July 8, 2011

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
jstevenson@osc.gov.on.ca

Anne-Marie Beaudoin
Directrice du secretariat
Autorité du marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246,22e étage
Montréal QC H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Re: Proposed National Instrument 23-103 Electronic Trading and Direct Electronic Access to Marketplaces

Scotia Capital Inc. ("SCI") appreciates the opportunity to respond to the above proposed National Instrument. SCI is supportive of the initiative to review and update regulations governing electronic trading in Canada in order to take into account new realities such as the multiple marketplace environment and increasing use of high frequency and algorithmic trading. We also appreciate that the Canadian Securities Administrators ("CSA") took the time to meet with the various stakeholders prior to drafting the proposed national instrument.

DEA definition

The definition for DEA is stated in the proposed rule as:

> *"direct electronic access" means the access to a marketplace provided to a client of a participant dealer through which the client transmits orders, directly or indirectly to the marketplace's execution systems under a participant dealer's marketplace participant identifier without re-entry or additional order management by the participant dealer."*

SCI would like to clarify what is intended to fall within this definition. In particular we would like to understand what constitutes "additional order management", which would exclude an order from the DEA definition. We note that most orders pass through a smart order router on the way to the markets, but we would expect these orders to still be considered DEA orders, though they arguably could be excluded based on the current wording. We do believe that orders sent to an algorithm provided by the participant

dealer should however be excluded from the definition since in these cases the participant, via its pre-programmed algorithm, is determining the actual child-orders booked through to the market. We would propose that language be considered to the effect of:

> *"an order will be considered to have received additional order management if it is not automatically booked, effectively unchanged and in its entirety, to a marketplace, with the exception of child orders that are split off from the order by a Smart Order Router and sent to other marketplaces to fulfill better priced tradable orders or other regulatory requirements."*

Differences between DEA Client Access and Participant Market Access

With respect to the Risk Management and Supervisory Controls, Policies and Procedures proposed in Section 3, we do agree that pre and post trade controls and monitoring procedures are necessary and should primarily be the responsibility of the participant dealer, however we would suggest that it may be more appropriate to consider the control and monitoring procedures for market access by participants themselves separately from those for their DEA clients. In particular many of the "Risks of Electronic Trading" identified in the Request for Comments do not apply to market access by a participant directly (e.g. liability risk, sub-delegation risk) or are dealt with through existing regulations or required policies and procedures (e.g. credit risk, market integrity risk).

Market Access by DEA Client

We are generally supportive of the proposed requirements for the monitoring and control of DEA client trading. We believe that a proper DEA monitoring and control regime includes direct control of pre-trade risk checks by the participant dealer and robust post trade monitoring systems and processes. We would however caution that mandated pre-trade checks should be kept to a minimum in order to avoid adding excessive cost, complexity and latency without a commensurate improvement in risk control and market stability. As we discuss in more specific comments below, we are concerned that some of the proposed requirements for DEA access may not achieve their desired goals and that the effectiveness of such controls to stop all potentially problematic orders may be over estimated.

Market Access by Participants

We believe that participants should have appropriate controls on systems used for their own market access but that the controls outlined in the proposed rule are likely excessive and duplicate existing requirements, policies and procedures in place at dealers.

For example, the requirement to prevent on a pre-order basis the entry of orders that do not comply with "applicable marketplace and regulatory rules" is already the responsibility of traders at a participant. They are themselves registered and already responsible for their trading. To require systems that would enforce those rules may in

fact lead to confusion over where the ultimate responsibility for compliance lies. The participant may choose to comply with their existing requirements by implementing some of the same controls and systems that would be mandated under the proposed requirements, but we don't believe that including those requirements here is necessary.

We also believe that the requirement to enforce credit and capital thresholds on the entry of orders by a participant is impractical and already enforced both as required by regulators and as part of prudent risk management practices. As regulated entities, dealers are already required to maintain adequate capital thresholds (IIROC Rule 17.2a and IIROC Rule 2600) and have controls and processes in place to effectively monitor and manage various types of risk. From a practical perspective we believe it is not feasible to apply effective real-time capital limits to all market access used by participant dealers. Dealers have many different trading strategies, asset classes, methods of trading (phone, foreign dealer etc.) and complex workflows (agency versus inventory trades) that will make it impractical to have any set of limits applied to equity trading systems that would meaningfully control credit risk.

We do believe that market access systems should have a number of controls including system access controls, 'fat finger' checks and limits on products or securities that the trader is allowed to trade. However to have limits based on aggregated and consolidated capital thresholds enforced on all the various trading systems employed by a dealer would be impractical, expensive to implement, and ultimately ineffective.

It may have been the intention of the CSA to address the risks specifically posed when dealers operate their own automated trading strategies, either for themselves or on behalf of client accounts. We would agree that such systems and strategies do warrant additional risk management and control, both as prudent business practice and to meet existing regulatory guidance on appropriate testing and operation of automated trading systems. In the context where a dealer is operating an automated proprietary trading strategy, we do agree that such systems should have controls in place to enforce the applicable capital and P&L limits, in the same way that a trader executing a manual strategy would be required to manage those limits.

