



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Dear Sirs/Mesdames:

Regulation of Direct Market Access Arrangements

We understand that the Canadian Securities Administrators (“CSA”) is reviewing the exchange and marketplace policies and regulations relating to Direct Market Access and Sponsored Access Arrangements (the “Regulations”). Members of the Investment Industry Association of Canada (the “Association” or “IIAC”) support this initiative, as it has become clear that the existing Regulations have failed to evolve with the changes in the general market structure.

In response to these concerns, in early 2009, the Association formed a working group to develop a proposal for an updated regulatory approach to Direct Market Access and Sponsored Access. Our recommendations are informed by the current experience of dealers and clients, as well as the IOSCO approach to Direct Market Access and Sponsored Access, as proposed in February 2009 Consultation Report on Policies on Direct Electronic Access (the “IOSCO Report”), the SIFMA response to proposed NASDAQ Sponsored Access regulation (the “SIFMA Recommendations”), and the SEC proposal on Risk Management Controls for Brokers or Dealers with Market Access, released January 2010 (the “SEC Proposal”).

Location/Administration of Direct Market Access and Sponsored Access Rules

The current Regulations reside with, and are administered by the various Canadian marketplaces. The result is that there are several, albeit similar, rules or policies governing the same activity, applied in different ways, by each marketplace. This has led to confusion and a lack of predictability in respect of these activities.

The Regulations all originate from a TSX Rule, created at a time where TSX was effectively the only Canadian senior equities exchange and was also a Self Regulatory Organization. In that environment, it was appropriate that TSX create and administer rules dealing with market access. However, the environment has changed significantly in the past number of years. In particular, the emergence of multiple marketplaces, the increasing numbers and sophistication of Direct Market Access and Sponsored Access clients, and the entry of high frequency trading clients has altered the trading landscape and introduced new market risks. As a result, a new approach to the regulation of this activity is required.

Given the increasing prevalence and complexity of Direct Market Access and Sponsored Access activities, in order to maintain market integrity, it is critical that the current patchwork of inconsistently applied policies be replaced with uniform regulations applied in a consistent manner, across all marketplaces.

To create a consistent and uniform regime, we recommend that regulation relating to Direct Market Access and Sponsored Access be contained in a National Instrument. This would ensure that all relevant parties, including exchanges, ATs, and access persons are subject to the jurisdiction of a regulator and a consistent set of regulations.

Scope of the Direct Market Access/ Sponsored Access Rule

We believe that Direct Market Access, as traditionally practiced and Sponsored Access arrangements represent two distinct means of market access for market participants. Each has distinct features and have distinct impacts to market risk. Consequently, a different approach to regulation of these practices is required.

For the purpose of this letter, we define Direct Market Access and Sponsored Access as follows:

Direct Market Access involves a member (“Sponsoring Member”) providing access to a marketplace to another person, firm or customer (“Sponsored Participant”) through the member’s order entry systems. The Sponsored Participant makes order entry and routing decisions, but the orders pass through order entry infrastructure that is under the Sponsoring Member’s control.

Under these arrangements, the Sponsoring Member typically does not manage the execution of orders, including the timing of the trades, price or volume or other elements of the order. However, the Sponsoring Member generally retains the ability to internally monitor, establish controls and filters, and if necessary, stop an order. (This definition is similar to the Automated Order Routing Through Intermediaries’ Infrastructure (AOR) in the IOSCO Report. These transactions should not fall under the scope of our proposed Sponsored Access regulation, as they are adequately dealt with under section 7.1 *Trading Supervision Obligations* of the IROC UMIR regulations.

Sponsored Access is the practice by a Sponsoring Member of providing access to a marketplace to Sponsored Participant, where the orders do not pass through the Sponsoring Member's system prior to entry into the marketplace.

