



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 The comments specific to the proposed Rule and draft Guidance Note have been summarized to correspond with the major components of the proposed amendments, followed by IIROC staff response to each specific comment.

Over-the-counter traded security fair pricing rule and draft Guidance Note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provided the following series of comments regarding the proposed OTC security fair pricing rule and/or its related draft Guidance Note: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 The term "OTC security" should be more clearly defined in the proposed rule or draft Guidance Note, specifically with regard to OTC derivative securities.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.

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.