

13.1.3 IDA Policy No. 5 - Code of Conduct for IDA Member Firms Trading in Wholesale Domestic Debt Markets

POLICY NO. 5

CODE OF CONDUCT FOR IDA MEMBER FIRMS TRADING IN WHOLESALE DOMESTIC DEBT MARKETS

PREFACE

This Policy No. 5 is black-lined to indicate amendments from the version that was published on July 15, 2005 at (2005) 28 OSCB 6125.

Purpose

Policy No. 5 describes the standards for trading by market participants in wholesale domestic Canadian debt markets. This IDA policy was developed jointly with the Bank of Canada and Department of Finance to ensure the integrity of Canadian debt securities markets and thereby to encourage liquidity, efficiency and the maintenance of active trading and lending and promote public confidence in such debt markets.

In its application to IDA Member Firms, Policy No. 5 is supplementary to and explanatory of the By-laws and Regulations of the Association. It does not replace or restrict the application of the IDA By-laws and Regulations to the wholesale domestic debt market.

History

In the spring of 1998 the Bank of Canada and Department of Finance introduced several initiatives, in consultation with the Investment Dealers Association and other market participants, to maintain a well-functioning market in Government of Canada securities.

These actions were prompted by what was perceived as potential challenges to the liquidity and integrity of debt markets, including such factors as declining benchmark issue size in response to falling government borrowing requirements, the predominance of heavily capitalized market-makers and the emergence of levered market participants³.

The federal government has defined its jurisdiction over domestic debt markets as the new issue or primary markets for Government of Canada securities. Since the liquidity and integrity of secondary markets are also at risk from reduced issue size, and capitalized and levered market participants, the Investment Dealers Association worked with the Bank of Canada and Department of Finance to develop a formal code of conduct for dealing practices in wholesale (i.e. institutional) domestic debt markets. This code of business conduct is embodied for IDA Members in IDA Policy No. 5, and is intended by the participants in its development to be applicable in principle to all participants in wholesale domestic markets. It complements the federal government's objective to safeguard the liquidity and integrity of domestic markets.

The IDA and the Provincial securities regulatory authorities (collectively the Canadian Securities Administrators (CSA)) also have in place specific and general rules that regulate domestic secondary market trading carried out by IDA member firms. Policy No. 5 provides further amplification and, in some cases, broader application of these rules in relation to domestic debt markets.

In 2002 the CSA and IDA conducted, through an independent consultant, a survey of domestic debt market participants, including Members, to determine whether they were encountering any problems in the debt market. The survey was followed by reviews of a number of IDA Members by Association Staff to further delineate the issues, one of which was the difficulty of developing operational and supervisory procedures from the general provisions of Policy No. 5. In 2004 the IDA struck a committee to revise Policy 5. That committee has worked with the Bank of Canada and the Department of Finance to develop this version of Policy No. 5.

Application

While IDA Policy No. 5 applies directly only to IDA member firms and their related companies (as defined in By-law 1.1), which play an active and integral role in domestic debt markets, this code of conduct should also guide the actions of all other market participants. Examples of such market participants are chartered banks, which play a role in the marketplace analogous to IDA

³ New auction rules (www.bankofcanada.ca/en/auct.htm#rules) were developed to set out the administrative and reporting procedures for Primary Dealers and Government Securities Distributors, and for their clients bidding at auctions for Government of Canada treasury bills and bonds. There were also revisions to the Terms of Participation, which defines the nomenclature for IDA member firms and chartered banks eligible to bid at Government of Canada securities auctions and the rules and responsibilities governing these designated Primary Dealers and Government Securities Distributors.

member firms, insurance companies, money managers, pension funds, mutual funds and hedge funds. The Bank of Canada and the Department of Finance are joining the Association in taking steps to make these institutions aware of the IDA code of conduct and encourage them to adopt and enforce similar rules. Members should also promote the standards established in this Policy among their affiliates, customers, and counterparties.

Aspects of the Policy require the co-operation of affiliates and customers of Members, for example in reporting and certain disclosure, and Members are expected to conduct their business in a way that will encourage compliance with the Policy by affiliates, customers and counterparties to the extent applicable.

