

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

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

Summary of nature and purpose of proposed Rule

On March 25, 2009, the Board of Directors (the Board) of the Investment Industry Regulatory Organization of Canada (IIROC) approved the publication for comment of proposed amendments to the Dealer Member Rules (the Rules) addressing the fair pricing of over-the-counter (OTC) traded securities, 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;
- 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.

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 is currently considering how best to implement such a system to monitor our Dealer Members' OTC security (both fixed income and equity) 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 security 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 clients. The proposed rule will cover transactions for both retail and institutional clients.

The first part 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. The second part 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.

There is no specific requirement in the proposed rule for documenting the considerations that went into the pricing of a transaction. IIROC is issuing a Draft Guidance Note for public comment that is intended to assist Dealer Members in determining fair and reasonable prices, and which transactions may require specific pricing documentation. A copy of the Draft Guidance Note is enclosed as "[Attachment C](#)".

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 oversight of 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 an encompassing, 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 one of the service bureaus has already reviewed the proposed trade confirmation disclosure requirements and indicated that it was not regarded as a significant project. Similar proposals are being passed in the United States.

The proposed amendments will be made effective on a date determined by IIROC staff that allows for a reasonable rule implementation period after approval is received from IIROC's recognizing regulators. IIROC staff invites comments regarding the appropriate length of such implementation period.

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 16, 2009 (90 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
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Investment Industry Regulatory Organization of Canada
416-943-6928
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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