

1.1.3 CSA Staff Notice 23-314 – Frequently Asked Questions about National Instrument 23-103 Electronic Trading

**CANADIAN SECURITIES ADMINISTRATORS
STAFF NOTICE 23-314**

FREQUENTLY ASKED QUESTIONS ABOUT NATIONAL INSTRUMENT 23-103 *ELECTRONIC TRADING*

The purpose of this notice is to answer some of the frequently asked questions (FAQs) regarding National Instrument 23-103 *Electronic Trading* (the rule or NI 23-103). NI 23-103 is effective on March 1, 2013 and sets out requirements that apply to marketplace participants, marketplaces and the use of automated order systems in order to address the risks of electronic trading.

The list of FAQs below is not exhaustive, but it includes key issues and questions market participants have posed to us. Staff of the Canadian Securities Administrators (CSA or we) may update these FAQs from time to time as necessary.

Some terms we use in this notice are defined in NI 23-103, National Instrument 21-101 *Marketplace Operation* (NI 21-101) or in National Instrument 23-101 *Trading Rules*.

A. SCOPE OF NI 23-103

A-1 Q: Does NI 23-103 apply to all securities trading activity on Canadian marketplaces, including debt and derivatives?

A: The scope of NI 23-103 is set out in subsection 1.1(2) of Companion Policy 23-103CP (CP). The rule applies to the electronic trading of securities, including debt securities, on marketplaces in Canada. NI 23-103 requires marketplace participants to ensure compliance with marketplace and regulatory requirements.

As set out in NI 21-101 and incorporated in NI 23-103, in Québec, standardized derivatives are considered to be securities and therefore the electronic trading of standardized derivatives on a marketplace in Québec would be subject to the requirements of NI 23-103. NI 23-103 and the CP also provide interpretations of “security” in Alberta, British Columbia and Ontario.

A-2 Q: Does NI 23-103 apply to all orders executed on a marketplace or only to orders generated by an automated order system?

A: The rule applies to the electronic trading of securities on marketplaces in Canada. Therefore, NI 23-103 applies to all orders sent electronically to a marketplace whether generated by an automated order system or not. This means that NI 23-103 applies to orders manually handled by a marketplace participant but sent electronically to a marketplace.

B. PRE-TRADE RISK MANAGEMENT AND SUPERVISORY CONTROLS

B-1 Q: What, if any, automated pre-trade controls are required for orders intermediated by a marketplace participant?

A: Subsection 3(3) of NI 23-103 sets out the minimum requirements regarding pre-trade risk controls including those relating to capital, credit, price and volume. Subsection 3(4) of the CP provides further guidance on minimum risk management and supervisory controls, policies and procedures.

It is important to note that each marketplace participant must examine its own business model to manage its financial, regulatory and other risks associated with marketplace access or providing clients with access to a marketplace. This examination will drive the specific controls that the marketplace participant will have to establish.

B-2 Q: Do pre-trade credit checks apply to proprietary order flow?

A: The requirement under subparagraph 3(3)(a)(i) of NI 23-103 is that a marketplace participant’s risk management and supervisory controls, policies and procedures must be reasonably designed to prevent the entry of one or more orders that would result in exceeding pre-determined credit or capital thresholds of the marketplace participant. Therefore, all order flow that is sent electronically by a marketplace participant to a marketplace, including proprietary order flow, would be subject to pre-trade capital or credit checks as applicable.

B-3 Q: Where should pre-trade risk controls be placed with respect to smart order routers?

A: NI 23-103 does not specify where the mandatory pre-trade risk controls should be placed with respect to a smart order router and therefore it is up to the marketplace participant to determine the optimal location of its pre-trade risk controls. Under section 3(2) of the rule, orders must pass through automated pre-trade risk filters that are under the control of the marketplace participant before being entered on a marketplace. Therefore, if orders do not pass through automated controls that have been

set by the marketplace participant prior to entry to a smart order router, the automated controls would have to be placed at the smart order router level.

We also note that under subsection 5(1) of NI 23-103, a marketplace participant must take all reasonable steps to ensure that the use of an automated order system, including a smart order router, by itself or any client, does not interfere with fair and orderly markets. Therefore, a marketplace participant must have a way to monitor if a smart order router used by itself or any client malfunctions and erroneously sends orders to a marketplace.

