

**13.1.2 Notice of Commission Approval – IIROC Over-the-Counter Fair Pricing Rule and Confirmation Disclosure Requirements**

**INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA (IIROC)**

**OVER-THE-COUNTER FAIR PRICING RULE AND  
CONFIRMATION DISCLOSURE REQUIREMENTS**

**NOTICE OF COMMISSION APPROVAL**

The Ontario Securities Commission (Commission) approved the enactment of a new IIROC Dealer Member Rule regarding the fair pricing of over-the-counter securities. The Commission also approved amendments to Dealer Member Rules 29 and 200.1(h) regarding the fair pricing of over-the-counter securities and associated confirmation disclosure requirements. In addition, the British Columbia Securities Commission did not object to, and the Alberta Securities Commission, the Autorité des marchés financiers, the Saskatchewan Financial Services Commission, the Financial Services Regulation Division of the Department of Government Services of Newfoundland and Labrador, the Nova Scotia Securities Commission and the New Brunswick Securities Commission approved the new and amended rules. The purpose of the new and amended rules is to enhance the fairness of pricing and transparency of over-the-counter securities transactions.

The proposed amendments were published for comment on June 4, 2010, at (2010) 33 OSCB 5165. IIROC summarized the comments it received on the proposed amendments and provided responses. A summary of the comments and IIROC's responses, a blacklined copy of the amendments showing the changes to the version published in June 2010, a clean version of the amendments and a Guidance Note are included in Chapter 13 of this Bulletin.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

OVER-THE-COUNTER SECURITIES FAIR PRICING RULE  
AND CONFIRMATION DISCLOSURE REQUIREMENTS

PROPOSED AMENDMENTS

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

**"RULE XXXX**

**Fair Pricing of Over-the-Counter Securities**

1. For purposes of this rule, "over-the-counter securities" includes contracts for difference and foreign exchange contracts, but does not include:
    - (a) primary market transactions in securities; and
    - (b) over-the-counter derivatives with non-standardized contract terms that are customized to the needs of a particular client and for which there is no secondary market.
  2. Every Dealer Member, when executing a transaction in over-the-counter securities for or on behalf of a customer as agent, shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.
  3. A Dealer Member must not:
    - (a) purchase over-the-counter securities for its own account from a customer or sell over-the-counter securities for its own account to a customer except at an aggregate price (including any mark-up or mark-down) that is fair and reasonable, taking into consideration all relevant factors, including the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the Dealer Member is entitled to a profit, and the total dollar amount of the transaction; and
    - (b) purchase or sell over-the-counter securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount, taking into consideration all relevant factors, including the availability of the securities involved in the transaction, the expense of executing or filling the customer's order, the value of the services rendered by the Dealer Member, and the amount of any other compensation received or to be received by the Dealer Member in connection with the transaction."
2. Dealer Member Rule 29 is amended by repealing sections 29.9 and 29.10 as follows:
- "29.9. A Dealer Member which purchases debt securities taken in trade shall purchase the securities at a fair market price at the time of purchase.
- A Dealer Member, in the course of a distribution of a fixed price offering of debt securities, shall ensure that any purchase of other debt securities taken in trade in relation to that offering is done at fair market price.
- 29.10. For the purpose of Rule 29.9, unless the subject matter or context otherwise requires, the expression:
- "Taken in Trade"** means the purchase by a Dealer Member as principal, or as agent, of a debt security from a customer pursuant to an agreement or understanding that the customer purchase other debt securities from or through the Dealer Member;
- "Fair market Price"** means a price not higher than the price at which the securities would be purchased from the customer or from a similarly situated customer in the ordinary course of business by a dealer in such securities in transactions of similar size and having similar characteristics but not involving a security taken in trade."

