EMDA
Exempt Market Dealers Association of Canada

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July 8, 2011

BY E-MAIL

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Superintendent of Securities, Consumer, Corporate and Insurance Services, Office of the Attorney General, Prince Edward Island
Superintendent of Securities, Government Services of Newfoundland and Labrador

c/o Ontario Securities Commission 20 Queen Street West, Suite 1903, Box 55 Toronto, ON M5H 3S8 *Attention*: John Stevenson, Secretary *E-mail*: jstevenson@osc.gov.on.ca	c/o Autorité des marchés financiers 800, square Victoria, 22e étage C.P. 246, tour de la Bourse Montréal (Québec) H4Z 1G3 *Attention*: Me Anne-Marie Beaudoin, Corporate Secretary *E-mail*: consultation-en-cours@lautorite.qc.ca

Dear Sirs and Mesdames:

Re: Notice of and Request for Comment on Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* (NI 23-103 or the Proposed Rule)

This submission is made by the Exempt Market Dealers Association of Canada (the **EMDA**) in response to the request for comments published by the Canadian Securities Administrators (**CSA**) on April 8, 2011 in connection with the Proposed Rule.

The EMDA is pleased to have the opportunity to provide comments on how the provisions of direct electronic access (**DEA**) under the Proposed Rule will impact exempt market dealers (**EMDs**). Our comments are respectfully submitted by the EMDA on behalf of our membership.

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1. WHO IS THE EMDA?

The EMDA (formerly the Limited Market Dealers Association of Canada) is a not-for-profit industry association founded in 2002 by a group of Canadian business people whose firms were active in the exempt securities market. The purpose of the EMDA is to:

- assist its members with understanding and implementing their regulatory responsibilities;
- ensure the highest standards of business conduct amongst its membership across Canada;
- increase public and industry awareness of the exempt market and its role;
- be the voice of the exempt market dealers locally and nationally to Canadian securities regulatory authorities, government agencies, other industry associations and the capital markets; and
- provide valuable services, cost saving opportunities, and business networking opportunities for its membership.

The EMDA also participates on a number of CSA, TSX and other marketplace committees and forums and regularly engages in formal and informal consultative processes with other industry participants and the CSA. Additional information about the EMDA is located on our web site at: www.emdacanada.com.

Please see Schedule A for a description of the Role of Exempt Market Dealers.

2. LACK OF CSA CONSULTATION REGARDING THE IMPACT ON EMDS UNDER THE PROPOSED RULE

We are pleased to read in the Notice that the CSA "*worked closely with the Investment Industry Regulatory Organization of Canada (**IIROC**) on development of the Proposed Rule*" and that the CSA "*met with numerous marketplaces, marketplace participants and service vendors*" to seek their views and comments.

Conspicuously omitted from the CSA consultation process was any apparent dialogue with EMDs, including the EMDA (the national industry association representing EMDs). We find this curious especially since the Proposed Rule has a direct impact on EMDs of whom you are requesting specific comments.

3. EXCLUSION OF EMDS AS ELIGIBLE DEA CLIENTS

Section 6(2) of the Proposed Rule provides that a "**participant dealer**" (defined as a marketplace participant that is an investment dealer – *i.e.*, IIROC firm) may not provide DEA to a "registrant", unless the registrant is:

(a) also a participant dealer; or

(b) a portfolio manager.

The CSA provided its rationale for this restriction of registrant DEA clients in the Notice and Companion Policy which we have summarized below as follows:

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- the CSA does not want to facilitate regulatory arbitrage with respect to trading;
- dealers who wish to have direct market access should be IIROC members and be subject to IIROC's Universal Market Integrity Rules (**UMIR rules**); and
- ensuring DEA clients are subject to UMIR rules will minimize regulatory risks.

As the CSA notes in the Companion Policy and Notice, the effect of section 6(2) of the Proposed Rules is to explicitly exclude EMDs from eligibility as DEA clients. We commend the CSA for specifically inviting feedback on this point but given the significance of this proposed exclusion, however, we feel strongly that the CSA should have taken additional steps to consult with the EMDA and EMDs prior to releasing the Proposed Rule. We note that IIROC does not represent nor regulate EMDs and its interests may not necessarily be aligned with the interests of EMDs.