B-4 Q: If a client is a DEA client and also sends orders to trading desks of the same firm, does the marketplace participant need to enforce an aggregated pre-trade capital limit on all of its client's trading with the firm, whether by DEA, telephone or orders sent to a sales trader?

A: If a marketplace participant does not enforce a pre-trade capital limit aggregated in real-time on all of its client's trading with the firm, a marketplace participant should establish separate limits for the various trading channels (both electronic and non-electronic) the DEA client uses at the firm. We emphasize that these limits need to be established in light of the marketplace participant's total financial exposure that can result from its client's order flow. A marketplace participant must first have a good understanding of its total exposure with respect to a specific client and then set pre-trade capital limits for each trading channel accordingly. The limits do not need to be electronically linked, but do need to consider the total exposure the marketplace participant faces with respect to its client.

B-5 Q: Is it acceptable for a marketplace participant to place separate pre-trade limits on each electronic marketplace access channel used by a client and continue to assess the aggregate risk posed by that client on a post-trade basis?

A: Yes. Pre-trade credit and capital limits may be applied to different electronic marketplace access channels separately but need to be determined in the aggregate as discussed in the answer to question B-4. We emphasize that it is important when setting limits in this manner that the limits be established in order to manage the total financial exposure of the marketplace participant that might result from its client.

B-6 Q: Must a marketplace participant's pre-trade risk controls take into account the threshold limits applicable to marketplaces established under section 8 of NI 23-103?

A: IIROC is currently consulting industry participants regarding the manner and levels at which the marketplace thresholds should be set. We note that the obligation in section 8 of NI 23-103 to not execute orders that exceed the price and volume thresholds as set by a regulation services provider or a marketplace that directly monitors the conduct of its participants rests with the marketplace, not the marketplace participant. Therefore, a marketplace participant is not obligated under NI 23-103 to specifically prevent sending orders that exceed a set marketplace threshold.¹

B-7 Q: Are pre-determined capital or credit thresholds to be based on: (i) all outstanding open orders in the marketplace, (ii) all orders staged to go out to the marketplace, open on the marketplace, and executed or (iii) executed orders only?

A: Guidance regarding the setting of pre-determined credit or capital thresholds is found in subsection 3(5) of the CP. Specifically, the CP notes that pre-determined credit or capital thresholds may be set based on different criteria, such as per order, per trade account, trading strategies or using a combination of these factors. The CP also states that the marketplace participant may also consider measuring compliance with set credit or capital thresholds on the basis of orders entered rather than executions obtained. In general, it is up to the marketplace participant to determine the best method as to how to set the pre-determined capital or credit threshold in order to manage the risks associated with marketplace access or providing clients with access to a marketplace. Regardless of how the marketplace participant measures compliance with its thresholds, the marketplace participant should consider whether to take into account the existence of executed but unsettled trades, including those from previous days. We expect that this consideration would be driven by the marketplace participant's assessment of its business model's risks.

B-8 Q: Please clarify what aggregate margin and capital limits would be required.

A: We are of the view that a one-size-fits-all approach with respect to limits for capital thresholds would not best serve our markets and therefore there are no specific capital limits that are mandated under NI 23-103. The rule uses a principles based

¹ However, if the trading of the marketplace participant is subject to the Universal Market Integrity Rules, IIROC will expect that the parameters be set to prevent an order exceeding the marketplace thresholds applicable to the marketplace on which the order is intended to be entered to the extent that such marketplace thresholds are publicly disclosed and readily ascertainable. See IIROC Notice 12-0364 - Rules Notice – Guidance Note – UMIR – *Guidance Respecting Electronic Trading* (December 7, 2012). At this time, IIROC has not established guidance on acceptable marketplace thresholds.

approach that provides a marketplace participant with flexibility in setting limits that are appropriate to its business model and risk tolerance. This approach is also in line with current global standards.

B-9 Q: Is a marketplace participant required to set risk controls to avoid price movements that trigger the single stock circuit breakers (i.e. reject orders that may impact price by greater than 10%)?

A: No. NI 23-103 does not require a marketplace participant to set risk controls that would prevent price movements that trigger the single stock circuit breakers; however, this would not preclude a marketplace participant from doing so if it thought important to manage its risks associated with marketplace access or providing clients with access to a marketplace.²

B-10 Q: As noted in the introduction of the CP, the intent of NI 23-103 is to focus on the gate-keeping functions of the executing broker. It is also noted that the clearing broker bears some responsibility in managing its risks under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). Are executing and clearing brokers required to share client information for the purposes of managing the pre-trade risk settings under NI 23-103?

