Chapter 13

SROs, Marketplaces and Clearing Agencies

13.1 SROs

13.1.1 IIROC Rules Notice – Request for Comments – Proposed over-the-counter securities fair pricing rule and confirmation disclosure requirements

RULES NOTICE
REQUEST FOR COMMENTS

Proposed over-the-counter securities fair pricing rule
and confirmation disclosure requirements

Summary of nature and purpose of proposed Rule

On April 30, 2010, the Board of Directors (the Board) of the Investment Industry Regulatory Organization of Canada (IIROC) approved the re-publication for comment of proposed amendments to the Dealer Member Rules (the Rules) addressing the fair pricing of over-the-counter (OTC) traded securities, with an exception for primary market transactions and OTC derivatives, and amending existing trade confirmation requirements to mandate yield disclosure for fixed income securities and remuneration disclosure on confirmations sent to retail clients for OTC transactions.

Specifically, the proposed amendments will:

- Require Dealer Members to fairly and reasonably price securities traded in OTC markets, with an exception for primary market transactions and OTC derivatives set out in the proposed fair pricing rule;
- Require Dealer Members to disclose yield to maturity on trade confirmations for fixed-income securities and notations for callable and variable rate securities; and
- Require Dealer Members to include on trade confirmations sent to retail clients in respect of OTC transactions a statement indicating that they have earned remuneration on those transactions unless the amount of any mark-up or mark-down, commissions and other service charges is disclosed on the confirmation.

The general purpose of these proposed amendments is to enhance the fairness of pricing and transparency of OTC market transactions.

Relevant proposal history

The proposed rules were previously published for comment with IIROC Rules Notice 09-0109 on April 17, 2009 for a 90 day comment period. IIROC staff has considered all of the comments received and thanks all of the commenters. In response to CSA and public comments received, IIROC staff has revised the OTC securities fair pricing rule to clarify the scope of the proposed rule by excluding primary market transactions and OTC derivatives. A copy of IIROC's draft response to public comments is attached as "Attachment D".

Reasons for republication

IIROC is republishing for comment the proposed amendments at this time in light of the following:

1. the intervening passage of time since the publication for comment of the last proposal;
2. the proposed scope refinements to the OTC securities fair pricing rule to exclude primary market transactions and OTC derivatives; and
3. the desire to inform Dealer Members of IIROC's planned implementation periods of 6 months for the confirmation disclosure requirements and 30 days for the OTC securities fair pricing rule.

The primary focus of the revised rule is to address the fair pricing of OTC products traded in the secondary market. As a result, the scope of the fair pricing rule has been clarified to exclude primary market transactions and OTC derivatives. Further details regarding these exclusions from the fair pricing rule are discussed below under the heading entitled “Proposed rules”. As the revision of the fair pricing rule constitutes a substantive change to the previously proposed rule, the proposed amendments are being republished for a further comment period of 30 days.

The Draft Guidance Note has also been revised in light of the changes to the OTC securities fair pricing rule and additional comments received. No revisions have been made to the requirements relating to fixed income yield disclosure or the remuneration disclosure statement to retail clients, and the corollary amendments to IIROC Dealer Member Rule 29 remain the same.

Finally, IIROC staff believes it is important that Dealer Members be made aware of the fact that based on consultations, IIROC has determined six months to be a reasonable implementation period for the confirmation disclosure requirements. The implementation period for the OTC securities fair pricing rule will be 30 days.

Issues and specific proposed amendments

The over-the-counter markets differ significantly in structure and operation from markets for listed securities. These differences generally result in less trade price transparency to clients. Retail investors in particular have less access to OTC security pricing (and yield) information than they do in the listed security markets.

In addition, the pricing mechanisms used for fixed income securities are less understood by retail clients. Specifically, retail clients may not understand the inverse relationship between price and yield or the various factors that can affect yield calculations and the relative risk of a particular fixed income security. All these factors contribute to the difficulty retail investors are faced with when determining whether a particular fixed income security is fairly priced (and therefore offers an appropriate yield) and of appropriate risk. IIROC therefore wishes to underscore the responsibility of Dealer Member firms to use their professional judgment and market expertise to diligently ascertain and provide fair prices to clients in all circumstances, particularly in situations where the Dealer Member must determine inferred market price because the most recent market price does not accurately reflect market value of that security.

Although most institutional clients have the ability to contact multiple institutional bond desks or use electronic trading systems to verify whether a price is fair, retail investors may not have this ability. In addition, although there are varying fixed income business structures at Dealer Member firms, at some firms registered representatives may only offer his/her clients fixed income securities currently carried in the firm’s inventory. This may make it difficult for the registered representative and the end-client to evaluate whether the current bid and offer prices (or yield) listed for the inventory position(s) are fair. Since in many cases it will be difficult for a retail client to confirm at a specific point in time the fairness of a price, the client must have confidence that the system itself, including the Dealer Member and its regulators, and all applicable laws, rules regulations and procedures, ensures that the client will receive a fair price.

Market regulators’ surveillance of fixed income market activity will provide the tools to monitor for patterns and trends in prices and will allow regulators to more effectively identify price outliers. IIROC plans to implement a system to monitor our Dealer Members’ OTC securities trading which would allow IIROC to identify circumstances where trade prices do not correspond with the prevailing market at that time.

The proposed rules are therefore intended to achieve the following objectives:

(1) to ensure that clients, in particular retail clients, are being provided bid and offer prices for OTC securities (both fixed income and equity) that are fair and reasonable in relation to prevailing market conditions;

(2) to ensure that clients are provided sufficient disclosure regarding the security at issue that will enable them, as well as the clients’ registered representative, to confirm through other market sources that the price being offered is a reasonable one in relation to prevailing market conditions;

(3) to underscore the principle that compliance activities are as important for OTC securities transactions as they are for listed securities transactions;

(4) to ensure that Dealer Members focus policies, procedures, supervisory and compliance efforts towards the OTC markets, in addition to the current focus on securities traded in organized markets, and provide Dealer Members’ compliance departments with regulatory support for their compliance activities with respect to OTC business; and

(5) to acknowledge and highlight that the OTC markets differ in form and structure from the more formalized nature of the markets for listed securities, and to regulate the OTC markets taking these idiosyncrasies into account.

By placing an obligation for fair pricing of OTC traded securities squarely on the Dealer Member, IIROC is ensuring that the Dealer Member has in place, and supervises and enforces, policies and procedures that ensure that the price paid or received by the end client is a fair and reasonable one, taking into account the surrounding contextual factors, including the price prevailing in the market at that time for that security and similar or comparable securities.

Investors should also have enough information to enable them to determine if they are in fact paying, or receiving, a fair price for that product. The proposed yield disclosure requirement is intended to provide investors with that information. Investors will be able to compare the yield disclosure to published yields of the security at issue and other comparable securities to assist that investor in determining whether a certain price is fair and reasonable, given all the surrounding contextual factors.

Current rules

Currently, rules that regulate Dealer Member activity in the debt markets in Canada are spread throughout the IIROC Dealer Member rulebook. Although some of these rules directly regulate debt, such as Dealer Member Rule 2800 (wholesale debt markets) and Dealer Member Rule 2800B (retail debt markets), most of the rules regulating Dealer Member activity in the debt markets are general rules not specifically aimed at the debt markets.

Of the general rules that regulate market activity, Dealer Member Rule 29.1 is the Rule which most relates to a fair pricing requirement. This broad, principles-based rule requires that all Dealer Members and their employees observe high standards of ethics and conduct in the transaction of their business and do not engage in any business conduct or practice which is unbecoming or detrimental to the public interest.

Dealer Member Rules 2800 and 2800B lay out, in detail, requirements for resources, systems, policies and procedures with respect to Canadian debt markets. These Rules also include a Duty to Deal Fairly, which requires that Members act fairly, honestly and in good faith when marketing, entering into, executing and administering trades in the domestic debt market, and requires that Dealer Members observe high standards of ethics and conduct and prohibit any business conduct or practice which is unbecoming or detrimental to the public interest.

Furthermore, Rule 2800B requires that Dealer Members have written procedures or guidelines issued to its registered representatives regarding mark-ups or commissions on debt or fixed income securities sold to retail customers, and have monitoring procedures to detect commissions or mark-ups which exceed those specified in the procedures or guidelines. Rules 2800 and 2800B also prohibit a Dealer Member from consummating a trade which is clearly outside the context of the prevailing market and has been proposed or agreed to as a result of a manifest error.

Proposed rules

The proposed rules encompass the following interrelated proposals:

1. Over-the-counter traded securities fair pricing rule

A principles-based rule is proposed that will require Dealer Members to provide or procure fair and reasonable prices for OTC securities (both fixed income and equity) transactions where such securities are purchased from or sold to either retail or institutional clients.