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

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

In the case of a trade in securities:

- (1) The quantity and description of the security,
- (2) The consideration,
- (3) Whether or not the person or company registered for trading acted as principal or agent,
- (4) If acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,

In the case of trades in commodity futures contracts:

- (5) The commodity and quantity bought or sold,
- (6) The price at which the contract was entered into,
- (7) The delivery month and year,

In the case of trades in commodity futures contract options:

- (8) The type and number of commodity futures contract options,
- (9) The premium,
- (10) The delivery month and year of the commodity futures contract that is the subject of the commodity futures contract option,
- (11) The declaration date,
- (12) The striking price;

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

- (13) The original principal amount of the trade,
- (14) The description of the security (including interest rate and maturity date),
- (15) The remaining principal amount (RPA) factor,
- (16) The purchase/sale price per \$100 of original principal amount,
- (17) The accrued interest,
- (18) The total settlement amount,
- (19) The settlement date,

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

central payor and transfer agent, a final confirmation shall be issued including all of the information required above;

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

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

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

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

And in the case of all over-the-counter traded securities, including contracts for difference and foreign exchange contracts, but excluding primary market transactions and over-the-counter derivatives with non-standardized contract terms that are customized to the needs of a particular client and for which there is no secondary market, where the amount of the mark-up or mark-down and other service charges applied by the Dealer Member has not been disclosed on the confirmation sent to retail clients, a statement as follows:

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

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

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

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

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

- (i) Prior to the trade, the client has consented in writing to waive the trade confirmation requirement;
- (ii) The client may terminate a waiver by notice in writing. The termination notice shall be effective upon receipt of the written notice by the Dealer Member, for trades following the date of receipt;
- (iii) The provision of a confirmation is not required under any applicable securities law, regulation or policy of the jurisdiction in which the client resides or the Dealer Member has obtained an exemption from any such law, regulation or policy by the responsible securities regulatory authority; and
- (iv)
  - (a) where a person other than the Dealer Member manages the account
    - (A) a trade confirmation has been sent to the manager of the account, and
    - (B) the Dealer Member complies with the requirements of Rule 200.1(c); or

- (b) where the Dealer Member manages the account:
  - (A) the account is not charged any commissions or fees based on the volume or value of transactions in the account;
  - (B) the Dealer Member sends to the client a monthly statement that is in compliance with Rule 200.1(c) and contains all of the information required to be contained in a confirmation under this Rule 200.1(h) except:
    - (1) the day and the stock exchange or commodity futures exchange upon which the trade took place;
    - (2) the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade;
    - (3) the name of the salesman, if any, in the transaction;
    - (4) the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,
    - (5) if acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,
  - (C) the Dealer Member maintains the information not required to be in the monthly statement pursuant to paragraph (B) and discloses to the client on the monthly statement that such information will be provided to the client on request.”

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  - (b) purchase or sell over-the-counter securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount, taking into consideration all relevant factors, including the availability of the securities involved in the transaction, the expense of executing or filling the customer's order, the value of the services rendered by the Dealer Member, and the amount of any other compensation received or to be received by the Dealer Member in connection with the transaction."
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- (20) The yield thereon calculated on a semi-annual basis in a manner consistent with the yield calculation for the debt instrument which has been stripped,
- (21) The yield thereon calculated on an annual basis in a manner consistent with the yield calculation for other debt securities which are commonly regarded as being competitive in the market with such coupons or residuals such as guaranteed investment certificates, bank deposit receipts and other indebtedness for which the term and interest rate is fixed.

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- (ii) The client may terminate a waiver by notice in writing. The termination notice shall be effective upon receipt of the written notice by the Dealer Member, for trades following the date of receipt;
- (iii) The provision of a confirmation is not required under any applicable securities law, regulation or policy of the jurisdiction in which the client resides or the Dealer Member has obtained an exemption from any such law, regulation or policy by the responsible securities regulatory authority; and
- (iv)
  - (a) where a person other than the Dealer Member manages the account
    - (A) a trade confirmation has been sent to the manager of the account, and
    - (B) the Dealer Member complies with the requirements of Rule 200.1(c); or



- (b) where the Dealer Member manages the account:
  - (A) the account is not charged any commissions or fees based on the volume or value of transactions in the account;
  - (B) the Dealer Member sends to the client a monthly statement that is in compliance with Rule 200.1(c) and contains all of the information required to be contained in a confirmation under this Rule 200.1(h) except:
    - (1) the day and the stock exchange or commodity futures exchange upon which the trade took place;
    - (2) the fee or other charge, if any, levied by any securities regulatory authority in connection with the trade;
    - (3) the name of the salesman, if any, in the transaction;
    - (4) the name of the dealer, if any, used by the Dealer Member as its agent to effect the trade; and,
    - (5) if acting as agent in a trade upon a stock exchange the name of the person or company from or to or through whom the security was bought or sold,
  - (C) the Dealer Member maintains the information not required to be in the monthly statement pursuant to paragraph (B) and discloses to the client on the monthly statement that such information will be provided to the client on request.”