Moreover, dealings between Members, their related companies, affiliates, customers and other counterparties must be on terms which are consistent with this Policy and such dealings shall be deemed to include any terms necessary for a party to implement or comply with this Policy. Members must not condone or knowingly facilitate conduct by their affiliates, customers or counterparties that deviates from this Policy and its purpose of maintaining and promoting public confidence in the integrity of the Domestic Debt Market. Subject to Applicable Law, the surveillance provisions of this Policy require reporting to the Association or appropriate authorities of the failure, or suspected failure, of Members, their affiliates, customers and counterparties to comply with this Policy.

Members generally are responsible for the conduct of their partners, directors, officers, registrants and other employees and compliance by such persons with the Rules of the Association pursuant to By-law 29.1. In addition, partners, directors, officers, registrants and other employees of Members and their related companies are expected to comply with the Rules of the Association and other regulatory requirements, and this Policy is to be construed as being applicable to related companies and such persons whenever reference is made to a Member.

Implementation and Compliance Expectations

Policy No 5 sets out specific requirements for dealing with customers and counterparties, including that customer dealings be carried out on a confidential basis, and standards related to market conduct. As with all IDA By-laws, Regulations and Policies, the Association expects member firms that are involved in wholesale domestic debt markets to have in place written policies and procedures relating to their dealings with customers and trading⁴. Such policies and procedures must address both Policy 5 and all other IDA and CSA regulations related to the Member's whole domestic debt market activities. These policies and procedures must be readily available to relevant employees, who must be properly trained and qualified. Internal controls and operating systems must be in place to support compliance.

The Association will audit Member's sales and trading activities in the Domestic Debt Markets to ensure compliance with this Policy.

The Policy also provides for 'on demand' reporting to the Association of large securities positions held by dealers or traded with customers, if market circumstances warrant the need for such information.

The terms of the Policy are binding on Members and all related companies of Members and failure to comply with the Policy may subject a Member, a related company or their personnel to sanctions pursuant to the enforcement and disciplinary By-laws of the Association. The disciplinary Rules of the Association provide for a wide range of sanctions, including fines of up to the greater of \$5,000,000 per offence for Members (\$1,000,000 per offence for Approved Persons) or triple the amount of the benefit from the breach, reprimands, suspension or termination of approval or expulsion. Notice of such sanctions is given to the public and government and other regulatory authorities in accordance with the Rules. In addition, other government or regulatory authorities such as the Bank of Canada, Department of Finance (Canada) or provincial securities regulatory authorities may, in their discretion, impose formal or informal sanctions including, in the case of Government of Canada securities, the suspension or removal by the Bank of Canada of eligible bidder status for auctions of such securities.

The Policy, together with applicable securities legislation, the auction rules and Terms of Participation for Primary Dealers and Government Securities Distributors, will ensure proper conduct of market participants at auctions of Government of Canada securities, in other primary markets and in secondary markets, and will result in the close coordination between federal authorities, the CSA, IDA member firms and Association staff in the exchange of detailed market information and the enforcement of proper market conduct.

⁴ See also IDA By-law 29.27.

POLICY NO. 5

TRADING IN WHOLESALE DOMESTIC DEBT MARKETS

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1. **DEFINITIONS**

The following terms used in this Policy shall have the meanings indicated:

“Applicable Laws” means the common or civil law or any statute or regulation of any jurisdiction in which Members and their related companies trade in the Domestic Debt Market, or any rule, policy, regulation, directive, order or other requirement of any regulatory authority, exchange or self-regulatory organization applicable to trading in, or having jurisdiction over, the Domestic Debt Market and/or Members or their related companies.

“Domestic Debt Market” means any Canadian wholesale debt market in which Members participate as dealers on their own account as principal, as agent for customers, as primary distributors or jobbers as approved by the Bank of Canada or in any other capacity and in respect of any debt or fixed income securities issued by any government in Canada or any Canadian institution, corporation or other entity or any derivative instruments thereon, and includes, without limitation, repo, security lending and other specialty or related debt markets.

“Rules” means the Constitution, By-laws, Regulations, Rulings, Policies and Forms of the Investment Dealers Association of Canada, from time to time in effect.