As the primary focus of this rule is to ensure the fair pricing of OTC products traded in the secondary market, the scope of the fair pricing rule has been clarified to exclude primary market transactions and OTC derivatives. OTC derivatives have been excluded in recognition of the fact that these transactions are primarily entered into by institutional clients on a bilateral basis with Dealer Members or their affiliates. Furthermore, while the proposed rule applies to dealings with both retail and institutional clients involving OTC fixed income and OTC equity transactions, there are unique considerations in relation to the pricing of OTC derivatives that were not factored into the previously proposed version of this rule. In light of these unique considerations, the first section of the proposed rule excludes application of the rule to OTC derivatives which are non-standardized derivative contracts tailored to the needs of a particular client and for which there is no active secondary market. The rule specifies that the OTC derivatives excluded must relate to non-standardized contracts because IIROC staff feels that to the extent that any such contracts may be standardized, such standardization is conducive to an active secondary market, in which case we believe that the fair pricing rule should apply as it does to other OTC securities for which there is a secondary market.

The first section of the rule also excludes primary market transactions from the fair pricing rule. This exclusion recognizes the fact that there is already in existence a well established process which imposes a pricing discipline upon primary market transactions. More specifically, and in contrast to the pricing of secondary market OTC transactions, which are priced solely by Dealer Members, primary market transactions are priced by negotiation between the issuer and one or more Dealer Members. Furthermore, the pricing factors included in the proposed rule and discussed in the Draft Guidance Note were drafted solely in contemplation of secondary market transactions in OTC securities and not in contemplation of OTC derivatives or primary market transactions.

Aside from the noted exclusions for primary market transactions and OTC derivatives, any transaction in securities that is not executed through an exchange will be covered by the proposed rule. References within the fair pricing rule and Draft Guidance Note to “over-the-counter securities”, “OTC securities”, “OTC-traded securities”, and any other similar derivations of such terms, are intended to refer to securities where the purchase or sale of such securities is not executed through an exchange.

Section 2 of the proposed rule establishes a general duty to use “reasonable efforts” to obtain a price that is fair and reasonable in relation to prevailing market conditions. As an example, this provision will be particularly relevant in the context of an illiquid market for a specific OTC security where a Dealer Member may be required to canvass various parties to source the availability and the price of the specific security.

Mark-ups and mark-downs in the case of principal transactions, and commissions or service charges in the case of agency transactions, are an important factor in arriving at an aggregate fair price for a client. Section 3 of the proposed rule addresses these issues. The fair pricing requirement will apply to all types of transactions in which a Member firm undertakes a purchase or sale of a relevant security for a client, whether the Member is engaging in the transaction as an agent or as a principal to the trade.

IIROC is also republishing for public comment the Draft Guidance Note that is intended to assist Dealer Members in determining fair and reasonable prices, and which transactions may require pricing documentation. A copy of the Draft Guidance Note is enclosed as “Attachment C”. The Draft Guidance Note has been revised to clarify the scope of the proposed rule, and discuss what constitutes a mark-up or mark-down and/or the basis on which such a mark-up or mark-down may be calculated.

The proposed OTC fair pricing rule is enclosed as part of “Attachment A”.

2. Fixed income security yield disclosure to clients

This rule will require the disclosure on trade confirmations of the yield to maturity for fixed income securities. The yield will be calculated based on the aggregate price to the client, according to market conventions for that particular security. Future guidance as to appropriate market conventions may be issued, if necessary. It may become necessary to issue such guidance if IIROC determines that there are significant discrepancies from market conventions in the calculation of yields, or if yield calculations are unreasonable.

The rule will also require confirmations to include notations for callable and variable rate securities. In the case of debt securities that are callable prior to maturity through any means, a notation of “callable” must be included on the confirmation. For debt securities carrying a variable rate coupon, a notation must be included on the confirmation as follows: “The coupon rate may vary”.

IIROC is proposing the yield disclosure rule as an amendment to Dealer Member Rule 200.1(h) regarding confirmation requirements. The yield disclosure requirements relating to stripped coupons and residual debt instruments already contained in Dealer Member Rule 200.1(h) will remain in place.

A black-lined copy of Dealer Member Rule 200.1(h) reflecting the proposed amendments is enclosed as “Attachment B”.

3. Remuneration disclosure statement to retail clients

IIROC is proposing a rule requiring Dealer Members to disclose on confirmations for all OTC transactions for retail clients the following statement: “The investment dealer’s remuneration on this transaction has been added to the price in the case of a purchase or deducted from the price in the case of a sale." This statement is similar to the text mandated on trade confirmations by FINRA in the United States in its current proposals awaiting SEC approval. The rule will apply to all OTC securities transactions where the amount of any mark-up or mark-down, commissions and other service charges is not disclosed on the trade confirmation sent to retail clients.

Where fee-based accounts are concerned, the proposed statement will be required on confirmations for OTC transactions if in fact there is a mark-up or mark-down, commission or other service charge relating to the transaction specifically.

In the case of introducing brokers, the proposed remuneration statement will have to be disclosed unless the amount of any and all mark-ups or mark-downs, commissions and other service charges associated with a transaction are disclosed on the confirmation, including any such form of remuneration with respect to a transaction on the part of the carrying broker.

IIROC is proposing the requirements relating to a remuneration disclosure statement as an amendment to Dealer Member Rule 200.1(h) regarding confirmation requirements. A black-lined copy of Dealer Member Rule 200.1(h) reflecting the proposed amendments is enclosed as “Attachment B”.

4. *Corollary amendments to IIROC Dealer Member Rule 29*

As a result of the proposed rule regarding the fair pricing of OTC securities, some corollary amendments must be made. Dealer Member Rule 29 currently includes Rules 29.9 and 29.10 concerning valuation of debt securities taken in trade. In light of the proposed OTC fair pricing rule, Rules 29.9 and 29.10 will be repealed to avoid redundancy or conflict with the new proposed rule.

Alternatives considered

The proposed amendments were developed in consultation with IIROC advisory committees. With the exception of one of the committees consulted, the consultation process revealed a fair degree of consensus in support of the proposed fair pricing rule and the yield disclosure requirements. However, IIROC's rule development relating to remuneration disclosure to retail clients has proved to be a more contentious proposal. Concerns were expressed by some members of one of the committees consulted, namely the Compliance and Legal Section, regarding possible operational issues associated with the disclosure requirements, particularly the remuneration disclosure statement.

In the course of consultations with IIROC advisory committees, IIROC staff has considered the possibility of requiring the disclosure to retail clients of the gross amount of mark-up or mark-downs, commissions and other service charges applied by Dealer Members to OTC fixed income security transactions.

Dealer Members expressed concerns about such a requirement, including:

- The difficulty of establishing an actual or inferred wholesale market price at the time of the transaction on a consistent basis across the Membership as a base on which to calculate mark-ups or mark-downs.

- The multiple pathways through which trades get executed. For example, a Dealer Member that has its own wholesale trading would include its full mark-up and any commission, while a Dealer Member who sources fixed income securities for its clients through another dealer's trading desk would disclose only its own mark-up or commission from the marked-up price at which it purchased the security from a wholesale firm. In addition, at firms where the fixed income security pricing provided to the retail desk is not exactly the same as the institutional desk pricing, the calculation of the mark-up may pose operational challenges.

- Disclosure would need to apply to all forms of fixed income instruments, including all types of fixed income securities (including money market and bond mutual funds) and fixed income deposit instruments, to equip the client to compare commissions paid across like instruments. If not, there would also be an inappropriate incentive to sell instruments such as fixed income mutual funds or guaranteed investment certificates that would not be subject to a confirmation commission disclosure requirement.

IIROC staff has also given consideration to mandating disclosure of the retail (investment advisor) portion only of the mark-up or commission applied to over-the-counter fixed income securities. As the retail mark-up or commission amount should be a more readily available figure existing in the systems of Dealer Members now, it was thought that disclosure of the retail figure alone would avoid the operational challenges associated with disclosure of gross mark-up and commission amounts. In addition, commission disclosure may be useful information to retail investors, even if they are unable to use the information to compare gross commissions by product or across firms. Retail investors may simply want to understand how much their firm made on the transaction. Nevertheless, the concerns relating to inappropriate incentives to sell other fixed income products not subject to a confirmation commission disclosure regime may still be applicable. There may also be the added concern that some compensation methodologies could diminish the retail mark-up or commission amount that is disclosed. Furthermore, disclosure of the retail portion only will not provide comprehensive disclosure, as any mark-up at the wholesale level would not be included.

Comparison with similar provisions in other jurisdictions

1. *Fair pricing provisions*

U.S. - Municipal Securities Rulemaking Board

The Municipal Securities Rulemaking Board (MSRB) is the American self-regulatory body responsible for rulemaking relating to the trading of municipal securities in the U.S. markets. The MSRB has enacted several rules with respect to the fair pricing of securities. MSRB's Rule G-17 is a principles-based rule which requires that brokers/dealers deal fairly with all persons. MSRB Rule G-18 is a fair pricing rule which requires that the dealer, when executing an agency transaction, make a reasonable effort to obtain a price that is "fair and reasonable in relation to prevailing market conditions".