Requirements to "Ensure" Compliance

There are a number of sections of the rule that indicate a requirement to "ensure" certain conditions are met or not violated (e.g. sections 3.3.b and 3.3.e). We believe that this represents an unreasonable and unattainable standard for DEA or market access trading systems, policies or procedures given the volume of orders and required speed of execution. No system will be able to categorically prevent all violations, however we support the standard proposed by the IIAC in their comment letter that "such Policies and Procedures are designed to reasonably ensure that the regulatory requirements will be met on a systematic basis, through pre and post trade monitoring, and timely intervention and correction when problems are discovered".

We are also concerned that the term "fair and orderly markets" use in sections 3.3.e and 5.1 represents a very broad and poorly defined concept. Particularly when combined with the strict 'ensure' standard discussed above we are concerned that this represents an unreasonable, vague, and ill-defined requirement. We agree that the example, given in the companion policy, of a steady stream of orders negatively impacting the price of a stock is a situation we may wish to avoid in some circumstances. However, we are concerned that a steady stream of orders sent maliciously or error may be indistinguishable from a stream of orders sent in reaction to news. This does not mean that efforts shouldn't be made to put in place controls that are reasonably designed to detect erroneous or otherwise problematic trades where possible. However we are unable to reach into the minds of DEA clients and regulators while making real time order routing decisions and as such cannot guarantee that we will be able to prevent from reaching the market all orders that might later be deemed to have impacted the catch basin of a 'fair and orderly market'.

Comments on Specific Sections

Section 3.3.a.i – Enforcement of Credit and Capital Thresholds
As noted above we believe that requiring the real time enforcement of capital limits on all dealer market access systems is impractical and would not achieve the desired goals. If the concern is specifically automated trading strategies operated by the dealer then that should be specified and the required controls identified.

We would also note that though enforcing aggregate capital or credit limits on DEA clients is possible and likely prudent, an executing dealer will only see the portion of a client's trading that is directed to it. Therefore the effectiveness of those controls in mitigating any broader systematic risks will be limited since a client could be executing with multiple dealers at the same time none of whom would be in a position to limit the client's overall exposure.

Section 3.3.b.i - Compliance with Regulatory and Marketplace Requirements

- *Participant Market Access*: Traders at participants are already responsible for compliance of their orders with applicable marketplace and regulatory requirements. Requiring market access systems to prevent such violations duplicates these existing requirements and could lead to confusion over ultimate responsibility for compliance. We would also note here that all orders submitted to exchanges and ATSs are marked with a trading ID assigned by the various marketplaces which is specifically attributed to an approved trader at a participant. This clearly indicates the trader responsible for the order in question and is true for both DEA and participant entered orders.
- *DEA Client Access*: We would seek further clarification on which marketplace and regulatory requirements would be required to be enforced on a pre-trade basis. It is our belief that the number and complexity of pre-trade checks be minimized to avoid introducing unnecessary cost and complexity into trading systems. As such, any new regulatory requirements that must be satisfied on a

pre-trade basis will need to be reviewed in the context of whether they are enforceable by pre-trade DEA filters and control systems.

Section 3.3.e - Fair and Orderly Markets
As noted above, we are concerned about the categorical nature of this requirement and the very broad scope of potential issues that it may refer to. It is not feasible that a system will be able to prevent all orders that may impact the fair and orderly operation of the market. It is however reasonable that systems, policies and procedures be designed so as to reasonably prevent such issues on a systematic basis.

Sections 3.4 and 3.5 – Control of Risk Management and Supervisory Controls
We are supportive of the requirement that risk management and supervisory control systems for DEA trading be under the 'direct and exclusive control of the marketplace participant'. We believe that having a client operate these processes, even if the participant is also provided access to them, introduces the potential for fundamental conflicts of interest in cases where client trading may need to be controlled or disabled.

We do not however think that the requirement that the provider of any risk management and supervisory controls be independent from any DEA client is a necessary restriction. As long as it can be shown that the instance of the controls in question are under the exclusive and direct control of the participant, and that the participant has satisfied themselves of the effectiveness of those controls (as required by section 3.7) then we believe that should be sufficient.

Section 5 – Use of Automated Systems

Under Section 5, Use of Automated Order Systems, SCI notes that section 5.2.(a) requires that the participant have the "necessary knowledge and understanding of any automated order system used by the marketplace participant or any client, including a DEA client" and "ensure that each automated order system is regularly tested".

As noted in the companion policy, participants are not always able to have full working knowledge or have access to direct testing of automated order systems utilized by DEA customers. Knowledge of the type of trading activity that a client will engage in is essential to putting in place appropriate monitoring systems, however detailed knowledge of individual trading strategies is typically considered to be sensitive competitive information by our clients. Currently we obtain certification from the customer that they have appropriately tested any automated order system that they may be using and the agreements require that any trading conducted must be completed within the context of marketplace rules, laws and regulation that govern trading activity on those markets to which trading results.