Under a Sponsored Access scenario, the Sponsoring Member is not able to monitor the order on a pre trade basis, and does not have control over any element of its execution. The technology used by the Sponsored Participant to undertake the trade could be owned, managed and tested by the Sponsored Participant or third parties, and is not controlled in any way by the Sponsoring Member. This includes situations where the Sponsored Participant, co-located at a marketplace has a direct connection with a matching engine. In these scenarios, the Sponsoring Member is only in a position to see the order as it occurs, or on a post execution basis. Their role is limited to providing a broker number, without having any influence over the execution of the trade, or the development or changes to the marketplace gateway . This is also known as "naked" or "unfiltered" access.

Currently under TSX Rule 2-500, the definition of Direct Market Access is so broad and imprecise that firms undertaking the same business may come to different conclusions as to whether they are conducting Direct Market Access or Sponsored Access. Rather than identifying the activities that constitute Direct Market Access and Sponsored Access, the TSX Rule designates "Eligible Clients" as the starting point for the Regulation. This structure is, in part, responsible for the over-reach and complexity of the Regulation.

The effect of this over-reach is that certain managed routing transactions could be interpreted to fall under the Direct Market Access definition, despite the fact that they are, in practice, just different approaches to a firm's normal order routing, which is regulated under IROC's UMIR. The TSX Rule also captures Sponsored Access arrangements which are not regulated under IROC or CSA rules, and require a different approach than Direct Market Access regulation. We believe it would be far more effective to isolate the specific activities that constitute Direct Market Access and Sponsored Access, and regulate them according to the risks they pose to the market. This approach is consistent with the IOSCO Report and the SIFMA Recommendations.

Regulating Sponsored Access

The SEC Proposal would have the effect of banning Sponsored Access by requiring Sponsoring Members to "implement pre-trade risk management controls and supervisory procedures that are reasonably designed to manage the financial, regulatory, and other risks of this business activity". The result is that Sponsored Access transactions would be transformed into Direct Market Access, as order flow would pass through systems and filters controlled and administered by the Sponsoring Member.

We support the general approach of requiring that all order flow be subject to pre-trade risk management controls and supervisory procedures for which the Sponsoring Members are ultimately responsible. However, we believe the SEC Proposal may be unduly restrictive, depending on how certain provisions are interpreted and implemented. Specifically, the provision requiring that the risk management controls and supervisory procedures be under the *direct and exclusive control* of the Sponsoring Member does not seem to recognize or accommodate the fact that much of the Sponsored Access, and certain activities characterized as Direct Market Access are

conducted through systems created and administered by third party technology providers. Although Sponsoring Members can establish, monitor and control the risk management filters, and can undertake supervision of trades conducted through these systems, they may not have *exclusive* physical control over the systems. We do not believe that the ability of the technology providers to access and adjust the system introduces any material risk, as the parameters and rules of access can be established in a contractual arrangement between third party technology providers and Sponsoring Members. Sponsoring Members should be allowed to rely on their vendors, recognizing that the Sponsoring Member bears the ultimate responsibility for the outcomes. If access through third parties is prohibited, all Direct Market Access and Sponsored Access activities would have to be conducted using “in-house” systems. Many firms do not have the technological capability to support these activities. This would have a significant negative impact on the market by considerably increasing the barriers to entry, excluding all but a small number of large dealers from undertaking this type of business.

It should also be noted that in a multiple-marketplace environment with best execution and trade through obligations, a Sponsored Participant may not have direct access to the market. Sponsored Participants may have their orders directed through a marketplace order router that is outside of the Sponsoring Member’s control, to ensure they meet their regulatory obligations.

Given that the activities comprising Direct Market Access are already appropriately regulated, any new marketplace access rule should be structured so that it does not apply to orders routed through the Sponsoring Member’s systems and infrastructure.

As noted above, under the SEC Proposal, a separate Sponsored Access rule is not required, because all trades will be required to pass through systems or filters controlled directly and exclusively by Sponsoring Members, and will be governed by the same regulations that deal with all other order flow. Although our members generally agree that subjecting all trading activity to some level of control is appropriate, the nature and level of control should not necessarily be the same for all types of trading activity. It is important that any new rules be specifically targeted to activities that are not covered by existing regulation, and be properly calibrated to manage the risks associated with the activity.