The MSRB has a second pricing rule, Rule G-30, which has two components: one regulates pricing in principal transactions and the other regulates pricing in agency transactions. Rule G-30(a) regulates pricing in principal transactions and can be

considered a “mark-up” rule. It requires that the aggregate price to a customer, including any mark-up or mark-down, is fair and reasonable, taking into account all relevant factors. These factors include:

- the best judgment of the dealer as to the fair market value of the securities at the time of the transaction,
- the expense involved in effecting the transaction,
- the fact that the broker/dealer is entitled to a profit, and
- the total dollar amount of the transaction.

Rule G-30(b) regulates the commission or service charge charged by a dealer in agency transactions. It states that the commission or service charge shall not be in excess of a fair and reasonable amount, taking into consideration all relevant factors, which in the case of an agency transaction include:

- the availability of the securities involved in the transaction,
- the expense of executing or filling the customer’s order,
- the value of the services rendered by the broker/dealer, and
- the amount of any other compensation received or to be received by the broker/dealer in connection with the transaction.

The MSRB has identified and highlighted various factors which may be relevant in making price determinations. In addition to those listed above, these include:

- the price or yield of the security;
- the maturity of the security;
- the nature of the broker/dealer’s business;
- the credit rating(s) of the security;
- the call and other specific features and terms of the security;
- the existence of a sinking fund;
- any issuer plans to call the issue;
- defaults; and
- the trading history of the security, including degree of market activity and existence of market makers.

U.S. – FINRA (NASD) Rules

FINRA (formerly NASD) has in place NASD Rule 2440 to regulate fair pricing with respect to all over the counter transactions, whether of listed or unlisted securities.

The mandatory portion of the NASD rule is a principles-based rule, which requires that the price is fair, taking into account all relevant circumstances. These circumstances include, but are not limited to, market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that the firm is entitled to a profit. The NASD rule requires that a dealer provide a fair price to the customer in transactions where the dealer is buying or selling for its own account. With respect to agency transactions, it requires that the investor be charged a fair commission or service charge.

The NASD rule, like the MSRB rule, is also supported by guidance. This guidance includes the “5% Policy”. The 5% policy suggests (but does not require) 5% as the maximum reasonable mark-up. NASD’s *IM 2440-1 Mark-up Policy* lists relevant factors that should be taken into account when determining whether a mark-up is reasonable. These include the type of security involved, the availability of the security in the market, the price of the security, the amount of money involved in a transaction, disclosure to the customer, the pattern of mark-ups of a member, the nature of the dealer’s business.

NASD has also issued *IM 2440-2 Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities*. This policy describes the process, in some detail, of determining whether the mark-up for a security is fair. According to this policy, the point from which the mark-up or mark-down of a transaction should be measured is the prevailing market price of the transaction. It further states that the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost for the security.

2. Mark-up and mark-down, and commission confirmation disclosure requirements

U.S. – Securities and Exchange Commission (SEC)

Under SEC Rule 10b-10 relating to confirmation of transactions, commission on agency transactions are required to be disclosed, but a principal's mark-up or mark-down is not.

U.S. – FINRA Rules

FINRA has filed with the SEC proposed Rule 2231 that would require its members, subject to specific exemptions, to provide clients in debt securities transactions with transaction specific disclosures relating to applicable charges and fees, credit ratings, the availability of last-sale transaction information, and certain interest, yield and call provisions. With respect to disclosure of charges, the proposed rule requires FINRA members acting as principal, if applicable, to include the following statement on confirmation of transactions:

> "The broker dealer's remuneration on this transaction has been added to the price in the case of a purchase or deducted from the price in the case of a sale."

This standard disclosure statement is intended to clarify for investors, especially those dealing with a FINRA member acting as principal, whether a member has obtained any remuneration in connection with the customer's debt securities transaction, since under SEC Rule 10b-10 agency commission are required to be disclosed, but a principal's mark-up or mark-down is not. FINRA is not proposing that the amount of a FINRA member's mark-up or mark-down be disclosed, and FINRA members would not be required to make any disclosures that would be duplicative of a disclosure already required under SEC Rule 10b-10 for a transaction.

The proposed rule would also require FINRA members to notify their clients of the availability of a disclosure document authored by FINRA discussing debt securities generally.

Proposed Rule classification

Statements have been made elsewhere as to the nature and effects of the proposed rule, as well as analysis. The purposes of the proposed rule are to:

- ensure compliance with securities laws;
- prevent fraudulent and manipulative acts and practices;
- promote just and equitable principles of trade and the duty to act fairly, honestly and in good faith;
- foster fair, equitable and ethical business standards and practices; and
- promote the protection of investors.

It is believed that the proposed rule and amendments will address fairness of pricing and enhance transparency of OTC market transactions. The benefits of the proposals will primarily accrue to investors. Fairer prices will clearly be advantageous to investors, and increased disclosure will enable investors to more accurately assess the returns and costs associated with their investments. Dealer Members will also benefit from increased investor confidence in their services and the integrity of the OTC markets.

The Board therefore has determined that the proposed amendments are not contrary to the public interest.

Due to the extent and substantive nature of the proposed amendments, they have been classified as Public Comment Rule proposals.

Effects of the proposed Rule on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance

The main costs associated with the proposals are associated with operational issues within Dealer Members. Dealer Members will not incur significant additional operational costs because of the fair pricing rule or yield disclosure rules. Dealer Members will however be required to take steps to amend their operations in order to comply with the yield disclosure and remuneration disclosure requirements, although some Dealer Members may already provide yield disclosure that complies with the proposed amendments.

IIROC staff believe that the benefits to investors accruing from these proposals outweigh the associated costs. The proposed amendments do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in furtherance of IIROC's regulatory objectives. They do not impose costs or restrictions on the activities of market participants (including Dealer Members and non-Dealer Members) that are disproportionate to the goals of the regulatory objectives sought to be realized.

Technological implications and implementation plan

The proposed amendments will require Dealer Members to update their systems in order to include the required information on trade confirmations. IIROC understands that the main service bureaus have reviewed the proposed trade confirmation disclosure requirements and indicated that it was not regarded as a significant project.

The proposed amendments relating to confirmation disclosure requirements will be made effective six months after IIROC staff issues a Notice indicating that approval has been received from IIROC's recognizing regulators. The OTC securities fair pricing rule will take effect 30 days after the issuance of such a Notice.

Request for public comment

Comments are sought on the proposed amendments. Comments should be made in writing. Two copies of each comment letter should be delivered by July 5, 2010 (30 days from the publication date of this Notice).

One copy should be addressed to the attention of:

Jamie Bulnes
Director, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, ON   M5H 3T9

The second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, ON   M5H 3S8
marketregulation@osc.gov.on.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (**www.iiroc.ca** under the heading "IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received").

Questions may be referred to:

Jamie Bulnes
Director, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
416-943-6928
jbulnes@iiroc.ca

Attachments

Attachment A – Proposed Amendments enacting a new Dealer Member Rule regarding the fair pricing of OTC securities and amending IIROC Dealer Member Rules 29 and 200.1(h)

Attachment B – Black line copy of IIROC Dealer Member Rule 200.1(h) reflecting amendments

Attachment C – Draft Guidance Note – Over-the-Counter Securities Fair Pricing

Attachment D – Summary of comments received and IIROC staff response to comments

Attachment A

Over-the-counter securities fair pricing rule and confirmation disclosure requirements

Proposed Amendments

1. A new Dealer Member Rule regarding the fair pricing of over-the-counter securities is enacted as follows:

“Rule XXXX

Fair Pricing of Over-the-Counter Securities

1. For purposes of this rule, “over-the-counter securities” does not include:

   (a) primary market transactions in securities; and

   (b) over-the-counter derivatives which are non-standardized contracts customized to the needs of a particular client and for which there is no secondary market.

2. Every Dealer Member, when executing a transaction in over-the-counter securities for or on behalf of a customer as agent, shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.

3. A Dealer Member must not:

   (a) purchase over-the-counter securities for its own account from a customer or sell over-the-counter securities for its own account to a customer except at an aggregate price (including any mark-up or mark-down) that is fair and reasonable, taking into consideration all relevant factors, including the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the Dealer Member is entitled to a profit, and the total dollar amount of the transaction; and

   (b) purchase or sell over-the-counter securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount, taking into consideration all relevant factors, including the availability of the securities involved in the transaction, the expense of executing or filling the customer's order, the value of the services rendered by the Dealer Member, and the amount of any other compensation received or to be received by the Dealer Member in connection with the transaction.”

2. Dealer Member Rule 29 is amended by repealing sections 29.9 and 29.10 as follows:

“29.9. A Dealer Member which purchases debt securities taken in trade shall purchase the securities at a fair market price at the time of purchase.

A Dealer Member, in the course of a distribution of a fixed price offering of debt securities, shall ensure that any purchase of other debt securities taken in trade in relation to that offering is done at fair market price.

29.10. For the purpose of Rule 29.9, unless the subject matter or context otherwise requires, the expression:

"Taken in Trade" means the purchase by a Dealer Member as principal, or as agent, of a debt security from a customer pursuant to an agreement or understanding that the customer purchase other debt securities from or through the Dealer Member;

"Fair market Price" means a price not higher than the price at which the securities would be purchased from the customer or from a similarly situated customer in the ordinary course of business by a dealer in such securities in transactions of similar size and having similar characteristics but not involving a security taken in trade."