We would suggest that it be noted in the National Instrument that participants may rely on information and certifications from their clients to fulfill the requirements to have necessary knowledge and understanding of automated order systems and to ensure appropriate testing has taken place.

Section 7.2.d – DEA Client Monitoring Arrangements

This section references the requirement for the participating dealer to confirm that a client has adequate arrangements to monitor the entry of orders through direct electronic access. SCI respectfully requests that the CSA expand on what the expectation would be in terms of verifying. We reiterate that a customer's activities are generally confidential and they may not be willing to provide physical access to review their controls. Therefore would a certification attached as part of the due diligence completed on the customer suffice?

Section 8.d – Cooperation of DEA Client with Investigations

In this section the agreement is expected to contain clauses that require a customer to fully cooperate with investigations by any securities regulatory authority. SCI challenges that this may not even be permissible under privacy and confidentiality requirements in other jurisdictions (e.g. providing client names) and instead we suggest that the CSA utilize existing protocols that exist under Memorandums of Understanding with various foreign regulatory authorities to obtain information when conducting investigations of securities trading activities.

Additionally, the CSA should explore whether information received through an order or investigative request that provides information from another party not actually named in that request as being valid evidence that could effectively be used or form part of an enforcement action.

Section 8.e.ii – Vary, Correct or Cancel an Order

We do not believe that the requirement for the participant dealer to 'vary' or 'correct' an order is a necessary or reasonable requirement. This terminology exists in the current exchange requirements for the provision of direct access and it always causes confusion and concern by clients signing the access agreements.

In practice the ability to cancel an order and reject further orders should be sufficient to deal with any potential issues. There may be a desire for the participant and their client to make arrangements whereby the participant could vary a client's order in a certain way, but we view that as a business arrangement and not a regulatory requirement.

As an example, would the expectation be that a participant could independently change the price limit on a client's order and then expect the client to take any trade resulting from the new higher price?

Section 8.h and 11 – Requirements on Foreign Dealers and Portfolio Managers
These sections require that any client of a DEA customer meet standards of section 7 and have an agreement in place with the DEA customer that establishes the terms of access. This section, along with section 11, effectively extends the requirements for the provision of DEA access out onto any of the participant's DEA clients who are able to trade for the accounts of their clients. It is highly impractical to require foreign dealers or portfolio

managers to re-paper agreements with all of their clients and adjust their supervisory controls and procedures in order to meet the requirements placed on Canadian participant dealers. The requirement to limit clients who can trade on behalf of their clients to appropriately registered entities in foreign jurisdictions that are signatories to the IOSCO MMOU is reasonable. This limitation on the type of entity and the jurisdictions that qualify should allow us to rely on the policies and procedures required of registered entities in those jurisdictions to provide the appropriate levels of oversight on their DEA access clients.

If onerous requirements are extended to foreign entities looking to provide DEA access to Canadian markets then there is a very real risk of limiting the number of entities that will seek to provide that access. This will cause them and their clients to seek liquidity in more easily accessed foreign jurisdictions, which in most cases will be the U.S.. We believe that through proper control and monitoring by Canadian participants this access for foreign entities can be provided safely without extending specific documentation and system requirements to them.

Section 10 – DEA client identifier

We support creation of a client identifier to enable regulators to monitor trading that may be occurring across multiple dealers and would otherwise go undetected. However we do not believe that participants should be required to release a list of client names to exchanges and ATSs. We view this as competitive information and releasing it could harm our businesses and potentially best execution for our clients if their trades were more easily identified by competitors. We do not see a compelling need for exchanges and ATSs to have client information. A list of unattributed DEA client IDs should be sufficient for any monitoring required by exchanges and in the event specific client information is required, that information could be accessed through the participant or the relevant regulatory authority.

Section 11.5 – Trading by DEA clients

We would like to seek clarification of the ability of a third party asset manager who has trading authority on an institutional client's account to be granted DEA access to trade that account. In this relationship we would view the client who holds the account to be the DEA client and would sign the DEA agreement with that entity. They would be responsible for controlling access to their DEA systems and making sure that the third party manager is authorized to use the system. We would like to understand if the CSA would see any issues with that DEA arrangement under the proposed requirements.

Section 18 – Effective Date

The proposed national instrument will require significant implementation efforts in many cases and the effective date for this regulation should allow for a realistic implementation period and be set in consultation with various market participants and stakeholders.

In summary, Scotia Capital is generally supportive of the proposed regulation and commends the CSA on their efforts to rationalize Canadian market access regulations. As noted we have some significant concerns regarding the requirements being applied to market access by Participants themselves and on potential requirements for foreign clients seeking DEA that may cause them to avoid our market altogether and seek liquidity elsewhere. We appreciate the opportunity to comment on the proposed regulations and are available to discuss any of our concerns or other questions you may have.

Yours Sincerely,

Evan Young
Director, Head of Electronic Execution Services
Institutional Equity
Scotia Capital Inc.
(416) 863-7281
evan_young@scotiacapital.com