2. **MEMBER STANDARDS AND PROCEDURES**

2.1 **Policies and Procedures**

Members shall have written policies and procedures relating to trading in the Domestic Debt Market and the matters identified in this Policy. Such policies and procedures shall be approved by the board of directors of the Member or an appropriate level of senior management and by the Association. The policies and procedures must be established and implemented by senior management and must be periodically reviewed to ensure that they are appropriate to the size, nature and complexity of the Member's business and remain appropriate as such business and market circumstances change.

2.2 **Responsibility**

Members shall ensure that all personnel engaged in Members' trading activities in the Domestic Debt Market are properly qualified and trained, are aware of all Applicable Laws, this Policy and internal policies and procedures relating to Domestic Debt Market Trading and are supervised by appropriate levels of management.

2.3 **Controls and Compliance**

Members shall maintain and enforce internal control and compliance procedures as part of the policies and procedures required in paragraph 2.1 above to ensure that trading in Domestic Debt Markets by the Member is in accordance with Applicable Laws and this Policy.

2.4 **Confidentiality**

Members shall ensure that dealings in the Domestic Debt Market with customers and counterparties is on a confidential basis. Except with the express permission of the party concerned or as required by Applicable Law or Rules (including requests for information or reporting by the Association or by the Bank of Canada), Members shall not disclose or discuss, or request that others disclose or discuss, the participation of any customer or counterparty in the Domestic Debt Market or the terms of any trading or anticipated trading by such customer or counterparty. In addition, Members shall ensure that their own trading activities are kept confidential including information with respect to customers and trading and planning strategies. The policies and procedures adopted to ensure confidentiality should restrict access to information to the personnel that require it to properly perform their job functions, confine trading to “restricted access” office areas by designated personnel and encourage the use of secure forms of communications and technology (e.g. careful use of cell or speaker phones, secure systems access and close supervision).

2.5 **Resources and Systems**

Members must devote adequate human, financial and operational resources to their trading activities in the Domestic Debt Market. Further, Members must implement operation and technological safeguards to ensure that their trading activities in the Domestic Debt Markets can be fully supported. This requirement contemplates not only that the Member have sufficient capital, liquidity support and personnel, but also that it

have comprehensive operational systems appropriate for Domestic Debt Market trading such as all aspects of risk management (market, credit, legal, etc.), transaction valuation, technology and financial reporting.

3. DEALINGS WITH CUSTOMERS AND COUNTERPARTIES

3.1 Know-Your-Client and Suitability

Members must learn the essential facts about every customer, order and account accepted and to ensure the suitability of investment recommendations made to a customer. This applies to Members dealing with all customers that trade in the Domestic Debt Market. IDA Policy 4 establishes minimum standards of supervision necessary to ensure compliance with Regulation 1300.1 in dealings with institutional clients and will be applicable to dealings with customers in the Domestic Debt Market.

3.2 Conflicts of Interest

Good business conduct as well as provisions of the other Rules of the Association and Applicable Law require that Members avoid conflicts of interest in their dealings with customers, counterparties and the public. Such conflicts can arise in many different circumstances but one of the underlying principles is that a fair, efficient and liquid Domestic Debt Market relies in part on open and unbiased dealings by Members, and fulfillment by Members of their duties to customers before their own interests or those of their personnel. The policies and procedures of Members should clearly describe the standards of conduct for Members and personnel. Examples of some of the matters to be included in the policies and procedures are restrictions and controls for trading in the accounts of Members' personnel, prohibition of the use of inside information and practices such as front running, fair client priority and allocation standards and prompt and accurate disclosure to customers and counterparties where any apparent but unavoidable conflict of interest arises.

4. MARKET CONDUCT

4.1 Duty to Deal Fairly

Members must observe high standards of ethics and conduct in the transaction of their business and prohibit any business conduct or practice which is unbecoming or detrimental to the public interest. Members must act fairly, honestly and in good faith when marketing, entering into, executing and administering trades in the Domestic Debt Market.

4.2 Criminal and Regulatory Offences

Members shall ensure that their trading in the Domestic Debt Market does not contravene any Applicable Law including, without limitation, money laundering, criminal or provincial securities legislation or the directions or requirements of the Bank of Canada or the Department of Finance (Canada) whether or not such directives or requirements are binding or have the force of law.