3. Dealer Member Rule 200.1(h) is repealed and replaced as follows:

“(h) Copies of confirmations of all purchases and sales of securities and of all trades in commodity futures contracts and commodity futures contract options and copies of notices of all other debits and credits of

money, securities, property, proceeds of loans and other items for the account of customers. Such written confirmations are required to be sent promptly to customers and shall set forth at least the day and the stock exchange or commodity futures exchange upon which the trade took place; the commission, if any, charged in respect of the trade; the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade; the name of the salesman, if any, in the transaction; the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,

In the case of a trade in securities:

(1) The quantity and description of the security,

(2) The consideration,

(3) Whether or not the person or company registered for trading acted as principal or agent,

(4) If acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,

In the case of trades in commodity futures contracts:

(5) The commodity and quantity bought or sold,

(6) The price at which the contract was entered into,

(7) The delivery month and year,

In the case of trades in commodity futures contract options:

(8) The type and number of commodity futures contract options,

(9) The premium,

(10) The delivery month and year of the commodity futures contract that is the subject of the commodity futures contract option,

(11) The declaration date,

(12) The striking price;

And in the case of trades in mortgage-backed securities and subject to the proviso below:

(13) The original principal amount of the trade,

(14) The description of the security (including interest rate and maturity date),

(15) The remaining principal amount (RPA) factor,

(16) The purchase/sale price per $100 of original principal amount,

(17) The accrued interest,

(18) The total settlement amount,

(19) The settlement date,

Provided that in the case of trades entered into from the third clearing day before month end to the fourth clearing day of the following month, inclusive, a preliminary confirmation shall be issued showing the trade date and the information in clauses (13), (14), (16) and (19) and indicating that the information in clauses (15), (17) and (18) cannot yet be determined and that a final confirmation will be issued as soon as such information is available. After the remaining principal amount factor for the security is available from the central payor and transfer agent, a final confirmation shall be issued including all of the information required above;

And in the case of stripped coupons and residual debt instruments:

(20) The yield thereon calculated on a semi-annual basis in a manner consistent with the yield calculation for the debt instrument which has been stripped,

(21) The yield thereon calculated on an annual basis in a manner consistent with the yield calculation for other debt securities which are commonly regarded as being competitive in the market with such coupons or residuals such as guaranteed investment certificates, bank deposit receipts and other indebtedness for which the term and interest rate is fixed.

And in the case of all other debt instruments, other than stripped coupons and residual debt instruments:

(22) The yield to maturity calculated in a manner consistent with market conventions for the security traded. Where the debt security is subject to call prior to maturity through any means, a notation of "callable" shall be included; and for debt securities carrying a variable coupon rate, the following notation must be included: "The coupon rate may vary."

And in the case of all over-the-counter traded securities where the amount of the mark-up or mark-down, commissions and other service charges applied by the Dealer Member has not been disclosed on the confirmation sent to retail clients, a statement as follows:

(23) "The investment dealer's remuneration on this transaction has been added to the price in the case of a purchase or deducted from the price in the case of a sale."

Each such confirmation shall, in respect of transactions involving securities of the Dealer Member or a related issuer of the Dealer Member, or in the course of a distribution to the public, securities of a connected issuer of the Dealer Member, state that the securities are securities of the Dealer Member, a related issuer of the Dealer Member or a connected issuer of the Dealer Member, as the case may be. For the purposes of this paragraph, the terms "related issuer" and "connected issuer" shall have the same meaning as ascribed to them in the Regulation made under the *Securities Act* (Ontario).

In the case of a Dealer Member controlled by or affiliated with a financial institution, the relationship between the Dealer Member and the financial institution shall be disclosed on each confirmation slip in connection with a trade in securities of a mutual fund sponsored by the financial institution or a corporation controlled by or affiliated with the financial institution.

The Corporation's policies with respect to electronic delivery of documents are set out in the applicable guideline.

Notwithstanding the provisions of this Rule 200.1(h), a Dealer Member shall not be required to provide a confirmation to a client in respect of a trade in a managed account, provided that:

(i) Prior to the trade, the client has consented in writing to waive the trade confirmation requirement;

(ii) The client may terminate a waiver by notice in writing. The termination notice shall be effective upon receipt of the written notice by the Dealer Member, for trades following the date of receipt;

(iii) The provision of a confirmation is not required under any applicable securities law, regulation or policy of the jurisdiction in which the client resides or the Dealer Member has obtained an exemption from any such law, regulation or policy by the responsible securities regulatory authority; and

(iv)

(a) where a person other than the Dealer Member manages the account

(A) a trade confirmation has been sent to the manager of the account, and

(B) the Dealer Member complies with the requirements of Rule 200.1(c); or

(b) where the Dealer Member manages the account:

(A) the account is not charged any commissions or fees based on the volume or value of transactions in the account;

(B) the Dealer Member sends to the client a monthly statement that is in compliance with Rule 200.1(c) and contains all of the information required to be contained in a confirmation under this Rule 200.1(h) except:

(1) the day and the stock exchange or commodity futures exchange upon which the trade took place;

(2) the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade;

(3) the name of the salesman, if any, in the transaction;

(4) the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,

(5) if acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,

(C) the Dealer Member maintains the information not required to be in the monthly statement pursuant to paragraph (B) and discloses to the client on the monthly statement that such information will be provided to the client on request."

Attachment B

Amendments to confirmation requirements for over-the-counter securities transactions

Black-line copy

Dealer Member Rule subsection 200.1(h)

(h) Copies of confirmations of all purchases and sales of securities and of all trades in commodity futures contracts and commodity futures contract options and copies of notices of all other debits and credits of money, securities, property, proceeds of loans and other items for the account of customers. Such written confirmations are required to be sent promptly to customers and shall set forth at least the day and the stock exchange or commodity futures exchange upon which the trade took place; the commission, if any, charged in respect of the trade; the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade; the name of the salesman, if any, in the transaction; the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,

In the case of a trade in securities:

(1) The quantity and description of the security,

(2) The consideration,

(3) Whether or not the person or company registered for trading acted as principal or agent,

(4) If acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,

In the case of trades in commodity futures contracts:

(5) The commodity and quantity bought or sold,

(6) The price at which the contract was entered into,

(7) The delivery month and year,

In the case of trades in commodity futures contract options:

(8) The type and number of commodity futures contract options,

(9) The premium,

(10) The delivery month and year of the commodity futures contract that is the subject of the commodity futures contract option,

(11) The declaration date,

(12) The striking price;

And in the case of trades in mortgage-backed securities and subject to the proviso below:

(13) The original principal amount of the trade,

(14) The description of the security (including interest rate and maturity date),

(15) The remaining principal amount (RPA) factor,

(16) The purchase/sale price per $100 of original principal amount,

(17) The accrued interest,

(18) The total settlement amount,

(19) The settlement date,

Provided that in the case of trades entered into from the third clearing day before month end to the fourth clearing day of the following month, inclusive, a preliminary confirmation shall be issued showing the trade date and the information in clauses (13), (14), (16) and (19) and indicating that the information in clauses (15), (17) and (18) cannot yet be determined and that a final confirmation will be issued as soon as such information is available. After the remaining principal amount factor for the security is available from the central payor and transfer agent, a final confirmation shall be issued including all of the information required above;

And in the case of stripped coupons and residual debt instruments:

(20) The yield thereon calculated on a semi-annual basis in a manner consistent with the yield calculation for the debt instrument which has been stripped,

(21) The yield thereon calculated on an annual basis in a manner consistent with the yield calculation for other debt securities which are commonly regarded as being competitive in the market with such coupons or residuals such as guaranteed investment certificates, bank deposit receipts and other indebtedness for which the term and interest rate is fixed.

And in the case of all other debt instruments, other than stripped coupons and residual debt instruments:

(22) The yield to maturity calculated in a manner consistent with market conventions for the security traded. Where the debt security is subject to call prior to maturity through any means, a notation of “callable” shall be included; and for debt securities carrying a variable coupon rate, the following notation must be included: “The coupon rate may vary.”

And in the case of all over-the-counter traded securities where the amount of the mark-up or mark-down, commissions and other service charges applied by the Dealer Member has not been disclosed on the confirmation sent to retail clients, a statement as follows:

(23) “The investment dealer’s remuneration on this transaction has been added to the price in the case of a purchase or deducted from the price in the case of a sale."

Each such confirmation shall, in respect of transactions involving securities of the Dealer Member or a related issuer of the Dealer Member, or in the course of a distribution to the public, securities of a connected issuer of the Dealer Member, state that the securities are securities of the Dealer Member, a related issuer of the Dealer Member or a connected issuer of the Dealer Member, as the case may be. For the purposes of this paragraph, the terms "related issuer" and "connected issuer" shall have the same meaning as ascribed to them in the Regulation made under the *Securities Act* (Ontario).

In the case of a Dealer Member controlled by or affiliated with a financial institution, the relationship between the Dealer Member and the financial institution shall be disclosed on each confirmation slip in connection with a trade in securities of a mutual fund sponsored by the financial institution or a corporation controlled by or affiliated with the financial institution.

