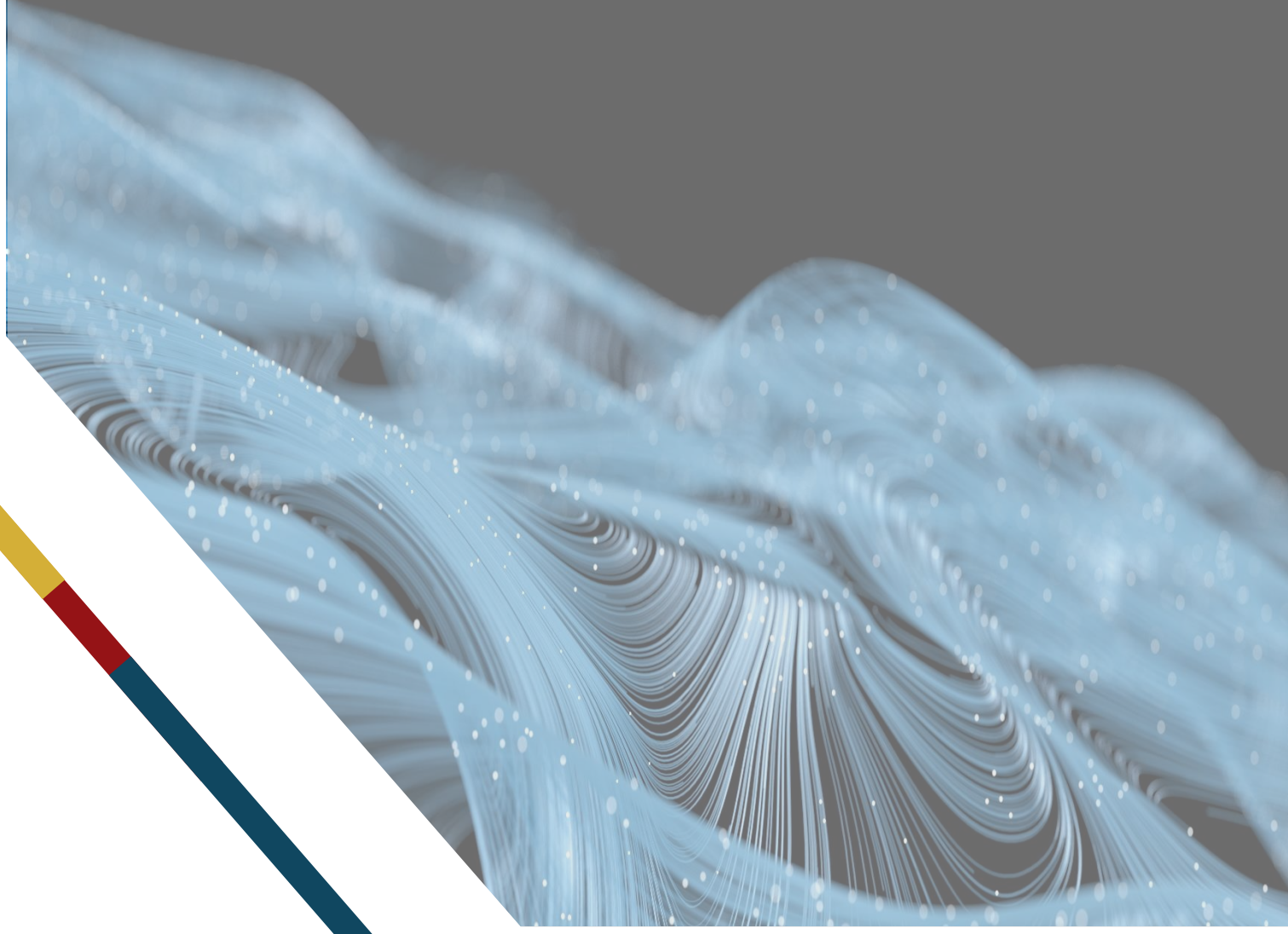

RE: CSA STAFF NOTICE AND CONSULTATION 11-348 – APPLICABILITY OF CANADIAN SECURITIES LAWS AND THE USE OF ARTIFICIAL INTELLIGENCE SYSTEMS IN CAPITAL MARKETS