A: There is no requirement under NI 23-103 for executing and clearing brokers to share client information for the purposes of managing pre-trade risk thresholds; however, a clearing broker may choose to require this information before continuing to provide its clearing services in order to meet its requirement under NI 31-103 to manage the risks of its business in accordance with prudent business practices.

B-11 Q: Since each ATS is also registered as a dealer, will an ATS be responsible for assigning limits for its subscribers?

A: No. The marketplace participant is obligated under section 3(1) of NI 23-103 to establish, maintain and ensure compliance with risk management and supervisory controls, policies and procedures that are reasonably designed to manage the risks associated with marketplace access or providing clients with access to a marketplace.

Third parties, including marketplaces, may provide the automated pre-trade risk controls required under section 3(2); however, as set out in section 3(5) of NI 23-103, a marketplace participant must directly and exclusively set and adjust the risk management and supervisory controls, policies and procedures, including those provided by third parties.

B-12 Q: May a third-party vendor set or adjust pre-trade risk limits at the specific written request of a marketplace participant?

A: Yes. A third-party vendor would be able to effect the setting or adjusting of a specific risk management or supervisory control, policy or procedure for a marketplace participant but only if the marketplace participant solely determines the specific threshold for each pre-trade risk control. We note that a third-party vendor may especially need to perform the actual setting or adjusting of risk limits in the case when there are connectivity issues or other outages between the vendor's system and the marketplace participant's system.

C. MONITORING OF TRADING ACTIVITY

C-1 Q: Does the requirement under subparagraph 3(3)(b)(iv) of NI 23-103 for compliance staff of a marketplace participant to receive immediate order and trade information refer to the compliance department of the firm or the business supervisors that have a compliance function?

A: The reference to "compliance staff" in subparagraph 3(3)(b)(iv) is meant to be interpreted broadly as the arrangements and set-up of compliance departments can widely vary among marketplace participants. The required order and trade information should go to the individual or group that has the main responsibility to review the compliance of those orders and trades with securities laws and IROC requirements for the marketplace participant.

C-2 Q: What types of same-day reviews of order and trade information are required under NI 23-103 given that prescribed capital and other risk checks will be applied automatically in real time? Are there any specific criteria that should be reviewed same day?

² However, if the trading of the marketplace participant is subject to the Universal Market Integrity Rules, IROC will expect that the parameters be set to prevent an order exceeding the limits publicly disclosed by IROC for the exercise of the power of a Market Integrity Official under Rule 10.9 of UMIR. See IROC Notice 12-0364 – Rules Notice – Guidance Note – UMIR – *Guidance Respecting Electronic Trading* (December 7, 2012). For the limits on price movement before IROC will consider regulatory intervention see IROC Notice 12-0040 - Guidance Note – UMIR – *Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012) and IROC Notice 12-0258 – Guidance Note – UMIR – *Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (August 20, 2012).

A: Order and trade information is to be reviewed regularly, in part to ensure that the automated pre-trade risk checks are functioning appropriately and also to identify any anomalous trading behaviour that cannot be identified merely through automated pre-trade risk controls. No specific criteria have been listed in NI 23-103 or the CP as to what must be reviewed on a same-day basis; rather, it is left up to the marketplace participant's discretion to determine what the relevant criteria should be and how often these criteria should be reviewed in order to prudently manage the risks of its business.

C-3 Q: In circumstances where introducing brokers know their clients best and set pre-trade risk thresholds for their clients, must a carrying broker also set pre-trade limits notwithstanding the introducing broker's pre-trade risk limits?

A: Section 4 of the CP explains that a participant dealer may, on a reasonable basis, authorize an investment dealer to set or adjust a specific risk management or supervisory control, policy or procedure on the participant dealer's behalf by written contract and after a thorough assessment of the investment dealer's risk management or supervisory control, policy or procedure. However, the participant dealer that is the executing dealer must also have reasonable controls in place to manage the risks it incurs by executing orders for other dealers. While an executing dealer may not need to set the limits for specific risk management or supervisory controls, policies or procedures for the ultimate client because it has authorized the introducing broker to do so, the executing dealer will need to ensure it sets limits for the flow it receives from the introducing broker as a whole.