The Corporation’s policies with respect to electronic delivery of documents are set out in the applicable guideline.

Notwithstanding the provisions of this Rule 200.1(h), a Dealer Member shall not be required to provide a confirmation to a client in respect of a trade in a managed account, provided that:

(i) Prior to the trade, the client has consented in writing to waive the trade confirmation requirement;

(ii) The client may terminate a waiver by notice in writing. The termination notice shall be effective upon receipt of the written notice by the Dealer Member, for trades following the date of receipt;

(iii) The provision of a confirmation is not required under any applicable securities law, regulation or policy of the jurisdiction in which the client resides or the Dealer Member has obtained an exemption from any such law, regulation or policy by the responsible securities regulatory authority; and

(iv)

(a) where a person other than the Dealer Member manages the account

(A) a trade confirmation has been sent to the manager of the account, and

(B) the Dealer Member complies with the requirements of Rule 200.1(c); or

(b) where the Dealer Member manages the account:

(A) the account is not charged any commissions or fees based on the volume or value of transactions in the account;

(B) the Dealer Member sends to the client a monthly statement that is in compliance with Rule 200.1(c) and contains all of the information required to be contained in a confirmation under this Rule 200.1(h) except:

(1) the day and the stock exchange or commodity futures exchange upon which the trade took place;

(2) the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade;

(3) the name of the salesman, if any, in the transaction;

(4) the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,

(5) if acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,

(C) the Dealer Member maintains the information not required to be in the monthly statement pursuant to paragraph (B) and discloses to the client on the monthly statement that such information will be provided to the client on request.

Attachment C

DRAFT Guidance Note XXXX

Fair Pricing of Over-the-Counter Securities

I. INTRODUCTION

Section 1 of Dealer Member Rule XXXX regarding the fair pricing of over-the-counter (OTC) traded securities (the Rule) delineates the scope of the Rule by setting out the exclusion of primary market transactions and OTC derivatives. Section 2 of the Rule establishes a general duty to use "reasonable efforts" to obtain a price that is fair and reasonable in relation to prevailing market conditions. Section 3 of the Rule addresses the fairness and reasonableness of mark-ups and mark-downs in the case of principal transactions, and commissions or service charges in the case of agency transactions, in arriving at an aggregate fair price for customers.

This Guidance Note discusses the scope of the Rule and the pricing considerations by Dealer Members in arriving at a fair price for both principal and agency transactions in OTC-traded securities, including IIROC's expectations regarding the "reasonable efforts" required of Dealer Members under section 2 of the Rule. The Guidance Note also outlines instances where supporting documentation may need to be maintained by Dealer Members for certain transactions.

II. SCOPE OF THE RULE

Section 1 of the Rule excludes the application of fair pricing requirements to primary market transactions and OTC derivatives which are non-standardized contracts tailored to the needs of a particular client and for which there is no secondary market.
Aside from the noted exclusions for primary market transactions and OTC derivatives, references within the Rule and this Guidance Note to "over-the-counter securities", "OTC securities", "OTC-traded securities", and any other similar derivations of such terms, are intended to refer to securities where the purchase or sale of such securities is not executed through an exchange. In particular, Dealer Members should take note of the application of the fair pricing rule to structured products commonly made available to retail clients, including Contracts for Difference (CFDs).

III. OTC SECURITIES FAIR PRICING CONSIDERATIONS

Principal transactions

In the case of principal transactions, section 3(a) of the Rule states that the aggregate transaction price to the customer, including any mark-up or mark-down, must be fair and reasonable taking into consideration all relevant factors. The Rule itself states that relevant factors for consideration include the following:

- the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction;
- the expense involved in effecting the transaction;
- the fact that the Dealer Member is entitled to a profit; and
- the total dollar amount of the transaction.

Determining a "fair and reasonable" price includes the concept that the price must bear a reasonable relationship to the prevailing market price of the security. Dealer Member compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction. As part of the aggregate price to the customer, a mark-up or mark-down also must be a fair and reasonable amount, taking into account all relevant factors.

Mark-ups and mark-downs

A "mark-up" refers to the Dealer Member's remuneration on a transaction that has been added to the price in the case of a purchase, while a "mark-down" refers to the Dealer Member's remuneration on a transaction that has been deducted from the price in the case of a sale. The starting point for the calculation of mark-ups and mark-downs is always the fair market value of the securities at the time of the transaction, or in other words, the prevailing market price where there is a sufficiently liquid market to establish a prevailing market price. Where an illiquid market exists for the OTC securities transacted, fair market value for the OTC securities transacted may be determined by the pricing considerations discussed in this Guidance Note. It should be noted that a Dealer Member may not be able to establish prevailing market price with reference to its contemporaneous cost.

While in many instances a Dealer Member's contemporaneous cost may approximate the prevailing market price, there may be occasions where, through misjudgment, error, or other factors, the Dealer Member's contemporaneous cost on a particular transaction may exceed the prevailing market value.

Agency transactions

Dealer Member compensation in agency transactions is usually taken in the form of a commission charged by the Dealer Member. For agency transactions, section 3(b) of the Rule states that a Dealer Member's commissions or service charges must not be in excess of a fair and reasonable amount, taking into consideration all relevant factors. The Rule indicates factors for consideration in determining fair and reasonable commissions or service charges, including the following:

- the availability of the securities involved in the transaction;
- the expense of executing or filling the customer's order;
- the value of the services rendered by the Dealer Member; and
- the amount of any other compensation received or to be received by the Dealer Member in connection with the transaction.

"Reasonable efforts" requirement

Aside from the compensation component of agency transactions, section 2 of the Rule establishes a duty for Dealer Members, when executing transactions in OTC securities for or on behalf of customers as agents, to use "reasonable efforts" to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions. In carrying out this duty, a Dealer Member will be held to the standard of exercising the same level of care and diligence that it would if undertaking an OTC transaction for its own account. When executing an OTC trade as agent for a customer, a Dealer Member will have to use diligence to ascertain a fair price. For example, in the context of an illiquid security this "reasonable efforts" requirement may require the Dealer Member to canvass various parties to source the availability and the price of the specific security. Passive acceptance of the first price quoted to a Dealer Member executing an agency transaction will not be sufficient.

It should be noted that carrying brokers executing trades on behalf of an introducing broker are also subject to the "reasonable efforts" requirement. This means that carrying brokers must make a "reasonable effort" to procure a price that is fair and reasonable in light of prevailing market conditions for the security and must employ the same care and diligence in doing so as if the transaction were being done for its own account. The carrying broker will need to know the current market value of the security, or use the requisite diligence discussed in the preceding paragraph in the attempt to ascertain a fair and reasonable price.

Other pricing factors

The foregoing identifies a number of factors that may be relevant to the determination of whether the aggregate transaction price is fair and reasonable, including any commission, mark-up or mark-down. For both principal and agency transactions, additional factors that may be relevant to the determination of whether the aggregate transaction price is fair and reasonable include the following:

- the service provided and expense involved in effecting the transaction;
- the availability of the securities in the market;
- the fact that the dealer is entitled to a profit;
- the total dollar amount and price of the transaction;
- the duration;
- the size of issue and market saturation from both the issuer and the industry/sector;
- the rating and call features of the security; and
- the fair market value at time of transaction and of any securities exchanged or traded in connection with the transaction.

A few of these factors have been mentioned in the discussion relating to either principal or agency transactions, but may be applicable to both types of transactions. Some of these factors relate primarily to the dealer compensation component of the transaction (e.g., the services provided by the dealer); others relate primarily to the question of market value (e.g., call features or the rating of the security). Both the compensation component and the market value/price component are relevant in arriving at an aggregate transaction price which is fair and reasonable.

Aside from the factors mentioned above, IIROC believes that one of the most important factors in determining whether the aggregate price to the customer is fair and reasonable is that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market.

Similar securities

Where pricing information cannot be obtained on the basis of the above factors, perhaps because there are no comparable trades for the security in question, pricing consideration may be based on comparable or “similar” securities. Generally, a “similar” security should be sufficiently equivalent to the subject security that it would serve as a reasonably fungible alternative investment. For purposes of pricing considerations based on “similar” securities, factors that Dealer Members should take into account include the following:

- credit quality of both securities;
- ratings;
- collateralization;
- spreads (over Canadian securities of similar duration) at which the securities are usually traded;
- general structural similarities (such as calls, maturity, embedded options);
- the size of the issue or float;
- recent turnover; and
- transferability.

The pricing factors incorporating “similar” securities are not hierarchal; that is, they may be considered in any order.

Economic models

In situations where neither the pricing factors above nor similar securities can be used to establish the prevailing market price, the Dealer Member may use pricing information derived from an economic model to determine the prevailing market price of an OTC security for purposes of determining a fair and reasonable price. An economic model used to identify prevailing market price should take into account issues such as credit quality, interest rates, industry sector, time to maturity, call provisions and other embedded options, coupon rate and face value, and all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods).