**DRAFT Guidance Note XXXX**

**Fair Pricing of Over-the-Counter Securities**

**I. INTRODUCTION**

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

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

**II. SCOPE OF THE RULE**

Section 1 of the Rule excludes the application of fair pricing requirements to primary market transactions and OTC derivatives 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.

**IIROC RESPONSE TO COMMENTS ON  
OVER-THE-COUNTER SECURITIES FAIR PRICING RULE  
AND CONFIRMATION DISCLOSURE REQUIREMENTS**

May 5, 2011

**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 re-published for comment on June 4, 2010. 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 the comments.

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

We have received the following comments regarding the over-the-counter (OTC) securities fair pricing rule:

- Three comment letters indicated their support for the proposed fair pricing initiative.
- One comment letter stated that minimal guidance was provided in the Notice as to how market participants fulfill their obligations or what amount of effort constitutes “reasonable” in terms of effort and price fairness. The comment letter indicated that guidance by regulators suggesting that access to the consolidated prices from Canada’s primary dealers, such as those that form the basis of the CanDeal composite, would constitute “reasonable effort” will standardize the application of the rule while increasing compliance by marketplace constituents.

***IIROC staff response***

We refer the commenter to the draft Guidance Note attached to the IIROC Notice requesting comments which provides guidance relating to the “reasonable efforts” requirement. We believe that the guidance provided therein is sufficient in that it states the standard which must be met in carrying out this duty, and provides an example in the context of an illiquid security. The proposed fair pricing rule is drafted as a principles-based rule. The context of each transaction will determine the manner in which a Dealer Member satisfies the fair pricing requirement and the degree of effort required. As a result, it would be inappropriate for IIROC to designate the consultation of one specific source of market information as a means of satisfying the fair pricing requirement.

**Fixed income security yield disclosure to clients**

We have received the following comments regarding the requirement to disclose on trade confirmations the yield to maturity for fixed income securities:

- One comment letter indicated its support for the inclusion of a requirement to disclose the yield on fixed income securities on trade confirmations delivered to clients.
- One comment letter indicated that some clarification regarding the disclosure of yield may be appropriate, particularly regarding the types of securities that are included in (or excluded from) “fixed income” securities. The comment letter asked whether guaranteed investments or principal protected notes were included in the definition.
- One comment letter suggested that the yield disclosure should only apply to retail clients, and would appreciate specific clarification from IIROC as to whether the yield disclosure requirement also applies to institutional clients.
- One comment letter stated that IIROC should be clearer on whether it is necessary to print “callable” or “the coupon rate may vary” for the applicable debt securities, on the front or back of the confirmation. The letter indicates that a service bureau has confirmed that they will encounter difficulties in adding this information due to the restricted space available, and therefore it would be preferable if a brief statement could be added to the back of the confirmation.

***IIROC staff response***

As the proposed amendments relating to yield disclosure indicate, the requirements apply to “all other debt instruments, other than stripped coupons and residual debt instruments.” The yield disclosure requirements applicable to stripped coupons and residual debt instruments will continue to exist in clauses (20) and (21) of Dealer Member Rule 200.1(h). Since the proposed

amendments apply to debt securities only, guaranteed investment certificates (GICs) and principal protected notes (PPNs) are not subject to the yield disclosure requirements. It should be noted with respect to GICs and PPNs that the concept of yield disclosure is basically inapplicable. In the case of GICs, the yield is the stated coupon rate. With PPNs, the yield is generally unknown at the time of purchase.

The yield disclosure requirements apply to debt transactions executed by both retail and institutional clients, therefore no distinction is made between retail and institutional clients in the proposed amendments. We have deliberately framed the rule in this manner to reflect IIROC's strongly held view regarding the significance of yield information to both retail and institutional clients.