4. WHY EMDs SHOULD BE ELIGIBLE DEA CLIENTS

In proposing the regulatory regime for DEA, the CSA, in effect, has done the following:

1. consciously declined to prescribe who eligible DEA clients may be;
2. established general standards for DEA clients (section 7(2)); and
3. placed the obligation on marketplace participants to assess the suitability of any potential DEA client they contract with and make marketplace participants accountable for the activity of its DEA client.

Based on the foregoing, we fail to see why EMDs are excluded as a category, when the regime is designed to require any potential DEA to be vetted on a case-by-case basis according to the minimum standards, a written agreement, training and as otherwise set out in the Proposed Rule. The EMDA does not support the proposed exclusion of EMDs as eligible DEA clients and we believe it is unwarranted.

Our views are based generally on the following reasoning:

1. we acknowledge that only IIROC dealers are presently eligible for exchange membership and thus only IIROC dealers may be DEA market participants/providers;
2. any client of a DEA market participant/provider under the Proposed Rule would be conducting their DEA through an IIROC dealer subject to UMIR; and
3. the only time the CSA expressed concern about DEA clients and being subject to UMIR rules was in respect of fully registered dealers (EMDs) which ignores the numerous other categories of potential DEA clients including individuals and non-registered entities that are not subject to UMIR rules.

We believe this reflects an unwarranted regulatory bias against EMDs.

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5. REGULATORY BIAS IN THE PROPOSED RULE

Section 6(2) (as noted above) limits DEA access to "**registrants"** who are participant dealers and 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 and is similarly defined in other jurisdictions in Canada.

This exclusion undermines the ability of EMDs to conduct trading activity that they are permitted to conduct pursuant to section 7.1(2)(d) of National Instrument 31-103 – *Registration Requirements and Exemption* (**NI 31-103**) for clients who are accredited investors or otherwise eligible EMD clients pursuant to National Instrument 45-106 – *Prospectus and Registration Exemptions* (**NI 45-106**). We fail to understand how it is reasonable to prevent EMDs from engaging in an electronic trading activity that utilizes DEA while certain individuals, non-registrants, proprietary traders, institutional traders and IIROC dealers may do so. It is not clear on what basis there is a common interest among this group that would require the automatic exclusion of EMDs, especially since all such members of this group are not required to directly comply with the UMIR rules which is the argument the CSA stated was its basis for excluding EMDs. Moreover, the EMDA sees no demonstrated basis for treating EMDs differently than any other potential DEA client who is subject to suitability requirements and other requirement set out in the Proposed Rules.

We respectfully suggest the CSA reconsider its proposed blanket exclusion of EMDs as DEA clients for the reasons set out below:

- **Investor Protection** - while many IIROC dealer clients may be sophisticated or institutional investors, they also include a substantial portion of retail clients/investors (*i.e.*, members of the public who do not satisfy any of the prospectus exemptions set out in NI 45-106). However **all** EMD clients are deemed to be sophisticated investors or investors who do not require the protection of securities regulation which is the basis of the exempt market as set out in NI 45-106. Accordingly, we are unable to see a meaningful basis for including an IIROC dealer who may have retail clients but excluding EMDs who have no retail clients as eligible DEA clients;

- **Proficiency** – there is no meaningful distinction between the proficiency requirements for registered individuals at EMDs versus. IIROC firms. We submit that the EMDs that are interested in engaging in DEA are likely to be ones managed by highly experienced former traders and IIROC dealer personnel – again suggesting no proficiency related rationale and a CSA bias against EMDs; and

- **Marketplace Integrity** – the Proposed Rules create a comprehensive obligation on the participant dealer to be responsible for ensuring that any trading activity undertaken by their clients is appropriately controlled and monitored – including UMIR obligations on dealers offering DEA. We acknowledge that DEA clients will be required to demonstrate their capability to comply with marketplace rules and regulatory requirements (Section 8(a) of the Proposed Rule) but fail to see how a registered EMD (as a blanket exclusion) is less capable of doing so than a non-registered firm or individual.