Reasonable compensation is not the same as fair pricing

It is important to note that the fair pricing responsibility of Dealer Members requires attention both to the market value of the security as well as to the reasonableness of compensation. Excessive commissions, mark-ups or mark-downs obviously may cause a violation of the fair pricing standards described above. However, it is also possible for a Dealer Member to restrict its profit on transactions to reasonable levels and still violate the Rule because of inattention to market value. For example, a Dealer Member may fail to assess the market value of a security when acquiring it from another dealer or customer and in consequence may pay a price well above market value. It would be a violation of fair pricing responsibilities for the Dealer Member to pass on this misjudgment to another customer, as either principal or agent, even if the Dealer Member makes little or no profit on the trade.

IV. DOCUMENTATION REQUIREMENTS

IIROC expects Dealer Members to maintain adequate documentation to support the pricing of OTC securities transactions. In most instances, existing transactions records, including audio recordings, will allow Dealer Members to reconstruct the basis on which an OTC transaction price was determined to be fair, and will therefore suffice for purposes of supporting the fairness of a transaction. IIROC anticipates that hard-to-value transactions, are likely to require additional supporting documentation. Proper

documentation of such transactions may be the subject of IIROC trading reviews, and the failure to maintain documentation to support the fairness of pricing of hard-to-value transactions will be a consideration in any potential enforcement actions.

IIROC has identified some instances where Dealer Members will likely need to maintain supporting documentation beyond existing transaction records. These situations include hard-to-value securities, bid-wanted procedures, structured products, and introducing broker/carrying broker arrangements. In arriving at a fair price for transactions, Dealer Members should document some of the information, processes and/or considerations discussed below with respect to each of these situations. Supporting documentation should be maintained to the extent necessary to establish the basis on which a customer transaction has received a fair and reasonable price.

Hard-to-value securities

Many debt securities issues are small in size and infrequently traded. For some of these issues, it may be difficult to obtain timely and reliable information on the features of the issue or its credit quality. These factors may make it difficult for a Dealer Member to determine market value with precision and may require that the assessment of market value be in the form of a wider range of values than would be possible for well-known, more liquid issues. Although it is expected that the intra-day price differentials for obscure and illiquid issues might generally be larger than for more well-known and liquid issues, Dealer Members nevertheless should be cognizant of their duty to establish market value as accurately as possible using reasonable diligence.

The specific degree of accuracy to which that market value can be determined will depend on the facts and circumstances of the particular issue and transaction, including such factors as the nature of the security, available information on the issue, etc. The specific actions that a Dealer Member may need to take to assess market value may also vary with the facts and circumstances. When a Dealer Member is unfamiliar with a security, the efforts necessary to establish its value may be greater than if the dealer is familiar with the security. The lack of a well-defined and active market for an issue does not negate the need for diligence in determining the market value as accurately as reasonably possible when fair pricing obligations apply. A Dealer Member may need to review recent transaction prices for the issue, and/or transaction prices for issues with similar credit quality and features as part of the duty to use diligence to determine the market value of the securities. If the features and credit quality of the issue are not known, it also may be necessary to obtain information on these factors directly or indirectly from “an established industry source.” For example, the current rating or other information on credit quality, the specific features and terms of the security, and any material information about the security such as issuer plans to call the issue, defaults, etc., all may affect the market value of securities.

Dealer Members should document their efforts in relation to hard-to-value securities.

The use of bid-wanted procedures

A widely disseminated and properly run bid-wanted procedure will offer important and valuable information on the market value of an issue. The effectiveness of this process in obtaining the true market value of a security, however, may vary depending on the nature of the security and how the procedure is conducted. A bid-wanted procedure is not always a conclusive determination of market value. Therefore, particularly when the market value of an issue is not known, a Dealer Member subject to the requirements of the fair pricing rule may need to check the results of the bid-wanted process against other objective data to fulfill its fair pricing obligations. Nonetheless, any reliance by Dealer Members on bid-wanted procedures to establish fair pricing should be documented.

Structured products

IIROC understands that the industry standard in regards to secondary trading in structured products is for a Dealer Member to obtain a bid from the institution that originated the product and pass on that price to its client. Structured products that have been sold to retail or institutional clients will be subject to the same standards as any other OTC transaction under the Rule and a Dealer Member may not simply pass on an unreasonable bid to a customer. This will require that the Dealer Member make a determination on whether or not the bid is reasonable given the circumstances (both client and market) and inform the client of their determination. As with hard-to-value securities, Dealer Members should document their considerations in determining fair pricing for structured products.

Introducing broker/carrying broker arrangements

Dealer Members have the responsibility of ensuring that the end prices it is offering to clients are reasonable even when the Dealer Member acts as an introducing broker and utilizes the systems, personnel or inventory of a carrying broker to execute OTC trades.

There may be situations where a carrying broker has added its mark-up and offered a security to an introducing broker at a reasonable price, however the addition of another commission at the introducer level may push the final client transaction to a

price level that no longer appears to be fair and reasonable. In order to avoid this type of situation, introducing brokers must be diligent and ensure that they are receiving as competitive a price as possible. A review of the carrying brokers' prices against other possible sources on a frequent basis (at least semi-annually) is one way in which this may be accomplished. Any such review should be documented by the introducing broker.

Carrying brokers, in turn, as discussed in the section above relating to the "reasonable efforts" requirement, are also subject to the fair pricing requirement when executing trades on behalf of an introducing broker, and must document transactions where warranted.

Attachment D

June 4, 2010

Re: IIROC response to comments on over-the-counter securities fair pricing rule and confirmation disclosure requirements

This summary responds to the four comment letters received on the proposed over-the-counter securities fair pricing rule and confirmation disclosure requirements that were published for comment on April 17, 2009. We have considered the comments received and we thank all the commenters for their submissions. The comments specific to the proposed Rule and draft Guidance Note have been summarized to correspond with the major components of the proposed amendments, followed by IIROC staff response to each specific comment.

Over-the-counter traded security fair pricing rule and draft Guidance Note

We have received the comments summarized below regarding the over-the-counter ("OTC") security fair pricing rule.

One comment letter provided the following series of comments regarding the proposed OTC security fair pricing rule and/or its related draft Guidance Note:

- It is unclear whether OTC derivatives are included in the term "OTC securities" and subject to the requirements of the proposed rule. Since OTC derivatives are, in most instances, highly tailored to the needs of the counterparties to the trade, have little or no secondary market and involve sophisticated investors, these instruments should fall outside the scope and intent of the proposed rule. The term "OTC security" should be more clearly defined in the proposed rule or draft Guidance Note, specifically with regard to OTC derivative securities.

> ***IIROC staff response***
>
> The primary focus of the rule initiative is to address the fair pricing of OTC products traded in the secondary market. As a result, the scope of the fair pricing rule has been clarified to exclude OTC derivatives. OTC derivatives transactions have been excluded in recognition of the fact that these transactions are primarily entered into by institutional clients on a bilateral basis with Dealer Members or their affiliates. Furthermore, while the proposed rule applies to dealings with both retail and institutional clients involving OTC fixed income and OTC equity transactions, there are unique considerations in relation to the pricing of OTC derivatives that were not factored into the previously proposed version of this rule. In light of these unique considerations, the revised rule does not apply to OTC derivatives which are non-standardized derivative contracts tailored to the needs of a particular client and for which there is no active secondary market.
>
> In order to further clarify the scope of the fair pricing rule, we have also excluded primary market transactions from application of the rule. This exclusion recognizes the fact that there is already in existence a well established process while imposes a pricing discipline upon primary market transactions. More specifically, and in contrast to the pricing of secondary market OTC transactions, which are priced solely by Dealer Members, primary market transactions are priced by negotiation between the issuer and one or more Dealer Members. Furthermore, the pricing factors included in the original proposed rule and discussed in the draft Guidance Note were drafted solely in contemplation of secondary market transactions in OTC securities and not in contemplation of OTC derivatives or primary market transactions.
>
> We have also revised the draft Guidance Note in order to clarify the scope of the proposed rule.

- Language should be included in the proposed rule and draft Guidance Note that a presumption exists that an OTC transaction is fairly priced unless a specific complaint or other information has arisen that would reasonably rebut this presumption of fairness.

> ***IIROC staff response***
>
> The proposed rule is intended as a principles-based rule establishing a positive obligation amongst Dealer Members to price OTC securities fairly and reasonably. While corresponding pricing obligations exist in respect of securities traded on listed markets, no specific pricing obligations exist in relation to OTC securities. To presume that OTC transactions are fairly priced unless a complaint or other information arises runs counter to the purpose of establishing an explicit fair pricing obligation. IIROC staff does not agree that the absence of a complaint means a price is fair. Investors may not have all the information necessary to assess the fairness of pricing. The proposed rule indicates various factors which will be determinative of whether a price is fair.

Imposing an explicit obligation for the fair pricing of OTC-traded securities on the Dealer Member ensures that Dealer Members have policies and procedures in place directed at the end price paid by the client being fair and reasonable. In light of the often opaque nature of OTC markets, the proposed rule will enhance the focus of supervisory and compliance efforts at Dealer Members towards the OTC markets, and provide the compliance function within Dealer Members with regulatory support for their compliance activities in respect of OTC business.

