

On this issue, the Proposed Rule may encourage EMDs to establish separate unregistered entities to conduct their proprietary trading in order to be eligible for DEA. We do not believe that an EMD establishing a separate unregistered firm in order to circumvent the Proposed Rule would be in the best interest of minimizing risk to the Canadian market.

(iv) *Global Access Platforms.* Currently, some of the larger global financial firms offer clients direct electronic access to global marketplaces, including Canadian marketplaces. For a Canadian firm to have access such global platforms, it must be registered as an EMD or investment dealer.

Under the Proposed Rule, global access providers will be required to either (a) remove Canadian marketplaces from their menu of marketplaces in their platform, or (b) prohibit EMDs from becoming global access clients. Since removing Canadian marketplaces from their platform would be detrimental to such firm's business with clients from outside Canada, the more likely outcome will be that EMDs will be precluded from accessing global marketplaces. The effect of this is that certain business activities currently conducted by EMDs will move to investment dealer firms.

(c) DEA Responsibility

The Proposed Rule imposes a framework around the provision of DEA that is consistent with the principle that the participant dealer bears responsibility to adequately manage the risks associated with allowing another firm to trade under its number (the "**Participant Dealer Responsibility Principle**"). In this regard, the Notice states as follows:

> The approach we have taken supports the principle that marketplace participants, including participant dealer, 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 [*Section III.2*].

We do not believe that prohibiting EMDs from DEA client eligibility is consistent with the Participant Dealer Responsibility Principle or the above referenced language from the Notice. Rather, in our view, the better approach would be to place responsibility on participant dealers to conduct the appropriate due diligence and make the determination of whether the particular EMD would be a suitable DEA client and, if so, pursuant to what limitations or restrictions.

5. Direct DEA / Naked Access

As described above, Direct DEA describes the circumstance where trades made by a DEA Client flow directly to a marketplace without passing through the systems of the participant dealer (or a third party system).

The Proposed Rule is unclear as to the extent and circumstances that Direct DEA activities would be permitted, if at all. It is our view that Direct DEA should be allowed to continue under the Proposed Rule.

(a) Advantages & Risks of Direct DEA

The most significant advantage for a DEA client to engage in Direct DEA is that it facilitates fast and efficient trade execution. This, in turn, has attracted new firms to access Canadian marketplaces who employ a variety of strategies predicated on high speeds and low latency. Among the numerous benefits of increased trading in the Canadian marketplaces are: increased liquidity, reduction in spreads, acceleration of price discovery, reduction in market volatility and reduction in trading fees.

Notwithstanding these benefits, because trades made using Direct DEA flow directly from the DEA client to the marketplace, the participant dealer is unable to use its own pre-trade control systems. As such, Direct DEA does pose greater risk to participant dealers than Indirect DEA due to the fact that the participant dealer can not, itself, stop an order prior to it

reaching the marketplace. Currently, participant dealers minimize this risk by, among other things, conducting appropriate due diligence on prospective Direct DEA clients to ensure that the Direct DEA client itself has adequate pre-trade control systems in place. As such, the participant dealer can ensure that any trade limitations/restrictions required by the participant dealer to mitigate risk are properly affected by the DEA client.

(b) Direct DEA under the Proposed Rule

The Proposed Rule is unclear as to the extent and circumstances that Direct DEA activities would be permitted, if at all.

Section 3(1) of the Proposed Rule requires marketplace participants to establish, maintain and ensure compliance with RM&SCPP that are reasonably designed to manage risks associated with marketplace access or providing clients with DEA. Section 3(2) sets out certain minimum elements that must be included in a firm's RM&SCPP, including "automated pre-trade controls". Section 3(4) states that the RM&SCPP (including those provided by a third party) must be under the direct and exclusive control of the market participant.

Read together, these provisions appear to effectively prohibit Direct DEA activity as participant dealers would no longer be able to rely on the Direct DEA client's automated pre-trade controls, regardless of the degree of sophistication of such controls. The CSA appears to confirm this and provides some rationale for this in the CP:

> We are aware that a DEA client that is not a registered dealer may maintain its own risk management controls. However, part of the intent of NI 23-103's [RM&SCPP] is to require a participant dealer to manage its risks associated with electronic trading and to protect the participant dealer under whose marketplace participant identifier the order is being entered. Consequently, a participant dealer must maintain risk management and supervisory controls, policies and procedures regardless of whether its DEA clients also maintain their own controls. *It is not appropriate for a participant dealer to rely on a DEA client's risk management controls, as the participant dealer would not be able to ensure the sufficiency of the DEA client's controls, nor would the controls be tailored to the particular needs of the participant dealer*. [*Emphasis Added*]

To the extent that the intention of the Proposed Rule was not prohibit Direct DEA, additional clarity would be helpful.

Notwithstanding the above, section 4 of the Proposed Rule allows for certain limited Direct DEA activities where the Direct DEA client is an investment dealer. The CP clarifies that this

was intended to address introducing/carrying broker or jitney arrangements that involve multiple dealers. The manner in which this is achieved is by permitting a participant dealer to reasonably allocate control over specific RM&SCPP to an investment dealer if certain conditions are met. Direct DEA activities would be possible under this provision as participant dealers could allocate control of their "automated pre-trade controls" to the investment dealer.

However, section 3(5) of the Proposed Rule states that a third party that provides RM&SCPP to a marketplace participant must be independent from each DEA client of that marketplace participant. In the Direct DEA scenario described in the preceding paragraph, the investment dealer is both the DEA client and the third party providing RM&SCPP services. As such, it appears that section 3(5) effectively removes the ability to engage in any Direct DEA activities, including with an investment dealer firm.