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6. NON-REGISTRANTS AND SOPHISTICATED INDIVIDUALS AS DEA CLIENTS

In restricting which registrants are eligible DEA clients, the Proposed Rule excludes any restriction on firms or individuals that are **not registrants** from becoming DEA clients. Under the Proposed Rule, acceptable DEA clients would include a number of categories of non-registrants, among them:

a) **non-registered proprietary trading firms** (which could include pension funds and institutional investors who are indirectly trading on behalf of others) but are exempt from registration by virtue of the "trade through a registered dealer exemption" set out in section 8.5 of NI 31-103;

b) **non-registered dealers in the exempt market who are exempt from registration as EMDs pursuant to the "Northwest Exemption"** (*i.e.*, local relief orders made available in certain Northwestern Canadian jurisdictions, consisting of Alberta, British Columbia, Manitoba, the Northwest territories, Nunavut and the Yukon Territory);

c) **non-registered foreign firms** that are not required to be registered in Canada (and may or may not be registered in their home jurisdiction);

d) **non-registered individuals**, including "individuals who are sophisticated…(for example former registered traders or floor brokers)"; and

e) **institutional investors and "institutional customers"** under IIROC rules.

The CSA has no jurisdiction to oversee the firms and individuals described above as it lacks any regulatory nexus with them, yet the CSA has deemed them to be potentially suitable DEA clients. This contrasts sharply with the treatment of EMDs which are subject to considerable oversight by the CSA including regulatory compliance reviews. NI 31-103 sets out a comprehensive dealer regulatory framework (substantially similar for all categories of dealer, including investment dealers) which requires EMDs to satisfy a number of regulatory obligations including:

- educational proficiency
- capital and solvency standards
- insurance
- audited financial statements
- know your client
- know your product
- trade suitability
- compliance policies and procedures
- books and records
- client statements
- trade confirmations
- disclosure of conflicts of interest and referral arrangements

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- maintenance of internal controls and supervision sufficient to manage risks associated with its business
- prudent business practices requirements
- registration obligations
- submission to CSA oversight and dealer compliance reviews

None of these above obligations is placed on the non-registrants the CSA has deemed to be suitable DEA clients. Accordingly, it is not clear how the CSA has determined that the suitability of a registered EMD does not meet standards set out for DEA clients in the Proposed Rule while a non-registered firm or individual does meet the standards as a DEA client.

7. EMDs ARE "INSTITUTIONAL CUSTOMERS" OF IIROC DEALERS

In Section 2(i) of Part III of the Notice titled "*Description of the Proposed Rule*", the CSA has requested specific feedback on whether individuals should be permitted DEA or whether DEA should be limited only to institutional investors. The IIROC definition of "institutional customer" includes an "accredited investor" as defined by NI 45-106. Section 1.1(d) of NI 45-106 states that an EMD is an accredited investor. Accordingly, if an accredited investor can be a DEA client it does not make sense that an EMD cannot be a DEA client when an EMD is an accredited investor under NI 45-106.

The exclusion of EMDs under the Proposed Rule effectively restricts an IIROC firm from offering a key product, DEA, to one particular type of institutional customer – an EMD - which we believe is an unwarranted restraint on the client base of IIROC dealers.

8. EXCLUDING EMDs RESULTS IN AN UNLEVEL PLAYING FIELD

Under the Proposed Rule, a DEA market participant/provider must be an IIROC member and therefore subject to the UMIR rules. This satisfies the CSA's concern that DEA be subject to UMIR rules. The Proposed Rule does not require all DEA clients to be subject to UMIR rules since this would amount to overregulation. By excluding EMDs on the basis that they do not satisfy the UMIR rules while allowing other DEA clients who do not satisfy UMIR rules is inconsistent and clearly reflects a regulatory bias against EMDs and treats them on an unlevel playing field.

9. EXCLUDING EMDs DOES NOT RESULTS IN REGULATORY ARBITRAGE

The CSA suggests that excluding EMDs as DEA clients prevents dealers from "opting out" of the UMIR rules and hence regulatory arbitrage between the two dealer registration categories – EMDs and investment dealers/IIROC members. We find this statement curious/confusing since the Proposed Rules do not require all DEA clients to be directly subject to the UMIR rules (whether they are EMDs or not).

It appears the CSA is suggesting that if EMDs can be DEA clients, then IIROC firms/individuals may be inclined to surrender their investment dealer registration/IIROC membership and become EMDs as a way of "opting out" of the UMIR rules and IIROC oversight. Again, if all DEA clients had to be directly subject to UMIR rules, then all DEA clients would have to be investment dealers/IIROC members, then this argument

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may have some merit. However, the Proposed Rules do not require all DEA clients to be directly subject to UMIR rules therefore we believe the CSAs concern is misplaced.