4.3 Prohibited Practices

Without limiting the generality of the foregoing, no Member or partner, officer, director, employee or agent of a Member shall:

- (a) engage in any trading practices in the Domestic Debt Market that are fraudulent, deceptive or manipulative; such as
 - (1) executing trades which are primarily intended to artificially increase trading volumes;
 - (2) executing trades which are primarily intended to artificially increase or decrease trading prices;
 - (3) spreading, or acquiescing or assisting in the spreading, of any rumours or information regarding issuers or the Domestic Debt Market that the Member or partner, director, officer, employee or agent of the Member knows or believes, or reasonably ought to know or believe, to be false or misleading;
 - (4) disseminating any information that falsely states or implies governmental approval of any institution or trading; or

- (5) conspiring or colluding with another market participant to manipulate or unfairly deal in the Domestic Debt Market.
- (b) engage in any trading which takes unfair advantage of customers, counterparties or material non-public information, such as:
 - (1) acting on specific knowledge of a new issue or client order in such a way as to unfairly profit from the expected resultant market movement and/or distort market levels;
 - (2) executing proprietary trades ahead of client orders on the same side of the market without first disclosing to the client the intention to do so and obtaining the client's approval;
 - (3) using proprietary information, the release of which could reasonably be expected to affect market prices, to profit unfairly;
 - (4) using material, non public information which may reasonably be expected to affect prices in the Domestic Debt Market, for gain; or
 - (5) abusing market procedures or conventions to obtain an unfair advantage over, or to unfairly prejudice, its counterparties or customers;
 - (6) consummating a trade where the price is clearly outside the context of the prevailing market and has been proposed or agreed as a result of manifest error.
- (c) engage in any trading in derivatives on Domestic Debt Market instruments in contravention of the above prohibitions;
- (d) accept any order from or effect any trade with another Domestic Debt Market participant if the Member knows or has reasonable grounds to believe that the other participant is, by giving the order or conducting the trade, contravening this Policy 5 or any Applicable Laws;
- (e) accept or permit any associate to accept, directly or indirectly, any material remuneration, benefit or other consideration from any person other than the Member or its affiliates or its related companies, in respect of the activities carried out by such partner, officer, director, employee or agent on behalf of the Member or its affiliates or its related companies in connection with the sale or placement of securities on behalf of any of them;
- (f) give, offer or agree to give or offer, directly or indirectly, to any partner, director, officer, employee, shareholder or agent of a customer, or any associate of such persons, a material advantage, benefit or other consideration in relation to any business of the customer with the Member, unless the prior written consent of the customer has first been obtained.

4.4 **Market Conventions and Clear Communication**

Members shall use clear and unambiguous language in course of their trading activities, particularly when negotiating trades on the Domestic Debt Market. Each kind of trading in the Domestic Debt market has its own unique terminology, definitions and calculations and a Member shall, prior to engaging in any trading, familiarize itself with the terminology and conventions relevant to that type of trading.

5. **ENFORCEMENT**

5.1 **Association Procedures to Apply**

Compliance by Members with the terms of this Policy will be enforced in accordance with the general compliance, investigative and disciplinary Rules of the Association.

5.2 **Surveillance**

Careful surveillance of the Domestic Debt Market and the trading activities of market participants is required to ensure that the objectives of this Policy are achieved. Members and their related companies are responsible for monitoring their trading and the conduct of their employees and agents. Members have an obligation to report promptly to the Association or any other authority having jurisdiction, including the Bank of Canada, breaches of the Policy or suspicious or irregular market conduct. Members should also encourage their

customers or counter-parties who raise concerns about any Domestic Debt Market activity or participants to report such concerns to the relevant authorities.

5.3 **Net Position Reports**

As part of the surveillance of Domestic Debt markets, the Association may require a Member and its related companies to file the IDA Net Position Report. Net Position Reports may be requested by either the Bank of Canada (for Government of Canada securities), or by the Association. The request for a report, and associated requests for information required to clarify individual Member's reports, would be undertaken as a preliminary step to identify large holdings of securities that could have allowed a participant to have undue influence or control over the Government of Canada, provincial, municipal or corporate debt markets.