March 31, 2025

Contents

March 31, 2025

Submitted via Email

Attention:

The Secretary
Ontario Securities Commission
2200-20 Queen Street West
Toronto, Ontario M5H 3S8
E-mail: comments@osc.gov.on.ca

Philippe Lebel
Corporate Secretary and Executive Director, Legal Affairs
Autorité des marchés
Place de la Cité, tour PwC
2640, boulevard Laurier, bureau 400
Québec (Québec) G1V 5C1
E-mail: consultation-en-cours@lautorite.qc.ca

Dear CSA:

EXECUTIVE SUMMARY

We appreciate the opportunity to respond to CSA Staff Notice and Consultation 11-348, *Applicability of Canadian Securities Laws and the use of Artificial Intelligence Systems in Capital Markets* ("**Notice and Consultation 11-348**") and commend the CSA for evaluating its existing principle-based framework and illustrating how it addresses AI. We agree that technology itself should not be regulated.

AI and other new technologies bring benefits and opportunities to better serve market participants. Technological innovation benefits market participants with lower operating costs and increased productivity. These benefits are passed onto to Canada's markets and investors.

While AI technologies may also present certain risks, the CSA has a well-established regulatory framework to address those risks irrespective of the technology used. Market participants must address the risks associated with all aspects of their business regardless of whether and how technology is used. Regulatory requirements do not change based on technology because regulatory objectives remain the same. We should avoid differing regulatory standards based on the use of technology.

AI can produce widely different risk profiles depending on where and how it is used. It cannot be subject to a one-size-fits-all approach. Doing so may disincentive the development and adoption of this technology to the detriment of the competitiveness of Canada's capital markets. A risk-based approach that draws on current regulatory obligations and focuses on high-risk uses will encourage innovation while addressing investor protection concerns.

A. REVIEW OF NOTICE AND CONSULTATION 11-348

i) Commendable Regulatory Goals

The CSA's stated goals of supporting an environment where the deployment of AI systems enhances investor experiences, benefits market efficiency and competition, and attracts capital to Canadian companies developing AI systems, while responsibly addressing risk, are laudable.

ii) Principled Based and Technology Neutral Regulation

Notice and Consultation 11-348 properly acknowledges that:

a) Securities laws are technology-neutral and apply regardless of the technology being used to conduct a given activity.

b) Securities legislation is, in many respects, principles-based and therefore allows for interpretation to fit different ways of undertaking a given activity. Depending on the technology, different actions may be necessary to meet the same requirements under securities law.

c) It is the activity being conducted, not the technology itself, that is regulated.

iii) A Fulsome Canadian Regulatory Framework

Notice and Consultation 11-348 outlined the many requirements under securities laws and regulation that apply to the use of AI systems, illustrating how Canada's extensive regulatory framework addresses AI concerns. It further acknowledges that market participants have likely adopted policies and procedures for matters such as technology, privacy, data, and third-party service providers that are applicable to their use of AI systems.

B. KEY CONSIDERATIONS TO THE USE AND REGULATION OF AI

i) The Effectiveness of the Canadian Framework

In recent years, generative AI has gained increased public attention due to the technological advancements that have been made and the potential benefits that this technology offers to users. But, the use of technology generally, and artificial intelligence specifically, in Canada's capital markets is not new. As acknowledged in Notice and Consultation 11-348 and observed by the Ontario Securities Commission[1], market participants already use AI and related technologies for a wide array of functions. For example, AI is used to analyze large volumes of data, predict market trends, devise investment strategies, detect fraud, address cybersecurity threats, and assist with compliance functions. With specific reference to fraud, cybersecurity and compliance, we note that bad actors actively use AI technology for ill intent. As such, it is important that market participants are able to use the same or better AI technology to protect markets and investors from fraud and threats to cybersecurity.