Authorizing an investment dealer to set or adjust a risk management or supervisory control, policy or procedure does not relieve the participant dealer of its obligations under section 3 of NI 23-103. We note that subsection 4(d) of NI 23-103 requires the participant dealer to regularly assess the adequacy and effectiveness of the setting or adjusting of the risk management or supervisory control, policy or procedure by the investment dealer.

D. AUTOMATED ORDER SYSTEMS

D-1 Q: Section 5(1) of NI 23-103 provides that a marketplace participant must ensure that the use of an automated order system by any client does not interfere with fair and orderly markets. What does this entail? For example, does this require an average daily volume check on client orders since a large market order can freeze a symbol? Does this apply equally to equity as well as equity options and other asset classes?

A: The requirement for a marketplace participant to take all reasonable steps to ensure that the use of an automated order system by any client does not interfere with fair and orderly markets is an overarching principle that obliges a marketplace participant to monitor and manage the use of each automated order system by a client.³ There is no requirement to conduct an average daily volume check under NI 23-103, but if a marketplace participant is of the view that this would be a useful tool to manage its risks and help ensure that the use of an automated order system by a client does not interfere with the fair and orderly functioning of the markets, the marketplace participant may choose to institute such a check.

The requirement under section 5(1) of the rule applies to each instance where a client uses an automated order system to trade a security, as that term is defined in each CSA jurisdiction. For the scope of NI 23-103, see our response to question A-1.

D-2 Q: Subsection 5(3)(b) of NI 23-103 requires that every automated order system used by a marketplace participant or any client is tested in accordance with prudent business practices. Can a marketplace participant rely on a third-party vendor for the testing of these systems and applications?

A: Section 5 of the CP outlines that a participating dealer does not necessarily have to conduct tests on each automated order system used by its clients itself but must be satisfied that these automated order systems have been appropriately tested.

A marketplace participant should consider how it documents the testing that has been conducted on an automated order system used by itself or any client.

D-3 Q: Subparagraph 5(3)(c)(ii) of NI 23-103 requires a marketplace participant to have controls in place to immediately prevent orders generated by an automated order system used by the marketplace participant or any client from reaching a marketplace. Would a reasonable process involving human interaction be considered to "immediately" stop orders from an automated order system from being entered on a market? For example, would a process where a marketplace participant calls a vendor or marketplace in order to terminate access for a third-party smart order router be considered to meet that standard?

³ If the trading of the marketplace participant is subject to the Universal Market Integrity Rules, Rule 10.9 of UMIR allows IIROC to delay, halt or suspend trading in a security at any time and for such period of time as IIROC may consider appropriate in the interest of a fair and orderly market. IIROC has issued guidance on when trading activity may be considered to be interfering with a "fair and orderly market". In particular, see IIROC Notice 12-0040 – Guidance Notice – UMIR – *Guidance Respecting the Implementation of Single-Stock Circuit Breakers* (February 2, 2012) and IIROC Notice 12-0258 – Guidance Note – UMIR – *Guidance on Regulatory Intervention for the Variation or Cancellation of Trades* (August 20, 2012).

A: The overarching requirement of this provision is that a marketplace participant's risk management controls, policies and procedures are reasonably designed to manage, in accordance with prudent business practices, the financial, regulatory and other risks associated with marketplace access or providing clients with access to a marketplace. It is therefore up to the marketplace participant, based on its business model, the type of order flow that it handles, and the speed at which a malfunctioning automated order system can harm market integrity, to determine whether an automated function or manual process to stop orders from reaching a marketplace is appropriate.

Implementation of NI 23-103

Further to Multilateral CSA Staff Notice 23-313 *Blanket Orders Exempting Marketplace Participant from Certain Provisions of National Instrument 23-103 Electronic Trading and Related OSC Staff Position*⁴, we note that New Brunswick has also issued a blanket order, effective March 1, 2013, that provides temporary relief from paragraph 3(3)(a) of NI 23-103 to marketplace participants that are testing the automated pre-trade risk controls required under paragraph 3(3)(a) of NI 23-103 by March 1, 2013. The blanket order grants relief until May 31, 2013.

If you have any questions about these FAQs or NI 23-103 generally, please contact any of the following CSA staff:

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⁴ (2012) 35 OSCB 11134