- Remove the suggested requirement from the draft Guidance Note for the member to "canvass various parties". Retain the language in the draft Guidance Note relating to the member's standard of exercising the same level of care and diligence that it would if undertaking an OTC transaction for its own account.

IIROC staff response

We are pleased that the commenter agrees with the standard IIROC has outlined for Dealer Members in respect of the "reasonable efforts" requirement, namely that a Dealer Member will be held to the standard of exercising the same level of care and diligence to that it would if undertaking an OTC transaction for its own account.

We do not believe it would be appropriate to remove from the Guidance Note the reference relating to the canvassing of other parties. The particular context of a transaction will dictate whether it would be appropriate for a reasonable effort to include the canvassing of other parties. Obviously, in the context of a proprietary product where one Dealer Member is the only source of such product, there cannot be an expectation that various parties will be canvassed. The requirement to provide a fair and reasonable price applies nonetheless. It should be noted that the canvassing of other parties was cited as an example in the guidance of how Dealer Members may comply with the "reasonable efforts" requirement. The specific context of the transaction may allow the Dealer Member to satisfy this requirement by other means. IIROC is more concerned about the passive acceptance by a Dealer Member of the first price it is quoted when executing an agency transaction without further analysis or "effort" on the part of the Dealer Member to determine whether the price quoted is fair and reasonable in relation to prevailing market conditions. Depending on the context, the canvassing of other parties may be one example of how a Dealer Member may undertake reasonable efforts to ascertain the fairness of a quoted price.

- Many of the pricing factors and considerations suggested in the draft Guidance Note must be identified as suggestions only, and cannot be enforced as strict requirements by IIROC. Both the Notice and the draft Guidance Note make many references to the "market" for OTC securities as a standard, when in fact such a "market" may not exist for a particular security. It may also be impractical and not feasible for members to develop pricing models comparing different securities where markets for a particular security do not exist. It is suggested that mandatory language be removed from the draft Guidance Note, and additional language be included recognizing that a member should provide transparency where prices can be published. A member should be required only to use its best judgment (including adherence to the member's standard of care outlined in the draft Guidance Note) where no market exists and comparisons to other securities are not feasible. IIROC should recognize that practices will vary from one member to another, and that enforcement of the proposed rule should take these differences into account.

IIROC staff response

We do not see where in the Guidance Note there is mandatory language that the commenter suggests be removed.

The proposed rule requires Dealer Members to provide clients with fair and reasonable pricing for OTC transactions. The commenter appears to be suggesting that a different standard should apply under different market conditions. We cannot contemplate any situation where it would be inappropriate for a Dealer Member to be required to provide a client with a fair and reasonable price. IIROC is firmly of the view that fair pricing is a fundamental principle that must apply under all market conditions, whether liquid or not.

The Guidance Note is intended to provide the proposed rule with complimentary guidance on how to comply with the rule. The methods discussed in the Guidance Note are not mandatory. For example, we indicate in the Guidance Note some of the considerations in arriving at a fair price. The context of a transaction will determine the manner in which a Dealer Member satisfies the fair pricing requirement, and the degree of effort required. Where pricing information relating to a particular security is unavailable, the Guidance Note suggests the possibility of using similar securities as a reference; and where neither pricing information nor similar securities are available, the Guidance Note indicates that the use of economic models to establish an appropriate price is permissible.

With respect to the use of such models where markets for a particular security do not exist, it is precisely in such circumstances where it is contemplated that the economic models referred to in the guidance may be used. IIROC staff understands that there are models that apply valuation methodologies without reference to market prices. In any event, the Guidance Note does not mandate the use of economic models, but merely points out that such models may be used by Dealer Members in situations where neither the pricing factors mentioned in the guidance nor similar securities can be used to establish a market price. Despite the possible use of economic models, some form of human judgment would always be regarded as appropriate.

The proposed fair pricing rule is a principles-based rule. There is flexibility for Dealer Members to comply with the intent and spirit of the rule in a variety of ways. Enforcement by IIROC will relate to compliance with the rule.

- The Notice states that "there is no specific requirement in the proposed rule for documenting the considerations that went into the pricing of a transaction", however, the Draft Guidance Note states that IIROC "expects Dealer Members to maintain adequate documentation to support the pricing of OTC securities transactions", and that "hard-to-value transactions are likely to require additional supporting documentation". These statements are vague and somewhat contradictory, and members expressed concern about how these requirements will be enforced by IIROC, especially given the lack of resources across all firms to document transactions. It is suggested that IIROC should acknowledge in the Notice and draft Guidance Note that it will take into account the general business models of each firm when reviewing documentation of considerations that went into the pricing of an OTC transaction.

IIROC staff response

Upon reflection, we agree with the comment and we have eliminated the reference that there is no specific documentation requirement from the Notice, but we have kept the guidance relating to documentation. The draft Guidance Note is intended to outline IIROC staff's expectations and views on how to comply with the proposed rule. Consistent with this purpose, the statements referred to from the draft Guidance Note outline IIROC's expectations that supporting documentation should be maintained by Dealer Members to the extent necessary to establish the basis on which a customer transaction has received a fair and reasonable price. It is therefore reasonable that the level of documentation associated with less liquid securities may be different given the lack of readily available pricing information.

Member Dealers are free to pursue whatever business models they desire, provided such models comply with IIROC Rules. As the OTC securities fair pricing rule is a principles-based rule, it is up to each Dealer Member to determine how they will comply with the rule.

- Amend the Draft Guidance Note to make it clear that introducing brokers may rely on the carrying brokers' adherence to the standard of care in completing its OTC transactions, and any associated documentation where securities are hard-to-value, or as otherwise appropriate.

IIROC staff response

The introducing broker/carrying broker relationship is not one of regulatory reliance, but rather a back office, operational relationship. Introducing brokers have the direct relationship with clients and a duty of care to their clients. As with all other Dealer Members, introducing brokers must conform to the IIROC Rules. The Guidance Note was intended to point out that introducing brokers have a responsibility to ensure that their clients are receiving a fair and reasonable price. While the Guidance Note does not suggest that introducing brokers must review pricing on a trade-by-trade basis, we do expect introducing brokers to undertake some form of periodic review (at least semi-annually) of the pricing being provided by carrying brokers in order to satisfy themselves that clients are receiving fair and reasonable prices. We have revised the Guidance Note to remind introducing brokers that they cannot rely on carrying brokers for their regulatory compliance.

One comment letter stated that requiring Dealer Members to fairly and reasonably price securities traded over-the-counter is an important step which should be universally acceptable.

IIROC staff response

IIROC agrees with this comment.

Fixed income security yield disclosure to clients

We have received the comments summarized below regarding the requirement to disclose on trade confirmations the yield to maturity for fixed income securities.

One comment letter provided the following series of comments regarding the yield disclosure requirements:

- Member firms ask that IIROC provide flexibility on the transition period to implement the disclosure elements of the proposed Rule. Members have recommended that IIROC allow for an initial period of time for firms to engage and decide upon common terminology, and for an additional period of time (of at least one year) for the technical implementation, including the language on the confirmations.

> ***IIROC staff response***
>
> IIROC intends to allow for a reasonable rule implementation period after approval is received from IIROC's recognizing regulators. We thank the commenter for their suggestions regarding the length of such implementation period and we will take these comments into consideration in establishing the appropriate implementation period.

- IIROC should allow for more flexibility on the disclosure language to be included on trade confirmations, including the use of abbreviations or legends, where appropriate. IIROC should engage in a dialogue with firms and service providers to discuss technical capabilities and limitations.

> ***IIROC staff response***
>
> We believe that to allow for variations from the proposed disclosure language could result in disclosure that is rendered meaningless. Standardization of the disclosure language will ensure that a minimum level of disclosure is provided to all clients.
>
> We acknowledge that the proposed requirements will require Dealer Members to update their systems in order to include the required information on trade confirmations. IIROC has consulted and continues to consult with the service bureaus to ensure the rules can come into effect according to a reasonable implementation plan. Similar proposals are being passed by FINRA in the United States that are far more complex than the IIROC proposed requirements in terms of the amount and possible variations of disclosure required, yet implementation issues do not appear to be an impediment to the viability of the FINRA proposals. IIROC believes its proposed requirements relating to disclosure achieve an effective and relatively streamlined form of disclosure.

- Further guidance must be provided on how members should calculate the "yield to maturity" to avoid confusion.

> ***IIROC staff response***
>
> We understand that several Dealer Members currently disclose yield to maturity calculations on trade confirmations for fixed income securities without apparent difficulty. In addition, existing requirements relating to the calculation of yield for stripped coupons and residual debt instruments do not appear to have presented Dealer Members with any problems despite the absence of specific guidance regarding such calculations.
>
> IIROC believes there is an ample amount of literature available regarding yield calculations, and that Dealer Members are sufficiently knowledgeable of the relevant market conventions that guidance should not be necessary. Our consultations with Dealer Members during rule development indicated that specific guidance regarding the calculation of yield to maturity was not necessary. We have nonetheless consulted industry representatives further in response to comments received and the consensus again appears to be that requiring the calculation of yield to maturity in accordance with market conventions is appropriate and that Dealer Members do not require guidance regarding yield calculations.

