

# IIROC NOTICE

## **Rules Notice Guidance Note**

Dealer Member Rules

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## **Guidance on fair pricing of over-the-counter securities**

### **I. INTRODUCTION**

Section 1 of Dealer Member Rule 3300 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 with non-standardized contract terms 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 a marketplace. 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) and foreign exchange contracts.

## **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 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 a fair and reasonable price. An economic model used to identify fair 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.

### **Pricing considerations – OTC securities other than debt securities**

The fair pricing principles apply to both principal and agency transactions for all OTC securities, other than those excluded in the Rule. In general, the pricing considerations for OTC securities other than debt should follow a similar approach to that outlined above for debt securities. Where an active market exists for the OTC securities, it may be relatively straight forward to establish a fair price based on prevailing market values. Where the OTC securities traded are less liquid, pricing considerations may be based on comparable or similar securities; and where no comparable or similar securities exist, Dealer Members may choose to use economic models where feasible.

#### 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.

#### Contracts for Difference (CFDs) and foreign exchange contracts

With respect to CFDs, the prevailing market price of the underlying assets at the time of the transaction is the primary consideration for determining the fair pricing of CFDs. Similarly, for



foreign exchange contracts, the exchange rate of the underlying interest (the currency pair) is the primary consideration for determining the fair pricing of foreign exchange contracts.

#### **IV. DOCUMENTATION**

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 with respect to each of the situations discussed below. 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 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 from established industry sources. 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 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**

As with hard-to-value securities, Dealer Members should document the basis on which structured product transactions are fairly priced unless the fair market value of a particular structured product is readily ascertainable. With respect to CFDs, IIROC anticipates that in most instances additional supporting documentation for CFDs will not be necessary since the prevailing market price of the underlying assets at the time of the transaction should be the primary consideration for determining the fairness of pricing. Similarly, in the case of foreign exchange contracts, additional documentation is unlikely to be necessary presuming the exchange rate of the underlying currency pair is readily available and the primary consideration for determining the fairness of pricing. However, in instances where a CFD or foreign exchange contract may be hard-to-value, documentation supporting the fairness of pricing should be maintained.

### **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.