

November 2, 2015

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RE: CSA Staff Notice and Request for Comment 21-315 Next Steps in Regulation and Transparency of the Fixed Income Market

FAIR Canada is pleased to offer comments on the CSA staff's plan to enhance regulation in the fixed income market by facilitating more informed decision-making among all market participants, regardless of their size; improve market integrity; and evaluate whether access to the fixed income market is fair and equitable for all investors (the "Consultation Document").

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

1. Overview

- 1.1. A wide-reaching overhaul of the Canadian fixed income market is long overdue. Investors are best served by fully transparent markets with price disclosure – where competitive bids and offers are displayed and executed at the best price and entered immediately and total commissions (and total compensation) are disclosed. This is not the situation with Canada's fixed income market. It is an opaque market especially for retail investors¹ and, in comparison to other jurisdictions, it has been described as: "among the worst in terms of transparency, it's the worst in terms of liquidity."²
- 1.2. Unlike equity markets, there is no public exchange where bonds are traded. Rather, they are private transactions where some larger institutions may trade bilaterally but most work with a dealer intermediary to find a trading counterparty or take on the position as principal. Orders are executed on a best efforts basis to obtain a fair price (rather than the best price). Market participants,

¹ Ontario Securities Commission, "The Canadian Fixed Income Market", (2014), at p 17.

² Ari Altstedter, "Canada's bond market among the world's worst for transparency, say traders", (July 7, 2014) Bloomberg News for the Financial Post.

especially retail investors, lack information about order and trade information along with what the fixed income offerings are and the cost of their transactions: “[S]ince bonds trade [over the counter], retail investors have limited access to pricing and trade volume information; have little ability to determine the components of the retail price; and have limited access to many bonds. Asymmetric information in the fixed income market places retail investors at a disadvantage relative to other participants. Furthermore, a significant number of bonds, ranging from 23-47%, are privately placed and only available to accredited investors.”³ Institutional investors pay less, on a per-unit basis, than retail investors to trade bonds and have greater market access and bargaining power.⁴ Institutional investors can leverage their dealer networks to access pre-trade information. However, more limited information is available to smaller institutions and retail investors.⁵

- 1.3. Market share is concentrated amongst five banks.⁶ There are fewer regulatory requirements in the fixed income market, especially with respect to trade reporting. There is, at present, no comprehensive source of reliable trading data available to dealers, investors or regulators.⁷
- 1.4. This is a huge market with approximately \$2.1 trillion in long-term securities and \$322 billion in money-market.⁸ Post-financial crisis, Canadian investors left equity funds for bond funds in a flight to quality: between 2009-2012 Canadian bond funds saw a net inflow of \$56 billion, while Canadian equity funds saw almost \$46 billion of outflows over the same period. With interest rates at record lows, retail investors attraction to Canadian government bonds such as Canada Savings Bonds has steadily declined as investors shift to higher-yielding products.⁹ Fixed income products continue to be important investments for retail investors as they allow for diversified, efficient risk-return portfolios. For example, compared to bank deposits, corporate bonds offer predictable cash flow with greater returns. Corporate bonds also provide higher returns than government bonds. It is believed that aging demographics will focus investor demand on fixed income products given their ability to provide regular income, capital preservation and lower volatility of returns.¹⁰
- 1.5. Canadian regulators have limited data on the amount of bonds held directly or indirectly by retail investors.¹¹ A fairly recent article in *The Globe and Mail* indicates that, in Canada, retail investors have invested around \$535 billion in fixed income securities, \$230 billion directly and \$305 billion indirectly through fixed income and balanced mutual funds and exchange traded funds. It is estimated that Canadians hold 20 percent of their financial wealth directly and indirectly in fixed income securities.¹²

³ OSC Report at p 4.

⁴ *Ibid* at p 5.

⁵ Canadian Securities Administrators Staff Notice and Request for Comment 21-315 Next Steps in Regulation and Transparency of the Fixed Income Market, (September 17, 2015), at p 2.

⁶ OSC Report at p 25.

⁷ *Ibid* at p 27.

⁸ *Ibid* at p 5.

⁹ *Ibid* at p 17.

¹⁰ Federico Knautd, “Why Canada needs transparent corporate bond markets”, (October 30, 2014), *Globe and Mail*.

¹¹ OSC Report at page 17.