One comment letter indicated its support for IIROC's proposal to require Dealer Members to disclose yield to maturity of fixed income instruments, indicating that it seems like a good first step to provide retail investors with sufficient information to determine if they are getting a fair price by allowing investors to compare yields available in the market through various information sources.

IIROC Staff Response

We thank the commenter for the support of this initiative and agree with the commenter that yield disclosure will provide investors with pertinent information that can be used for comparative purposes.

Remuneration disclosure statement to retail clients

We have received the comments summarized below regarding the remuneration disclosure requirement on trade confirmations sent to retail clients.

One comment letter provided the following series of comments regarding the remuneration disclosure requirement:

- IIROC should revisit the proposed remuneration disclosure requirement taking into consideration other industry regulatory initiatives, such as Registration Reform and IIROC's Client Relationship Model (CRM) proposal. Should IIROC proceed with the proposed remuneration disclosure requirement more guidance is required for members as to when disclosure statements are to be included on trade confirmations, especially in relation to fee-based accounts.

IIROC staff response

IIROC staff views the proposed remuneration disclosure requirement and regulatory initiatives such as Registration Reform and CRM as complimentary, and not inconsistent or mutually exclusive. Remuneration disclosure is proposed as a matter of transparency, not as initiative intended to address specific conflicts of interest. Furthermore, the fact that generic disclosure of fees may be provided does not mean that transactional disclosure should not be provided. The CRM proposal is about relationship disclosure, whereas the proposed remuneration disclosure requirements concern transactional disclosure. The remuneration disclosure statement is proposed as alternative to disclosure of the actual amount of remuneration made by a Dealer Member on an OTC securities transaction. The proposed amendment clearly indicates that where the actual amount of any "mark-up or mark-down, commissions and other service charges" applicable to an OTC securities transaction is not disclosed on the confirmation sent to a retail client, then the disclosure statement must appear on the confirmation.

We feel the proposed remuneration disclosure amendment is unambiguous in terms of when the remuneration disclosure statement must be included on trade confirmations. Essentially, the disclosure statement must appear any time the actual amount made in respect of an OTC securities transaction by a Dealer Member is not disclosed to a retail client on a confirmation. In terms of fee-based accounts, we recognize that Dealer Member compensation for these types of accounts is generally based on the assets in the account. In theory, there should be no charges applied by the Dealer Member based on the transactions which take place in the account. As a result, where a transaction in an OTC security takes place in a fee-based account, there is no requirement to include the disclosure statement on the trade confirmation provided that there is no actual mark-up or mark-down, commission, or other service charge associated with the transaction. However, if the transaction in the fee-based account includes a mark-up or mark-down embedded in the price received by the client (for example, a mark-up from the trade desk to the price received by the client on the purchase of a bond), then the confirmation for that transaction must include the remuneration disclosure statement.

- IIROC should provide more clarification on what constitutes a "mark-up" or "mark-down", to ensure consistency in the application of the proposed rule across all member firms.

IIROC staff response

We indicated in the draft guidance provided with the proposed amendments that Dealer Member compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction. We have revised our guidance to include a distinct discussion of what constitutes a mark-up or mark-down and/or the basis on which such a mark-up or mark-down may be calculated.

- Instead of strictly prescribing language as set out in the proposed rule, consider more flexible language to be included on all trade confirmations, including language stating that remuneration "may" have been added or deducted. This flexibility would allow for easier technical implementation and would avoid an incorrect statement appearing on a confirmation when uncertainty exists as to the existence of a mark-up or mark-down.

IIROC staff response

We considered similar comments during the course of our consultation with Dealer Members. It should be kept in mind that the proposed language of the remuneration disclosure statement is an alternative to disclosure on confirmations of the actual amount of the Dealer Member's remuneration. Permitting variations to the proposed language would diminish the value of the disclosure statement and render it an inappropriate alternative to disclosure of the actual dollar amount of remuneration.

In terms of technical implementation issues, we note that the proposed disclosure statement is similar to the text mandated on trade confirmations by FINRA in the United States in its current proposal awaiting SEC approval. We do not see why there should be any uncertainty as to the existence of a mark-up or mark-down, particularly since we have clarified in the Guidance Note what constitutes a mark-up or mark-down. Dealer Members should be able to tell a client that enquires whether or not a mark-up or mark-down has been applied to the transaction.

One comment letter indicated that the remuneration disclosure statement on trade confirmations to retail clients is a necessary start and should be considered a bare minimum requirement, and not an end goal. The commenter stated that investors have the right to know not only that a commission and any other remuneration is being charged, but also the absolute amount. The commenter believes that any obstacles to disclosing total remuneration can be overcome, and that in the interim, disclosure of the investment advisor portion of the commission would be a useful halfway measure. The commenter recognizes that such disclosure could cause some distortions between those Dealer Members with in-house fixed income desks and those who rely on liquidity providers and outside desks; however, the commenter suggests that the value of actual information about costs to retail customers outweighs any such distortions.

IIROC staff response

There are structural impediments to ascertaining the full and true amount of Dealer Member remuneration on a transaction. The commenter acknowledges these difficulties, and in our view distortions may lead to greater client confusion. As a result, IIROC staff have proposed a remuneration disclosure statement combined with yield disclosure because it is not subject to the same type of distortions. Implementing these requirements does not mean that IIROC will not revisit the issue at some point.

The remuneration disclosure statement is proposed as an alternative to disclosure of the actual amount of the Dealer Member's remuneration. Some Dealer Members may opt to provide clients with the actual dollar amount of the remuneration. At a minimum, retail clients will be provided with some form of remuneration disclosure that is not currently mandated. We discuss in the IIROC Rules Notice requesting comments on these proposals the alternatives considered in relation to remuneration disclosure.

One comment letter outlined the belief that retail clients are taken advantage of because there is insufficient transparency in OTC bond market transactions.

IIROC Staff Response

Both the remuneration disclosure requirements and the yield disclosure requirements are intended to provide greater transparency in relation to OTC transactions.

Other Issues

One comment letter stated that a problem faced by retail investors is the difficulty of purchasing initial offerings of Canadian bonds, noting that a percentage of equity offerings are generally allotted for retail distribution.

IIROC staff response

Improprieties relating to the allocation of bond offerings are something that IIROC will review in the course of its surveillance of bond trading and its business conduct reviews of Dealer Members.

One comment letter suggested that grey market trading should be limited to accredited investors and institutional clients that have sufficient expertise to make their own valuation determination. The letter also suggested that CUB be upgraded to provide

full last sale pricing disclosure, and that all provinces sign onto the reporting requirement so that pricing is based on full Canadian trade disclosure.

> ***IIROC staff response***
>
> The Canadian Unlisted Board (CUB) is a reporting system for OTC trading in unlisted and unquoted equity securities in Ontario as required under the Ontario Securities Act. Dealer Members have suitability requirements that should determine for whom trading in securities reportable on CUB is appropriate. IIROC does not administer CUB, but the commenters suggestions will be conveyed to the Ontario Securities Commission.

One comment letter suggests that IIROC follow the FINRA example of making available a fixed income primer on their website and notes that FINRA's requirement to refer to such information on confirmation slips is a good idea.

> ***IIROC staff response***
> Our website has a link to the Canadian Securities Administrators' brochure entitled "Investments at a glance", which contains a section on fixed income securities providing the type of investor education information the commenter suggests. This link is in the Investors section of IIROC's website, under the heading "Investing Basics". The online brochure is also available directly at the following link:
> http://www.securities-administrators.ca/uploadedFiles/General/pdfs/Investments_at_a_glance-ENG.pdf
> http://www.osc.gov.on.ca/documents/en/Investors/res_invest-glance_en.pdf.
>
> We note that the website of the Investor Education Fund – GetSmarterAboutMoney.ca – also provides a primer on bonds. We have added a link to this primer in the Investors section of IIROC's website. The primer on bonds may also be accessed directly at the following link:
> http://www.getsmarteraboutmoney.ca/managing-your-money/investing/bonds/Pages/default.aspx.

One comment letter noted the concern about regulatory arbitrage and that investors may end up with alternative investments that do not have to disclose commissions or compensation. The letter states that more disclosure across all products will benefit investors, and that all investments should be treated the same, regardless of their regulatory jurisdiction. The commenter calls on the federal and provincial regulators of the banks, life insurers, and other financial services companies to ensure that the same levels of disclosure apply to all fixed income products, including guaranteed investment certificates, structured products, and investment-oriented insurance products.

> ***IIROC staff response***
>
> We agree with the commenter's concern about regulatory arbitrage and the benefits of enhanced disclosure for similar investments offered through various regulatory jurisdictions. IIROC would be supportive of an initiative requiring comparable regulation in relation to products sold by financial institutions that are equivalent or similar to the investments offered by IIROC Dealer Members. As IIROC does not regulate the financial institutions referenced by the commenter, we suggest that the commenter make their views known to the Financial Consumer Agency of Canada and the Department of Finance.