In addition to section 3(5), other provisions of the Proposed Rule appear to be inconsistent with the CSA's general prohibition of Direct DEA activities. An example is provide below.

Section 11(2) provides that only certain classes of DEA clients may engage in DEA trading on account of their clients. These include: (a) participant dealers; (b) portfolio managers; or (c) certain foreign entities authorized in a category analogous to the entities referred to in (a) and (b). Further, Section 11(3) provides that:

> [w]here a DEA client is using direct electronic access to trade for the accounts of its clients, pursuant to subsection (2), the clients' orders must flow through the systems of the *DEA client before being entered on a marketplace directly* or indirectly through a participant dealer. [*Emphasis Added*]

The italicized language above specifically contemplates orders flowing directly from such DEA clients to the marketplace (without going through the participant dealer's system). In other words, section 11(3) appears to contemplate Direct DEA activity involving a DEA client who is a participant dealer, portfolio manager or foreign equivalent of each, so long as the DEA client was trading on account of its client. This appears to be contrary to the above discussion which outlines that Direct DEA activities may be prohibited under the Proposed Rule. Additional guidance would be helpful in this regard.

(c) Direct DEA should be Permissible

It is our view that Direct DEA should continue to be permitted in Canada.

As described above, the higher speed and reduced latency achievable through Direct DEA has attracted many firms to the Canadian markets who are able employ a variety of trading

strategies. This, in turn, provides numerous benefits to Canadian investors: increased liquidity, reduction in spreads, acceleration of price discovery and reduction in market volatility. As a consequence of the Proposed Rule's effective prohibition on Direct DEA, many firms who rely on speed of trade execution may choose to leave the Canadian markets, thereby negatively impacting the Canadian marketplace and investors (either directly through elimination of the benefits listed in the preceding sentence, or indirectly through increased trading fees as a result of potential decreased trading volumes on Canadian marketplaces).

Secondly, we do not believe that prohibiting Direct DEA is consistent with the Participant Dealer Responsibility Principle. Namely, as it is the participant dealer who bears ultimately responsibility to adequately manage the risks associated with allowing another firm to trade under its number, the participant dealer should be permitted to rely on the DEA client for automated pre-trade controls in appropriate circumstances. Consistent with the Participant Dealer Responsibility Principle, we propose that participant dealers continue to be permitted to rely on Direct DEA client's systems with respect to automated pre-trade controls. Participant dealers would continue to be responsible for ensuring that they conduct thorough due diligence on potential Direct DEA clients and that automated pre-trade controls are tailored to (a) the particular needs of the participant dealer; and (b) reflect the specific risks associated with the Direct DEA client's proposed trading activity.

In considering the topic of Direct DEA activity, the CSA may want to consider the distinction between trades made by the Direct DEA client for its own account (proprietary trades) and those made for the accounts of its clients. It is our understanding that many foreign firms who currently engage in Direct DEA activities are doing so for their own account (proprietary trading), rather than that of their clients. DEA activities limited to proprietary trading do not raise the same risk or public interest issues as does trading on behalf of clients.

6. Provision of DEA to Retail Investors

The Notice seeks specific feedback on whether individuals should be permitted DEA or whether DEA should be limited to institutional investors and a limited number of other persons such as former registered traders or floor brokers.

As indicated in the CP, it is the CSA's view that, in general, retail investors should not be using DEA and should be routing orders using order-execution services as defined and provided under IIROC rules. However, the CSA acknowledges that there are some circumstances in which individuals are sophisticated and have access to the necessary technology to use DEA (e.g., former registered traders or floor brokers). In these circumstances, the CSA 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.

Generally, we agree with the concerns expressed by the CSA on permitting DEA to individuals. However, it is our view that these concerns may be mitigated by not only the RM&SCPP obligations imposed on participant dealers under the Proposed Rule, but also through the general obligations imposed on registrants/authorized persons under applicable securities laws (i.e., suitability, know-your-client, etc.).

For example, to the extent that the individual is a client of a firm that has suitability obligations (e.g., a registrant or equivalent), such firm would be obligated to determine whether the individual would be suitable for DEA activity and, if so, the appropriate limits/restrictions which should be imposed on such individual. This obligation should exist regardless of whether the individual is classified as retail, institutional or as a person with some special knowledge (i.e., former registered trader or floor broker).

It is our view that the CSA should not limit its analysis to attempting to determine which classes of individuals should or should not be permitted DEA. Rather, the better approach, in our view, is to ensure that only individuals who are provided the protections afforded through dealing with a registrant (or equivalent) are able to be potential DEA clients. Ensuring that, among other things, appropriate suitability and RM&SCPP obligations exist with respect to individuals permitted DEA is in our view essential.

7. Requirements Applicable to Marketplaces

Lastly, we note that Part 4 of the Proposed Rule provides requirements applicable to marketplaces. Penson supports these requirements and, in particular, is very supportive of section 16, which provides clarity on circumstances where a marketplace may cancel, vary or correct executed trades.

While we appreciate that marketplaces must have the ability to cancel, vary or correct a trade, such ability should not be exercised in a capricious or arbitrary matter, particularly where a conflict of interest may exist. For example, a conflict often arises as a result of the fact that a party to a trade is frequently an affiliate of an entity that owns the marketplace. In such circumstances, the decision by a marketplace to cancel, vary or correct a trade may be impacted by the fact that an affiliate of its ownership is a party to the trade.

In our view, section 16 of the Proposed Rule provides Canadian investors with additional certainty in their marketplaces.

Penson Financial Services Canada
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Thank you for considering our comments on the Proposed Rule. We would happy to discuss and provide you with any further information you may require relating to any of our comments.

Sincerely,

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c.c: John Skain
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