¹² Knautd, “Why Canada needs transparent corporate bond markets”. The OSC Report at page 18 to 19 includes the following information about retail investor participation: Reports from Investor Economics indicate that in Canada, direct bond holdings (both corporate and government) account for approximately 10% of retail assets held in full-service brokerage accounts. For online or discount brokerages, bonds account for around 3% of client assets. Studies in other jurisdictions indicate that retail investors predominately participate in corporate bond markets through mutual funds. According to the Bank of Canada, mutual funds are estimated to hold 16% of outstanding corporate bonds

1.6. In short, this is a large and important market for retail investors but they are largely left in the dark as the market is opaque. FAIR Canada commends the OSC for producing its report on the Canadian Fixed Income Market (the “OSC Report”) and we commend the CSA for proposing reforms to this area of our markets. We set out our comments below on the CSA’s reform proposals. In general, we are supportive as the reforms are long overdue. However, we believe the extent of reforms are too limited - more should be done to improve transparency, fairness and efficiency and integrity of this market for all market participants, especially retail investors.

2. Facilitate More Informed Decision-Making Among All Market Participants

2.1. The CSA proposes to address the fixed income market’s limited transparency by implementing the CRM2 requirements, making changes to the System for Electronic Document Analysis and Retrieval (SEDAR) and working with the Investment Industry Regulatory Organization of Canada (IIROC) to increase post-trade transparency for corporate debt securities including making changes so that regulators have access to fixed income data. We comment on the proposed changes directly below.

Cost and Performance Requirements

- 2.2. CRM2 requirements will require trade confirmations to disclose either (i) the total amount of any mark-up or mark-down, commission or other service charges the dealer applied to the transaction or (ii) the total amount of any commission charge to the client by the dealer and, if the dealer applied a mark-up or mark-down or any service charge other than a commission, the following notification: “dealer firm remuneration has been added to the price of this security (in the case of a purchase) or deducted from the price of this security (in the case of a sale). This amount was in addition to any commission this trade confirmation shows was charged to you.” If the second option is taken, the total compensation the dealer receives will likely not be disclosed, and retail investors will not know the full cost to buy or sell a bond.
- 2.3. Experience in the United States suggests the second option will be chosen predominantly. There, disclosure requirements for fixed income investments do not require intermediaries to disclose on trade confirmations the amounts of markups or markdowns for trades arranged on a principal basis (as opposed to an agency basis). The result? Nearly all customer transactions end up being reported as trades executed on a principal basis and the markup or markdown amount is not disclosed. The Consumer Federation of America maintains this enables U.S. firms to charge more than they otherwise would if they provided that cost information because investors, not seeing the transaction cost itemized on their confirmations, may mistakenly believe they are paying no trading costs even though trading costs actually are high.¹³
- 2.4. FAIR Canada believes it is likely that Canadian dealers will, given the option, choose to disclose in a manner that prevents retail investors from knowing the dealers’ total compensation. As a result, retail investors will not know how much their bond trade really cost. Retail investors will not have sufficient information to see whether they are receiving a fair deal and whether there is fair (let alone “best”) execution. The likely result will be that retail investors will continue to unwittingly incur high trading costs.

issued in Canada. According to Investor Economics based on 2014 data, Canadian domiciled fixed income mutual funds had \$312 billion in AUM.

¹³ Letter from Consumer Federation of America to FINRA dated January 20, 2015 at p 4 to 5, available online at: <http://consumerfed.org/wp-content/uploads/2010/08/FINRA-MSRB-proposed-rules-01-20-2015.pdf>.

- 2.5. It should be noted that recently the United States' Financial Industry Regulatory Organization and the Municipal Securities Rulemaking Board have proposed reforms to heighten confirmation disclosure of pricing information by disclosing on the customer confirmation the price to the customer and the price to the member of a transaction in the same security and the differential between those two prices.¹⁴ Such reforms are part of efforts to improve the public availability of information, including pre-trade information, in the fixed income markets in the United States.¹⁵ FAIR Canada recommends that the CSA impose heightened confirmation disclosure so that retail investors can directly see the transaction costs they are paying.
- 2.6. With respect to performance, FAIR Canada agrees that the investment performance reports will provide retail investors with information to help them assess how their investments, including fixed income investments, perform over time. However, in order to assess value, investors need to know what it cost them, in total, to achieve that return.