The notations of "callable" and "the coupon rate may vary" for applicable debt securities must be printed on the front of the trade confirmation, as is the practice with other requirements contained in Dealer Member Rule 200.1(h) concerning confirmation requirements. We believe that allowing these notations to be printed on the back of the confirmation may often result in the client missing this important disclosure item.

As we have indicated in response to previous comments regarding the operational issues associated with the proposed amendments, we acknowledge that the proposed requirements will require Dealer Members to update their systems in order to include the required information on trade confirmations. Having said that, IIROC has consulted with the major 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 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.

#### **Remuneration disclosure statement to retail clients**

We have received the following comments regarding the remuneration disclosure requirement on trade confirmations sent to retail clients:

- One comment letter states that the mark-up or mark-down on OTC equity security trades should be required to be disclosed on trade confirmations. The proposed inclusion of the 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" is an improvement on the current state of disclosure, but does not go far enough to give retail investors concrete information on what they, in fact, have paid for their trades.
- One comment letter suggests that IIROC should allow for the remuneration statement to be situated on the back of the trade confirmation, due to its lengthy explanation. The comment letter also indicates that it may be difficult for service providers to differentiate between some dealer members' retail and institutional trades.

#### ***IIROC staff response***

As we have previously indicated, there are structural impediments to determining the actual, dollar amount of remuneration received by a Dealer Member with respect to a transaction involving an OTC debt security. These impediments could result in clients receiving inaccurate information which would, in all likelihood, give rise to greater client confusion. IIROC believes that the same structural impediments and possibility of client confusion exists for OTC equity transactions.

With respect to the suggestion that the remuneration disclosure statement be situated on the back of the confirmation, it should be kept in mind that the remuneration disclosure statement is proposed as an alternative to disclosing the actual amount of the Dealer Member's remuneration on the trade confirmation. In light of that fact, we believe that allowing the remuneration disclosure statement to be printed on the back of the confirmation would diminish the value of the disclosure to a point that it could no longer be considered to be an appropriate alternative to disclosure of the actual dollar amount of remuneration.

With respect to the operational issues relating to the printing of the remuneration disclosure statement, we refer the commenter to our response on the preceding page regarding the operational issues associated with the proposed amendments generally. Furthermore, there is no requirement to suppress the remuneration disclosure statement on confirmations for institutional clients. To be clear, the requirement applies only in respect of retail clients; however, we have no objection to Dealer Members providing the statement to both retail and institutional clients.

#### **Other Issues - Implementation**

We have received the following comments regarding the implementation of the proposed amendments:



- One comment letter indicated that the proposed effective date of six months from publication for the confirmation disclosure requirement does not provide enough time for Dealer Members to make the required system changes as Dealer Members will be reliant upon third-party service providers for many of the systems changes. Aside from the vendors' work requirements, Dealer Members will also need to make necessary changes to some of their in-house systems and allow time for adequate testing. The likely timing of IIROC's approval of the rule is also problematic as the six month implementation period will straddle firms' fiscal and calendar year end where system freezes are common. The limited amount of space currently available on the client confirmation continues to be an issue in need of address by Dealer Members and also contributes to the need for some additional time.
- In respect of the yield disclosure and remuneration disclosure statement requirements, one comment letter stated that Dealer Members need to avoid any manual interventions in order to comply with these new requirements. The comment letter suggests that the cost of monitoring these new processes will outweigh the benefit, which may result in Dealer Members being non-complainant with IIROC regulations.

***IIROC staff response***

We have agreed to lengthen the period of time in which Dealer Members must implement the system changes, relating to confirmation disclosure, to one year after IIROC staff issues a Notice confirming that approval of the amendments has been received from IIROC's recognizing regulators. Dealer Members will need to revise their systems as required to include the required information on trade confirmations. The level of manual intervention will need to be determined by each Dealer Member, although we anticipate that Dealer Members will design their systems to avoid manual intervention to the greatest extent possible. The confirmation disclosure requirements have not changed from the time IIROC first proposed these amendments and the service bureaus have been aware of this proposal since that time. IIROC firmly believes that the direct benefit to investors, and the related enhancement of investor confidence in the industry, outweighs the associated costs. IIROC has given careful consideration to the appropriate length of time for the implementation period relating to the confirmation disclosure requirements and we expect Dealer Members to be compliant with these requirements by the implementation date, particularly in light of the one year implementation period.