July 15, 2011

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Saskatchewan Financial Services Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut Ontario Securities Commission
Superintendent of Securities, Prince Edward Island

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Re: Request for Comments on the Canadian Securities Administrators ("CSA") Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces*

Dear Sirs/Mesdames:

Chi-X Canada ATS Limited ("Chi-X Canada" or "we") welcomes the opportunity to provide comments on CSA's Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplace* ("Proposed Rule" "NI 23-103").

We commend the CSA for creating a regulatory framework for electronic trading including requirements for marketplace participants and marketplaces and the provision of direct electronic access ("DEA"). Given the scale and speed of electronic trading, order entry errors from automated systems pose an increasing risk to the market. At best, errors may result in short term market disruptions, and at worst, they may threaten the financial viability of a firm and cascade into contagion that can threaten the financial system itself. As a result, we support the introduction of mandated risk management controls and supervisory procedures to ensure that the Canadian market and investors are not subject to any undue risks represented by electronic trading and, in particular, DEA.

We believe the Proposed Rule's effective ban of "naked" or unfiltered sponsored access is a positive development for the Canadian market. However, we note that certain unintended consequences may result from the Proposed Rule that need to be considered before moving forward. Some DEA clients filter all

order flow through robust proprietary pre-trade controls. If certain clients forego using their own controls and instead rely solely on those used by their dealer, there is a potential for a lower standard to be applied. Consequently, although we support the CSA's proposal to establish a minimum standard of pre-trade checks we would encourage you to create a higher standard and work with the industry to establish a broader set of guidelines for risk management regarding electronic trading which, in addition of pre-trade controls, would also include intra-day risk controls and pattern controls. In our opinion, FIX Protocol Limited's Equity Risk Controls provides a good example of this type of collaboration.

The Proposed Rule distributes the obligation to assess what risk management and supervisory controls are necessary to manage the risk represented by electronic trading between brokers and marketplaces. Although we support more specific requirements for dealers to manage the risk of order flow passing through their systems, we question whether marketplaces are best positioned to be assigned a similar obligation. Given limited access to client information and trading activity across markets, marketplaces are not equipped with the necessary analytics to make these determinations. Instead, we believe that IIROC is best positioned to bear this responsibility given its size and the ability to scale its recent investment in SMARTS to meet these needs. Any additional costs will be equitably distributed to the dealers responsible as IIROC's new market regulation fee model recovers costs based on the number of messages and trades. Additional controls that are deemed necessary can then be mandated at IIROC's direction. This not only will ensure consistency across marketplaces but would provide transparency to all stakeholders.

Our specific comments to the Rule are provided below:

## Specific Comments

### REQUIREMENTS APPLICABLE TO MARKET PARTICIPANTS

**Minimum Required Automated Pre-trade Controls**

As stated previously, we commend the CSA for creating a minimum standard of pre-trade controls and specifically for including additional controls not contained within the Securities and Exchange Commissions' Market Access Rule 15c3-5. Whereas both rules include similar pre-trade checks to manage financial exposure and compliance with regulatory requirements, NI 23-103 also mandates controls that will:

1) enable the marketplace participant to immediately stop or cancel one or more orders entered by the marketplace participant or DEA client, and
2) enable the marketplace participant to immediately suspend or terminate any DEA granted to a DEA client.

We believe it is essential that dealers are able to manage orders exposed on a marketplace and be able to control access to marketplaces by DEA clients. Because dealers are responsible for orders entered with their ID, it is imperative that they are able to mitigate the risk presented by a system malfunction or inability to monitor a client's credit or capital limits. In addition, the costs incurred by these added requirements should be minimal as existing products are available today to provide dealers' with these types of controls.

We note that although many pre-trade controls required by the Proposed Rule are already in use by dealers today, some may require significant investment and a thorough due diligence process in determining appropriate limits for clients. Learning from the US experience, we recommend that the CSA



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work closely with the Industry to understand what work may be required to implement each new control before the Proposed Rule becomes effective. Depending on feedback received, a staggered implementation schedule may be appropriate allowing for different dates for different controls. Checks that are critical to protect the dealer and the market can be implemented first, followed by those that require more significant investment and resources. Any proposed checks that are controversial or will be difficult to implement because of technology issues can be deferred for further assessment.

**New regulations for automatic trading systems**

The Proposed Rule includes new requirements for marketplace participants to ensure that they have necessary knowledge and understanding with respect to all automated order systems used. Paragraph 5(2)(b) requires that each automated order system used by the dealer or its client is appropriately tested before its initial use and after any significant changes have been made. We believe that although it is imperative for dealers to test their own automated trading systems, it is not appropriate for dealers to be required to test the automated systems of their DEA customers, as testing raises serious confidentiality concerns and may infringe on intellectual property rights of clients' trading systems and strategies. Although we understand the intention behind this proposal, we question what additional value mandated testing will provide given the pre-trade controls already required by the Proposed Rule. In the instance where an automated system encounters a problem or fails to function as intended, effective dealer pre-trade checks will prevent orders from reaching the market and will reduce any potential negative impact on an orderly market. If testing is mandated as proposed, we recommend either an independent third party solution, or that DEA clients are able to certify that automated systems have been tested in accordance to a standard developed by IIROC and the CSA. In this way client confidentiality will be protected and a consistent standard for testing will be applied by all dealers.