[1] Ontario Securities Commission and Ernst & Young LLP, *Artificial Intelligence in Capital Markets: Exploring Use Cases in Ontario* (2023), online: https://www.osc.ca/en/news-events/news/osc-releases-report-artificial-intelligence-ontarios-capital-markets

Firms remain responsible for how AI is used and the accuracy of AI outputs, which should be consistent with legal and regulatory standards and internal policies and procedures. When a regulated activity is being performed using any technology, including AI, it should continue to be subject to the same extensive securities laws and regulations that apply if technology were not used. As recognized in Notice and Consultation 11-348, Canada's securities laws and regulation apply to the conduct of market participants rather than any specific technologies that are used to facilitate that conduct. These laws and regulations have proven effective in addressing the use of emerging technology including AI. Both regulators and market participants have relied upon existing laws and regulations to implement a variety of emerging technologies, including AI, without the need for amendments. The varied and developing nature of AI technology and its range of uses amongst market participants renders the promulgation of additional rules or guidance impractical.

In addition to other applicable legislation (for example, privacy), Canada's legal and regulatory framework imposes multiple requirements applicable to AI, providing ample reason to refrain from adding additional ones. Before adding any additional regulatory requirements, a relevant, material gap in all existing legal requirements would need to be identified. No such gap is currently apparent.

ii) <u>The Benefits of a Risk-Based Approach</u>

As recognized in Notice and Consultation 11-348, generative AI and related technologies offer significant advantages to investors and market participants in terms of improved efficiency, revenue generation, and risk mitigation. Canada should be a preferred destination for companies developing new technologies. An overly restrictive approach risks discouraging firms from creating/adopting new AI technologies in Canada in favour of other jurisdictions with more flexible regulations.

We therefore caution against premature regulations, likely to be outdated before or shortly after they are finalized, that will dissuade innovation and prevent firms from realizing the benefits of AI. The use of AI and other technology can vary significantly within a firm and across firms, which presents a very broad range of uses, risk and mitigation options. The implementation of any new technology requires a risk-based and technology agnostic approach.

Subjecting every new technology, including AI applications, to onerous risk assessments and audits that are unnecessary or impracticable depletes resources on lower risk applications and chills innovation. All firms would be challenged by how to allocate compliance resources to ensure resources are not diverted from higher risk application. It also impedes the ability of smaller and emerging firms, who are particularly impacted by costs and compliance burdens brought on by unnecessary regulation, to participate in AI's benefits. They cannot benefit from economies of scale in the same way as larger operations, hurting their ability to compete or enter the market, as applicable. These realities negatively impact investors through less options and higher costs.

A risk-based approach focuses on the main concern, such as high-risk uses of AI and other emerging technologies. The ability to apply existing law and regulations to current technology through a risk-based approach also focuses on market action and results, as opposed to the technology used to get results. It eliminates the need for a precise definition of AI, which may become quickly outdated due to the quick pace of evolving technology. It is also non-prescriptive and gives market participants flexibility to address AI differently, depending on their varying risks, by applying the foundational concepts available through securities law and regulation and other legislation.

iii) Useful Regulatory Efforts to Understand and Address AI

The IIAC commends the CSA's efforts to have a deeper, common understanding of how market participants use AI. Reviewing current requirements with transparency and requesting public comments is appreciated.

Regulators should effectively collaborate with market participants to understand the uses of AI, its advancements, and its related risks on practical levels, through sandboxes or invitational workshops on discrete topics. In the interim, restraint should be exercised on any public statements regarding the limitations on AI abilities and corresponding firm abilities to show regulatory requirements are met, as these statement may be inadvertently misleading or quickly become outdated.[2] In reviewing the current requirements that apply to AI, the IIAC also encourages the CSA to consider the other federal and provincial laws that apply to market participant use of IA technology including, for example, emerging privacy laws.

C. APPLICATION OF KEY CONSIDERATIONS TO THE CONSULTATION QUESTIONS

The questions posed in the Notice and Consultation 11-348 address three main issues: i) new regulatory requirements, ii) new operational requirements and iii) new systemic risks:

i) New Regulatory Requirements

a) Generally

Questions: The possible need for new or amended rules/guidance to address the risks that may be associated with the use of AI systems.

Response: Please see the above comments. Canada's existing securities laws, and resulting governance frameworks, can adequately accommodate the use of AI by market participants.