We remind the CSA that the distinction between EMDs and investment dealers/IIROC members is clearly permitted under Canadian securities law and is a reflection of different business models and not regulatory arbitrage. In fact, we believe that if the CSA excludes EMDs from being DEA clients, it may force EMDs to surrender their EMD registration in favour of being unregistered and becoming a DEA client of a DEA market participant/provider. We believe this actually represents a form of arbitrage and surely an unintended consequence of the Proposed Rules.

10. PROPOSED RULE UNFAIRLY RESTRICTS EMD ACCESS TO PUBLIC MARKETS

Excluding EMDs as DEA clients restricts the means by which EMDs may access trading in publicly listed securities or investment funds for their clients (as they are permitted to do under section 7.1(2)(d) of NI 31-103). We fail to understand how it is reasonable to prevent EMDs from engaging in using an electronic trading mechanism while certain individuals, non-registrants, proprietary traders, institutional traders and IIROC dealers may do so. Given the requirement for DEA participant dealers/providers to assess their potential clients on a case-by-case basis and ensure they adhere to the DEA client standards, and the fact that all DEA clients will be conducting their trading through a registered IIROC dealer (DEA participant dealer/provider), we see no demonstrated basis for treat EMD differently than any other potential DEA client.

11. PORTFOLIO MANAGERS DISADVANTAGED BY THE EXCLUSION OF EMDs

The client base of most discretionary portfolio managers (**PMs**)are high net worth individuals or institutional investors that almost invariably qualify as accredited investors or otherwise eligible clients of an EMD under the criteria set out in NI 45-106. Consequently, many registered PMs are also registered in the EMD category for reasons related to distribution of products and servicing accredited investors, including in non-discretionary activities which fall outside their PM registration.

PMs are principally engaged in advising clients but that advice obviously leads to significant trading on behalf of those clients. PMs usually have a related or third party IIROC dealer through which they conduct their trading using DEA. The effect of the exclusion of EMDs as DEA clients introduces uncertainty as to whether their additional registration as an EMD now disqualifies them as DEA client. We urge the CSA to clarify that PMs holding EMD registrations are not negatively impacted.

More significantly, the EMD exclusion leads to an odd result where a PM can have DEA access when trading as a discretionary adviser, yet cannot have DEA access when it acts (usually through the exact same trader) as an EMD. Section 11.(2) of the Proposed Rule compounds this result by suggesting that an IIROC dealer or PM may trade for their own account and also for its clients, but no EMD may trade using DEA on behalf of its clients. We fail to see the regulatory benefit of restricting market access for a highly qualified PM adviser firm the moment the firm, having complied with its dealer registration obligation, actually acts as a dealer. We encourage the CSA to revisit and clarify the issue of DEA for PMs who are also registered EMDs.

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12. EXCLUDING EMDs WILL IMPACT INTERNATIONAL DEALERS

Foreign investment dealers may rely on the international dealer exemption under NI 31-103 and not require dealer registration in Canada. However, many of those foreign dealers also conduct some client activity outside the restrictions of the international dealer exemption and have therefore registered as EMDs in Canada. If an EMD is excluded from being a DEA client under the Proposed Rule, it would require the international dealer who engages in DEA to surrender its EMD registration and end its client relationship with its EMD clients. This unfairly limits international dealer activity and may eliminate access to certain international dealers for Canadian accredited investors and institutional investors. We are concerned this is another unintended consequence of the Proposed Rule.

13. UMIR WILL APPLY TO ALL DEA TRADING – REGARDLESS OF DEA CLIENTS BEING EMDs

The CSA has expressed concern that all dealers engaged in DEA should be subject to UMIR rules. We agree, however, believe it should apply to DEA market participants/providers, not all DEA clients.

Section 6(1) of the Proposed Rule states that only "participant dealers" may provide DEA, which means only IIROC dealers subject to UMIR rules may provide DEA. If participant dealers offering DEA are all subject to UMIR rules it logically follows that all trading access through DEA will be subject to UMIR rules, regardless of whether UMIR rules apply to a DEA client or not. The CSA's regulatory objective of ensuring marketplace trading is governed by UMIR rules thus seems quite well addressed by the provisions of section 6.(1) of the Proposed Rules.