SEDAR Disclosure

- 2.7. Enhancements to SEDAR include making it easier for investors to find relevant documents for fixed income offerings, especially trust indentures and credit agreements. Such information will very likely be used by institutional and sophisticated investors to assess fixed income offerings but it is unlikely to be used by unsophisticated retail investors. Sophisticated and institutional investors know about SEDAR, can access the information and know how to interpret it so as to help assess whether they are paying a fair price. Most unsophisticated retail investors will not be aware of SEDAR and, even if directed to it, they are unlikely to navigate SEDAR with any degree of expertise and therefore will not benefit from it. Ordinary Canadians may benefit indirectly through their pension holdings but are unlikely to benefit directly as individual investors.

Transparency for Fixed Income Securities

- 2.8. The CSA proposes to increase transparency for corporate debt securities by proposing that trade information for all such securities executed by dealers be made publicly available, subject to delayed dissemination and volume caps, by the end of 2017.
- 2.9. IIROC will act as the information processor under NI 21-101 and will gather information on all fixed income trades executed by IIROC Dealer Members in accordance with IIROC's Debt Reporting Rule.¹⁶ FAIR Canada supports the robust accumulation of data by regulators in order to improve the policy-making process and improve regulation of the fixed income market. We believe it is appropriate to require all market participants to report fixed income trade information to IIROC, so that IIROC can establish a comprehensive source of information, including exempt market dealers.
- 2.10. The second aspect of the plan to increase transparency is to publish the information, starting with a subset of the information reported. Trades in Designated Corporate Debt Securities (certain bonds in accordance with certain selection criteria based on trading volumes, whether the bonds are included in domestic Canadian corporate bond indices, issue size and whether highly liquid¹⁷) and trades

¹⁴ FINRA Regulatory Notice 14-52, "Pricing Disclosure in the Fixed Income Markets", (November 2014); and MSRB regulatory Notice 2014-20, "Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations", (November 17, 2014).

¹⁵ SEC Chair Mary Jo White, Chairman's Address at SEC Speaks 2015, (February 20, 2015) available online at: <http://www.sec.gov/news/speech/2015-spch022015mjw.html>.

¹⁶ CSA Consultation Document at p 3 to 5.

¹⁷ CanPX selected 415 corporate debt securities as Designated Corporate Debt Securities which was 58% of the corporate debt securities traded over a one year period.

marked as “retail” will be made available, with information for all corporate debt securities eventually being made public.

- 2.11. The information will be subject to dissemination delays and volume caps. Most likely such information will have a “dissemination delay” of two days following the trade (i.e. a T+2 basis). This is in contrast to CanPX’s current one-hour dissemination delay. The information will be subject to volume caps. The Consultation Document explains: “[t]his means that, for those trades that have volumes over \$2 million for investment grade corporate bonds and \$200,000 for non-investment grade corporate bonds, the actual volumes will not be shown in the display. Instead, the volumes will be reflected as \$2 million+ and \$200,000+ respectively. These volume caps are the same that are used today...”¹⁸
- 2.12. The CSA indicates that it has met with stakeholders and discussed the impact of transparency on liquidity and “...how any potentially negative impact can be mitigated. They indicated that delayed dissemination and volume caps are potential ways to mitigate this impact. We agree...In our view, the approach to increase transparency is a balanced one that addresses the need for information but does so in a way that addresses concerns that too much transparency can impact liquidity.”¹⁹
- 2.13. FAIR Canada makes three broad points. First, we are unaware of the CSA consulting any organizations representing the interests of retail investors as part of this consultative process. That should have been done.
- 2.14. Secondly, the CSA Consultation Document should compare its proposals for pre- and post-trade transparency with those of other jurisdictions and in particular, the United States and Europe. The rationale for the approach taken in Canada should be explained. Why should Canada lag behind and have less transparency than those other jurisdictions? Since 2002, the United States has had the Transaction Reporting and Compliance Engine (“TRACE”) system which requires bond dealers to report transaction data for U.S. corporate bonds in near real-time (within 15 minutes). FINRA makes that transaction data available to the public for free. As noted in the OSC Report, the U.S. market is the only jurisdiction that disseminates, in real-time, post-trade information on all corporate bonds. The UK and European regulators collect aggregated trade reports to monitor bond activity, but do not currently have a system like TRACE in place.²⁰ However, recently, regulatory developments have occurred in Europe. The final legislative texts of the new Markets in Financial Instruments Directive (MiFID II) and the Markets in financial Instruments Regulation (MiFIR) were approved by the European Parliament and the European Council and came into force on June 12, 2014. Technical standards were released by the European Securities and Markets Authority (“ESMA”) in September 2015.²¹ The new transparency regime will extend to bonds, structured products, emission allowances and derivatives (collectively called “non-equity financial instruments) and will include requirements for pre-trade as well as post-trade transparency which will apply to market operators and investment firms operating a trading venue. Waivers from the pre-trade transparency requirements will apply in certain circumstances, including for large orders. Post trade information to be made public will be the price, volume and time of the transactions, and such information will be