OSFI's E-23 draft Guideline on Model Risk Management, ISO, NIS has raised areas of concern which include the expectation that a financial institution apply a detailed model-risk management framework across its use of models, regardless of whether a particular use creates a material risk, and broad definitions of model and model risk which may include those that would not present any meaningful risk. [3] The draft guideline has been described as not aligned with comparable guidance in other key markets, such as the United States and United Kingdom, making financial institutions in Canada less likely to adopt productivity-enhancing and risk-reducing technology than global competitors. [4]

---

[2] For example, with respect to Portfolio Management, Notice and Consultation 11-348 states in part:

"At the current stage of development of AI systems, we do not believe it is possible to use an AI system as a substitute for an advising representative acting as decision-maker for clients' investments and consistently satisfy regulatory requirements such as for suitability determinations or reliably deliver desired outcomes for clients".

This is contrary to statements recognizing the possibility of using AI systems to design portfolios and execute portfolio management autonomously and the use of AI by investment funds.

See also: Decision Making Support.

[3] OSFI to finalize risk management guidance covering the use of AI and machine learning within models - Osler, Hoskin & Harcourt LLP

[4] OSFI to finalize risk management guidance covering the use of AI and machine learning within models - Osler, Hoskin & Harcourt LLP

b) Explainability

Questions: The standard of explainability that should be applied to AI systems and the possible need for new or amended rules/guidance on the use of AI systems that are less "explainable".

Response: As recognized by Notice and Consultation 11-348, what constitutes an appropriate degree of explainability will depend on the circumstances. The complexity and materiality of AI models often vary significantly based on each model's parameters and business use. Depending on the uses of a particular AI process, granular explainability may not be relevant. The necessity of explaining an AI process depends on the risks associated with that process. For example, a complex AI model may pose little risk to investors.

Given the wide variety of use cases and the different materiality of associated risks, AI explainability should be flexible and tailored. Firms are best placed to consider whether there is a need for explainability, and if, so, the appropriate level. The CSA and CIRO may usefully collaborate with firms to delineate the appropriate scope of documentation for certain AI uses in the application of reasonable supervisory efforts.

c) KYC

Questions: The use of FinTech solutions that rely on AI systems for KYC and client onboarding and any related need for regulatory accommodation or restrictions.

Response: Please see the above comments. A firm's regulatory obligations do not change whether AI supports the provision of these services to clients or is the primary means by which these services are provided.

Reasonable interpretation or housekeeping amendments may be made to National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). NI 31-103 imposes KYC and suitability requirements on a registrant.[5] The term registrant is undefined. It may be interpreted to include firms. If currently assumed to include only a natural person, a registrant should be defined to include registered firms.[6]

Reasonable interpretation or housekeeping amendments reflect the reality that increased reliance will be placed on AI systems to conduct registerable activity.

d) KYP

Questions: The possible expansion of KYP obligations related to product shelf and reasonable alternatives to account for the use of AI technology.

Response: KYP obligations should not be expanded. KYP responsibilities are tailored to the firm, its business model, and clients. Firms are expected to establish, maintain and apply policies, procedures and controls relating to the know-your-product process, in accordance with the firm's business model, the types of securities offered, the proficiency of its individuals and the nature of the relationships that the firm and its registered individuals have with the clients.[7]

[5] Sections 13.2 and 13.2 of NI 31-103
[6] Notice and Consultation 11-348 also uses the term registrant. For example, Decision Making Support.
[7] NI 31-103 Companion Policy, Know Your Product

Also, different KYP obligations are imposed on a registered firm[8] and registered individuals.[9] KYP obligations may uniformly apply to registrants, defined or interpreted to include registered firms.

e) Outsourcing

Questions: The possible need for additional rules for the use of third-party products or services that rely on AI systems.

Response: Please see the above comments.

In meeting their current regulatory requirements, firms can draw from their existing third-party risk management processes to address third party AI applications.

The factors informing third party requirements that may be imposed by the registrant, through, for example, commercially reasonable diligence, testing, internal audits, and contractual terms that vary with AI use and risk levels.

ii) <u>New Operational Requirements</u>

a) Data Sources

Questions: The sources of data that are used by AI systems and measures market participants should take to address source-related risks.

Response: Please see the above comments.

When determining what data sources to use for an AI system, market participants are subject to multiple regulatory obligations. The measures that market participants need to put in place to address the risks associated with AI and meet their regulatory obligations will necessarily vary based on the AI system and the way the participant uses it.