POLICY NO. 5B

RETAIL DEBT MARKET TRADING AND SUPERVISION

Purpose

Policy No. 5B describes the standards for trading and supervision by IDA Members of retail domestic debt market activity.

Policy No. 5B is supplementary to and explanatory of the By-laws and Regulations of the Association. It does not replace or restrict the application of the IDA By-laws and Regulations to the retail domestic debt market.

1. DEFINITIONS

“**Retail Debt Market Trading**” means trading conducted by Members, whether as principal or agent, to fill orders received from a retail customer for any debt or fixed income securities or any derivative instruments thereon including, without limitation, repo, security lending and other specialty or related debt markets.

“**Retail Customer**” means a customer of the Member that is not an institutional client as defined in IDA Policy 4.

2. MEMBER POLICIES AND PROCEDURES

Members shall have written policies and procedures relating to trading in the Retail Debt Market and the matters identified in this Policy. Such policies and procedures shall be approved by the board of directors of the Member or an appropriate level of senior management and by the Association. The policies and procedures must be established and implemented by senior management and must be periodically reviewed to ensure that they are appropriate to the size, nature and complexity of the Member's business and remain appropriate as such business and market circumstances change.

3. COMMISSIONS AND MARK-UPS

Members must have written procedures or guidelines issued to its registered representatives regarding mark-ups or commissions on debt or fixed income securities sold to the Member's retail customers. The Member must have reasonable monitoring procedures to detect and monitor mark-ups or commissions which exceed those specified in the written procedures or guidelines and ensure that such mark-up or commission is justified in the reasonable judgment of the Member.

4. MARKET CONDUCT

4.1 Duty to Deal Fairly

Members must observe high standards of ethics and conduct in the transaction of their business and prohibit any business conduct or practice which is unbecoming or detrimental to the public interest. Members shall act fairly, honestly and in good faith when marketing, entering into, executing and administering trades in the Retail Debt Market.

4.2 Prohibited Practices

Without limiting the generality of the foregoing, no Member or partner, officer, director, employee or agent of a Member shall:

- (a) engage in any trading practices in the Retail Debt Market that are fraudulent, deceptive or manipulative; such as
 - (1) executing trades which are primarily intended to artificially increase trading volumes;
 - (2) executing trades which are primarily intended to artificially increase or decrease trading prices;
 - (3) spreading, or acquiescing or assisting in the spreading, of any rumours or information regarding issuers that the Member or partner, director, officer, employee or agent of the Member knows or believes, or reasonably ought to know or believe, to be false or misleading;

- (4) disseminating any information that falsely states or implies governmental approval of any institution or trading; or
 - (5) conspiring or colluding with another registrant to manipulate or unfairly deal in the Retail Debt Market.
- (b) engage in any trading which takes unfair advantage of customers, counterparties or material non-public information, such as:
 - (1) acting on specific knowledge of a new issue or client order in such a way as to unfairly profit from the expected resultant market movement and/or distort market levels;
 - (2) executing proprietary trades ahead of client orders on the same side of the market without first disclosing to the client the intention to do so and obtaining the client's approval;
 - (3) using proprietary information, the release of which could reasonably be expected to affect market prices, to profit unfairly;
 - (4) using material, non public information which may reasonably be expected to affect prices in the Domestic Debt Market, for gain; or
 - (5) abusing market procedures or conventions to obtain an unfair advantage over, or to unfairly prejudice, its counterparties or customers;
 - (6) consummating a trade where the price is clearly outside the context of the prevailing market and has been proposed or agreed as a result of manifest error.
- (c) engage in any trading in derivatives on debt market instruments in contravention of the above prohibitions.
- (d) accept any order from or effect any trade for a retail customer if the Member knows or has reasonable grounds to believe that the customer is, by giving the order or conducting the trade, contravening this Policy 5B or any statute or regulation, or any rule, policy, directive, order or other requirement of any regulatory authority, exchange or self-regulatory organization governing the Member or the market in which the trade will be effected.