## REQUIREMENTS SPECIFIC TO DEA

**DEA Agreements**

The Proposed Rule includes a requirement for a participant dealer to enter into a written agreement with each DEA client before access is provided. In addition, Section 8 outlines certain commitments that must be made by each DEA client in the agreement. We support this requirement which is consistent with international best practice and included by IOSCO as one of the key principles for regulation of DEA. We suggest that in addition to this agreement, the CSA also require a second agreement be in place for every DEA client relationship that is executed by and among the DEA client, sponsoring participant dealer and marketplace (tri-party agreement). This supplemental agreement will clearly set out the roles and responsibilities of each party in a sponsored client relationship and formalize the commitments already in place from the client to the dealer and the dealer to the marketplace. It will also assist in establishing a contractual relationship between the marketplace and the DEA client.

## REQUIREMENTS APPLICABLE TO MARKETPLACES

**Marketplace Controls Relating to Electronic Trading**

NI 23-103 would provide marketplaces with the ability and the authority to immediately terminate access granted to a marketplace participant or DEA client. Although we recognize that marketplaces are best positioned to control access from a technological perspective, we do not believe they are best positioned to make a holistic determination on the risks posed by a DEA client to deny access or present an overall risk to the greater market. Marketplaces lack the necessary analytics to assess whether termination is appropriate. They do not have access to order, trade and credit information across marketplaces required to understand if a customer's system is experiencing a problem that may warrant termination.



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Additionally, a marketplace may not have readily available resources or tools required to conduct proper surveillance or due diligence.

Instead, we believe that IIROC is better positioned to undertake this capability given its size and scale, and because of its regulatory mandate. Unlike a marketplace, IIROC has a view of trading activity across all markets and can therefore determine if and when a client's algorithm is malfunctioning or if its trading activity poses a risk to market integrity. It is also the natural extension of IIROC's technological investment in SMARTS that can be scaled to meet the needs of this function. Additional costs will be allocated to the dealers responsible for the activity because IIROC's new market regulation fee model recovers costs based on number of messages and trades. This solution also will ensure determinations are applied consistently across marketplaces and prevent instances where a client's access is terminated on one marketplace and not another because of the same issue. Finally, by having this responsibility reside with IIROC, any perceived conflicts that may be created by a marketplace making these determinations such as its ownership structure are eliminated.

Having markets take on responsibility for making these determinations also appears inconsistent with the approach the CSA has taken regarding clearly erroneous trades in the Proposed Rule. Section 16 sets out that a determination to cancel or amend a trade can only be made by IIROC unless both parties agree to the change, or the change is necessary to correct an error caused by a system of the marketplace. Why should a marketplace be granted the power to terminate access when it is not granted the power to determine when a clearly erroneous trade occurred?

The Proposed Rule also places an obligation on marketplaces to assess the adequacy of risk controls at the marketplace level in addition to that given to dealers. Specifically, the Proposed Rule requires marketplaces to assess what risk management controls, policies and procedures are required at the marketplace level in addition to those required by their marketplace participants to ensure that marketplaces do not interfere with fair and orderly markets. For the reasons noted above, we question whether marketplaces are best positioned to make these assessments and instead believe that any additional required risk management controls at the marketplace level should be mandated at the direction of IIROC or the CSA.

Finally, CP 23-103 requires that a marketplace take steps to ensure it does not engage in activity that interferes with "fair and orderly markets." This overarching principle is also referred to in other areas of the Proposed Rule including dealers' testing of automated trading systems, and dealers being required to ensure that the entry of orders does not interfere with fair and orderly markets. We ask for greater clarity on what would constitute activity that interferes with fair and orderly markets. Is this limited to order and trade activity, or does it also extended to other practices such as access requirements and fee setting?

**Marketplace Thresholds**

We support mandatory marketplace price parameters that will prevent erroneous orders from being executed. By requiring all marketplaces to prevent trades that are entered beyond a certain threshold determined by a regulation service provider (RSP), the effectiveness of one marketplace's price control will not be undermined by another marketplace using a different parameter. Today, a smart order router that sends an order that is not accepted by a marketplace because it exceeds a price parameter will simply route the order to another marketplace with a wider threshold. This in turn undermines the effectiveness of the control and fails to protect the market from the instability caused by the erroneous trade. We believe that although thresholds should be harmonized, marketplaces should be allowed to maintain flexibility over what technical implementation to use so long as orders entered outside the established thresholds are prevented from trading. We also believe it is important when a RSP sets a threshold that the calculation methodology and reference price used is clear.



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We would like to thank the CSA for the opportunity to respond to the Rule Proposal and welcome a meeting to discuss our submission with the staffs.

Sincerely,

Chi-X Canada



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