Registered firms are subject to different registration categories and business models. The function of each AI model and the context in which it is operating are also important and varies. The risks associated with different AI models often differ greatly. For these reasons, firms typically face different risks to the integrity of the data underlying their deployments of AI, which are not suited to a "one-size-fits-all" approach to supervising firms' data governance.

It would be overly burdensome to require firms to test data integrity for every application regardless of the materiality and risk of the application.

[8] Section 13.2.1(1) of NI 31-103
[9] Sections 13.2.1(2), (2.1), (3) of NI 31-103

b) Human in the Loop

Questions: The role of humans in AI governance systems (i.e., a "human in the loop").

Response: The way in which the review of AI systems is built into a firm's governance framework will necessarily depend on the AI system at issue and how it is being used.

c) Monitoring

Questions: The effective monitoring of AI systems to identify variations in model outputs and related risks.

Response: Please see the above comments. Effective monitoring is entirely dependent on, among other factors, the type of AI system and the function for which that system is used.

iii) Systemic Risk

Questions: Theoretical systemic risks related to coordinated market manipulation, herding, and biases.

Response: Given the benefits of AI, securities regulators must avoid regulating against speculative or hypothetical AI risks. There have been suggestions that the risks posed by advanced AI models to market stability may be overstated, at least for now.[10] Research by the Central Bank of the Netherlands and AFM[11] indicates that most financial institutions currently favour simpler, supervised learning models over the complex. Most firms keep human oversight over trading and investment including kill-switch functions. Applications in financial markets are tailored to specific tasks rather than monolithic. These are coupled with firm-specific choices in data inputs, making it unlikely that all market participants will use the same algorithms for their investment and/or trading strategies:

> "Even if two investment managers use the same type of model with identical base architecture, their implementations are likely to differ significantly due to critical design and development decisions. Managers make different choices about data handling – including the type, frequency, scope, sources, structure, and preprocessing techniques – and many firms now incorporate diverse alternative datasets, such as environmental, social and governance (ESG) factors, satellite imagery or social media sentiment. These implementation differences and non-traditional data sources introduce substantial diversity into the decision-making process."[12]

Finally, even if many market participants use similar AI models that generate similar signals, trades can only occur when there are willing counterparties, and some participants will take contrarian positions: "For example, investment managers manage funds with varying objectives and strategies, reflecting their underlying investors' varied investment time horizons and risk appetites, and it is this inherent diversity in fund mandates and investor preference that ultimately influences how investment managers deploy AI models in their investment and/or trading strategies."[13]

---

[10] https://www.sidley.com/en/insights/newsupdates/2024/12/artificial-intelligence-in-financial-markets-systemic-risk-and-market-abuse-concerns#:~:text=WHAT%20ARE%20THE%20KEY%20SYSTEMIC,potential%20to%20undermine%20market%20stability.

[11] https://www.dnb.nl/en/sector-news/supervision-2024/afm-and-dnb-publish-report-on-the-impact-of-ai-on-the-financial-sector-and-supervision/

[12] https://www.institutionalinvestor.com/article/2dozjcglv7kxsgr3t4feo/opinion/secs-ai-driven-market-risk-worries-justified-caution-or-misplaced-concern

[13] https://www.sidley.com/en/insights/newsupdates/2024/12/artificial-intelligence-in-financial-markets-systemic-risk-and-market-abuse-concerns#:~:text=WHAT%20ARE%20THE%20KEY%20SYSTEMIC,potential%20to%20undermine%20market%20stability

D. CONCLUSION

Existing securities laws and regulations provide for firm risk management frameworks that are continuously updated to address emerging technologies such as AI.

A scaled, proportionate and risk-based approach to the continued implementation of current securities laws and regulations, rather than any technology specific rules, will serve the benefits of continued innovation and investor protection.

RESPECTFULLY SUBMITTED,

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

cc.

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Service Newfoundland and Labrador
Northwest Territories Office of the Superintendent of Securities
Office of the Yukon Superintendent of Securities
Nunavut Securities Office

.

IIAC

Investment Industry Association of Canada

ACCVM

Association canadienne du commerce des valeurs mobilières