The further suggestion that DEA clients who are dealers must be subject to UMIR rules and thus IIROC dealers is redundant and ignores the requirement that all DEA clients meet the standards set out in the Proposed Rule including, complying with marketplace requirements. The CSA appears to ignore the obvious point that UMIR rules will not apply to any other potential DEA clients the CSA is comfortable with, including PMs and unregistered firms or individuals.

In explaining its view that UMIR rules must apply only to DEA clients who are dealers, the CSA states in section 6 of the Companion Policy of the Proposed Rules that:

> *"UMIR obligations on the DEA client in this instance assist in minimizing the regulatory risks associated with DEA."*

We respectfully submit that if the CSA wishes to take the position that UMIR rules must directly apply at two levels in a DEA arrangement (first at the level of the DEA market participant/provider, and again at the level of the DEA client), then the CSA must logically exclude **all** non IIROC firms or individuals as DEA clients – not just EMDs.

14. SATISFYING CSA CONCERNS ABOUT EMDs AS DEA CLIENTS

We believe the CSA has prudently placed full responsibility for the qualification, assessment and behaviour of DEA clients where it belongs – on the role of the IIROC dealer that is the DEA market participant/provider. This approach is consistent with the general principles of know your client in a dealer-client relationship and

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properly observes the significant obligations of a dealer to its client and to the integrity of the capital markets and the public interest.

The EMDA supports the CSA's requirements that DEA market participants/providers ensure their clients meet all regulatory standards and that the DEA market participant/provider "*maintains risk management and supervisory controls, policies and procedures regardless of whether its DEA clients also maintain their own controls*". We believe this supports the concept that EMDs be permitted DEA clients subject to the due diligence and oversight of the IIROC firm which agrees to provide the DEA to a particular EMD. **Not all EMDs will be interested in, or capable of, satisfying the DEA client and other requirements in the Proposed Rule, however, the EMDA strongly believes that no EMD should be disqualified as a DEA client simply because they are a qualified and registered EMD.**

We encourage the CSA to reconsider its exclusion of EMDs as DEA clients and instead continue to emphasize the responsibility on DEA market participants/providers to conduct appropriate due diligence on its clients and make the determination of whether a particular EMD is a suitable DEA client. We believe this affords proper protection for the marketplace and satisfies the regulatory objectives of the CSA in establishing an important new regulatory framework for the DEA marketplace.

AN INVITATION TO MEET WITH THE CSA

We invite the CSA to meet with the EMDA to help us better understand the CSA's concerns regarding EMDs as eligible DEA clients which will allow us the opportunity to address those concerns and fully communicate them to our EMD members across Canada.

We would also be pleased to assist the CSA with the EMDA's views and analysis on any future regulatory issues that directly impact EMDs. As a national EMD industry association, we believe the EMDA can play an important and helpful role supporting the CSA in its policy development and oversight of the capital markets and the exempt market regulatory framework.

We thank you for the opportunity to provide you with our comments on the Proposed Rule. If you have any questions or concerns, we ask that you direct them to my attention at: gritchie@emdacanada.com or 1-877-363-3632.

Yours very truly,

"*Geoffrey Ritchie*"

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*The views expressed in this submission reflect the views of the EMDA and are the personal views of the authors. They do not reflect the views of the authors' employer or law firm (or its clients).

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Schedule A

The Role of Exempt Market Dealers

EMDs are exempt market securities dealers registered under provincial securities legislation in one or more jurisdictions in Canada. The regulatory framework for EMDs is set out in National Instrument 31-103 *Registration Requirements and Exemptions* (**NI 31-103**) along with the framework for all other categories of dealer: investment dealer, mutual fund dealer, scholarship plan dealers and restricted dealers. The qualification criteria for exempt purchasers and exempt securities are found in National Instrument 45-106 *Prospectus and Registration Exemptions* (**NI 45-106**).

The EMD is a national category of registration, and EMDs have the ability to act in two primary capacities in the capital markets: 1) as a dealer or underwriter for any securities which are prospectus exempt, or 2) as a dealer for any securities, including investment funds which are prospectus qualified (mutual funds) or prospectus exempt (pooled funds), provided they are sold only to clients who qualify for the purchase of exempt securities. EMDs represent a significant variety of business models and sector roles ranging from private placements in resources, real estate, technology, health care, etc., to servicing of institutional and high net worth clients in a number of industries.

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