**IDA RESPONSES TO COMMENT RECEIVED ON
PROPOSED POLICY NO. 5 – CODE OF CONDUCT FOR IDA MEMBER FIRMS
TRADING IN WHOLESALE DOMESTIC DEBT MARKETS AND
PROPOSED POLICY NO. 5B – RETAIL DEBT MARKET TRADING AND SUPERVISION**

Response to Comments on Policy No. 5 and No. 5B

There was only one comment letter received, from the Bourse de Montreal, commenting on Policy 5. There were no comments on Policy 5B.

Comment

The Bourse comment letter expresses concerns that Policy 5 opens the door for the IDA to encroach on its field of competence – the surveillance and regulation of its listed derivatives market, including derivatives on fixed income instruments.

IDA Response

IDA By-laws, Regulations and Policies frequently overlap with those of other regulatory and self-regulatory agencies, including members of the CSA. This does not mean that there is or needs to be duplication of regulatory effort. The IDA recognizes that the Bourse has systems, information and expertise to regulate the trading in its market. It would be foolhardy in the extreme for the IDA to even consider attempting to duplicate or encroach on the Bourse's regulatory programs.

It is nonetheless useful for the IDA to have regulations directed at activity carried on in different markets and subject to the primary jurisdiction of those markets. Some Members, for example, are not participating organizations in those markets but trade through participating organizations. In the event of some improper trading activity by such a Member, the IDA would be the only one of the two organizations having jurisdiction to take action.

Comment

The Bourse also expresses concern that the duplication of regulations presents the possibility of a market participant being disciplined more than once for the same infraction. Except in extraordinary circumstances, such as a violation which called into question the suitability of a market participant to continue as a Member of the IDA, the IDA is opposed to duplicative regulation and would be highly unlikely to succeed in an action imposing double jeopardy.

IDA Response

Canadian regulatory and self-regulatory organizations have a long history of working out overlaps in jurisdiction with working protocols and case-by-case decisions. Policy 5 is not intended and does nothing to alter that approach.

Comment

The Bourse comment letter expresses concern that subsequent rule changes by either the Bourse or the IDA will result in a misalignment of rules between the two organizations. It suggests including a provision that in the event of any contradiction between Policy 5 and those of the exchange or SRO having primary jurisdiction in a market, those of the organization having primary jurisdiction will apply.

The Bourse notes that the provisions of Policy 5, and particularly Section 4.3 thereof, are consistent with the rules of the Bourse. All IDA rules changes are subject to comment and the Bourse will remain free to comment in the unlikely event that the IDA changes Policy 5 in a way that creates such a misalignment. Similarly, the IDA would comment on any Bourse rule changes coming to its attention that were contradictory of Policy 5 or any other IDA By-law, Regulation or Policy.

IDA Response

While it is the IDA's general policy to ensure harmony between its rules and those of other regulatory and self-regulatory organizations having jurisdiction over its Members, whether the IDA would change a proposed or existing rule to prevent such a contradiction has to be left to a case-by-case decision. It has always been the protocol that where Canadian SROs have different rules, the most stringent rule applies to common Members. The IDA sees no reason to change that approach.

Comment

The Bourse comment letter suggests that Section 5.1 of Policy 5 on the application of IDA procedures to enforcement actions under the Policy be changed to note that in the event it appears that the regulations of the exchange or SRO have not been

complied with by a Member that is a participating organization of the exchange or SRO, the IDA will leave the investigation and enforcement of the matter to the exchange or SRO.

IDA Response

Section 5.1 is a very general statement that other IDA procedures apply to the enforcement of the Policy. It is silent on the question being raised by the Bourse which is one of practical administration as noted above. The IDA sees no reason to make the addition suggested.

Comment

The Bourse comment letter raises issues regarding the Net Position Reports provided for in section 5.3 of Policy 5.

IDA Response

The content of those reports is not part of the proposed revisions to IDA Policy 5. These reports were designed in consultation with the Bank of Canada for limited purposes and are rarely requested. The specific criticisms and suggestions raised by the Bourse are not germane to the purposes of the report.

Comment

The Bourse suggests adding a statement that compliance with section 5.3 of Policy 5 does not relieve a Member from any obligation to file any position reports required by an exchange or SRO of which the Member is a participant.

IDA Response

There is no suggestion in section 5.3 of such relief, nor does the IDA see any likelihood that any exchange or SRO participant would read such relief into section 5.3.