¹⁸ CSA Consultation Document at p 7.

¹⁹ Ibid at p 6.

²⁰ OSC Report at p 32.

²¹ European Securities and Markets Authority, “Final Report: Draft Regulatory and Implementing standards on MiFD II and MiFIR”, (September 20, 2015), available online at: https://www.esma.europa.eu/system/files/2015-esma-1464_-_final_report_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf.

delayed in certain instances (for large transactions or less liquid products).²² If retail investors in Canada will obtain less post-trade transparency than in other leading jurisdictions, namely the U.S. and Europe, such differences should be discussed and explained.

2.15. Thirdly, the argument from industry players that increased transparency will decrease liquidity needs to be examined carefully for accuracy since such arguments may be self-serving and reflect a strong desire to maintain the status quo given the profits being made under the current system. According to a media article, Wall Street bond traders lost \$1 billion in commissions in the first year after TRACE was implemented when the difference between bids to buy and offers to sell corporate bonds narrowed. Smaller dealers gained market share at the expense of larger ones as all traders were able to share the same prices.²³

2.16. The OSC Report discussed the impact of increasing post-trade transparency as follows:

“Empirical evidence gathered after the rollout of the TRACE system, showed that post-trade transparency lowered transaction costs in the fixed income market without decreasing liquidity. As a corollary, these findings indicate that greater price transparency, leads to less information asymmetry and lower economic rents, which makes the market more efficient. However, in a more recent study, researchers argue that while post-trade transparency has reduced transaction costs in the fixed income market, it has had a negative impact on liquidity, particularly for less frequently traded bonds.”

We urge the CSA to not assume that, in Canada, increasing post-trade transparency will decrease liquidity. The Consultation Document should discuss the state of the academic research and assess the need for further study to determine whether liquidity will be impacted. The impact on liquidity (if any) also has to be balanced against the improvements to market fairness and efficiency that come from decreasing information asymmetry and lowering economic rents.

Timing

2.17. Dissemination for all trades in all corporate debt securities and for new issues of corporate debt will not occur until mid-2017. Given that near real time post trade transparency has been in place in the U.S. since 2002, FAIR Canada urges the CSA to implement on a faster timeline.

3. Improved Market Integrity

3.1. FAIR Canada supports the collection of comprehensive data by regulators and urges regulators, as described above, to make this data as comprehensive as possible by including all relevant market participants, including those in the exempt market.

4. Evaluating Access to the Fixed Income Market

4.1. The Consultation Document indicates that the CSA is establishing a working group comprised of IIROC and CSA staff to examine the issue that small institutional investors (let alone retail investors) have limited ability to participate in new debt offerings. “This group will conduct a comprehensive review of dealers’ allocation practices among clients to collect data related to how initial debt offerings are

²² See CSA Notice of Approval for Amendments to National Instrument 21-101 Marketplace Operation (October 23, 2014).

²³ Altstedter, “Canada’s bond market the world’s worst for transparency, says traders”.

allocated between the different market participants and understand how allocations are done. Based on this review, we will determine whether further regulatory action is needed.”²⁴

- 4.2. FAIR Canada supports the establishment of a working group to examine this issue. However, we would like to see it extended to examine the ability of retail clients to participate in the primary market, and we urge the working group to proceed expeditiously and anticipate the impact (if any) of the other reforms being proposed in the fixed income market.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Neil Gross at 416-214-3408/ neil.gross@faircanada.ca or Marian Passmore at 416-214-3441/ marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

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²⁴ CSA Consultation Document at p 8.