In terms of calibrating risk, it also may be appropriate to consider the resources available to Sponsoring Members to cover counterparty and credit risks should a problem arise. Certain members have suggested that rather than imposing vigorous pre-trade filtering, dealers undertaking Sponsored Access activities be subject to higher capital requirements corresponding to the increased risk.

Any new Sponsored Access rule should set out the obligations for the Sponsoring Members, Sponsored Participants and marketplaces. The rule should allow Sponsoring Members to determine which of their clients they wish to provide this service, based on their own due diligence and risk assessment, rather than the current Eligible Client approach. The due diligence requirements and required contractual provisions should be principles based and flexible enough to allow for differences in the client profile and the particular services and transactions offered by the Sponsoring Member. The IOSCO Report details certain factors that Sponsoring Members should be considering in respect of potential Sponsored Participants. These factors include:

- Familiarity with market rules
- Degree of financial experience
- Prior sanctions for improper trading activity
- Evidence of a proven track record of responsible trading and supervisory oversight
- Ability to meet appropriate credit and risk guidelines
- Minimum thresholds for assets under management
- Proposed trading strategy and associated volumes

The IOSCO report also recommends that a Sponsored Participant should be required to meet minimum standards, including

- Appropriate financial resources;
- Familiarity with the rules of the market and ability to comply with such rules;
- Knowledge of the order entry system which the client is permitted to utilize; and
- Proficiency in the use of that system

We believe these are all appropriate considerations in the Sponsoring Members' assessment of their clients.

Content of the Sponsored Access Rule - General

Although the current regulatory regime is fragmented and over-reaching, there are certain elements of the TSX Rules and Policies that are appropriate, and should be retained in some manner in the Sponsored Access regulatory regime. Currently TSX Policy 2-502 contains system requirements and the required terms of the agreement between Sponsoring Members and Sponsored Participants. Although certain of these provisions as outlined below, should be retained, in order to accommodate certain differences in business practices, the agreement between Sponsored Participants and Sponsoring Members should be less prescriptive and more principles based, addressing the recommended minimum standards as discussed above.

Under the current regime, all of the responsibilities for ensuring compliance and maintenance of market integrity are imposed exclusively on Sponsoring Members. This includes situations in which the Sponsoring Members do not have the ability to exercise control over orders submitted under their number. Consistent with the SIFMA Recommendations, we believe that marketplaces that have facilitated, and are profiting from the Sponsored Access arrangements have an obligation to share the burden of managing systemic risk and promoting market integrity with Sponsored Participants and Sponsoring Members. Given the emergence of high frequency traders in the Sponsored Access realm, the risk to the market has significantly increased, due to the magnitude and speed of orders generated by these participants. Marketplaces must ensure that their systems are able to manage these risks. Safeguards, such as throttling systems (such as those in place at the NYSE) that detect and prevent order traffic exceeding acceptable levels, or other filters and technological controls provide a means through which marketplaces may meet their market integrity obligations.

Content of the Sponsored Access Rule – Specific Provisions

As discussed previously, we believe that Direct Market Access arrangements are adequately regulated under provisions of the UMIRs and consequently do not require special regulations. With respect to Sponsored Access arrangements, however, there are certain provisions of the TSX rule which we believe could be usefully incorporated into Sponsored Access Regulations. Specifically:

- The requirement for the Sponsoring Member to ensure security of access to the system raises questions about the ability of the Sponsoring Members to monitor the Sponsored Participant's procedures (for instance, who will have access to passwords and how they are safeguarded). It is not practical to require Sponsoring Members to create and monitor their clients' compliance and security procedures, as these matters are outside of their control. We suggest that either the provision be amended to require that only an Approved Person at the Sponsored Participant may undertake trades, or that the agreement between the Sponsored Participant and the Sponsoring Member have a provision mandating appropriate controls on access, but allowing Sponsoring Members to determine how implement those controls.
- The basic requirements relating to the Sponsored Participant's responsibility to comply with marketplace and regulatory requirements should be retained in an agreement between the Sponsoring Member and the Sponsored Participant. The agreement should set out provisions allowing for the establishment and amendment of parameters that define the orders that may be entered by the Sponsored Participants, including restrictions on specific securities and sizes of orders. The regulation should not require that such terms be specifically stated in the agreement, as this will result in a need to continually alter agreements as business requirements change over time.
- The Sponsoring Member should have the right to reject an order for any reason and also have the right to correct rather than change or remove an order in the book, and the right to cancel any trade made by the client for any reason. The wording should be amended to use the term "correct" rather than "change" to address a situation where the order is changed from a market order to a limit order, or where the order is sent in without a fixed price, and the Sponsoring Member subsequently puts in a price range. Not all Sponsoring Members put limits on orders, as some are of the view that it requires too many decisions to be made by the Sponsoring Member, which may be inappropriate in certain situations. For instance, the Sponsoring Member may be required to determine what securities should be subject to limits. This is a risk that should be borne by the Sponsored Participant, and should not be subject to authority granted to the Sponsoring Member. We suggest changes to orders not be a required term of the agreement, but be optional and subject to negotiation between the parties.
- The existing sections requiring the Sponsoring Member to train and keep the Sponsored Participant updated in respect of marketplace requirements and entry of orders should be removed. The onus for education and updating Sponsored

Participants should be on the Sponsored Participant, as to do otherwise would place an unnecessary layer of regulation on Sponsoring Members. Given that Sponsoring Members are ultimately responsible for client activities, they currently undertake this function, but have different practices to fulfill the requirement. The Regulation should simply require that the Sponsoring Member have reasonable evidence that the Sponsored Participant is adequately trained, and understands the rules of the Canadian marketplace as appropriate, prior to permitting the Sponsored Participant to engage in trading. The industry should be responsible for establishing best practices in respect of training Sponsored Participants.

- It is essential that the Sponsoring Member have the ability to receive an immediate report of, or to view on a real time basis, the entry or execution of orders. This is in order to ensure the Sponsored Participant observes the parameters set in the agreement. Consistent with the SEC Proposal, the Sponsoring Member should also have the capability of rejecting orders that do not fall within the designated parameters of authorized orders for a particular Sponsored Participant.

Other Issues / Considerations

Standards of Supervision

We do not feel there is a need for additional supervision standards for Sponsored Access and Direct Market Access, given the requirements of UMIR 7.1 *Trading Supervision Obligations*. We do not support provisions that would require that Direct Market Access and Sponsored Access be tested separately and elements of UMIR 7.1 specifically targeted. However, we endorse provisions that require Sponsoring Members to ensure sampling includes all business lines, including Sponsored Access and Direct Market Access.

Conclusion – Next Steps

The nature of Direct Market Access arrangements has evolved significantly since the initial regulation was enacted by the TSX. The inception of Sponsored Access, new entrants to the market, and the introduction of a multiple marketplace environment has created, and exposed gaps and overlaps in the Regulation. The fundamental shift in the structure of the Canadian market has resulted in a need to re-evaluate not only the details in the existing Direct Market Access rules and policies, but the structure of, and organizations responsible for administration and enforcement of the Regulation. The CSA must also consider the effect that new regulation will have on the competitiveness of the Canadian capital markets. While it is important to note the direction of international, and in particular US regulation, it is critical to develop a solution that addresses the needs of the Canadian market environment, including the need to remain competitive on an international level.

The Direct Market Access Committee of the IIAC thanks you for considering our submission, and would be pleased to work with the CSA and IIROC to help develop the new regulatory structure. We look forward to meeting with you and other interested stakeholders in the process of developing the updated regulation.

If you have any questions or comments, please do not hesitate to contact either of the undersigned.

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