INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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July 14, 2009

Mr. Jamie Bulnes
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Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
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DELIVERED VIA EMAIL

Dear Mr. Bulnes:

RE: Request for comments: Rules Notice 09-0109 "Proposed over-the-counter securities fair pricing rule and confirmation disclosure requirements (the "Notice")

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the Notice and the related Draft Guidance Note entitled "Over-the-Counter Securities Fair Pricing", issued on April 17, 2009.

The IIAC recognizes and appreciates that the Investment Industry Regulatory Organization of Canada (IIROC) has already considered industry input while developing the Notice, and has amended the draft Notice published for comment in accordance with some of the concerns previously expressed by members. However, a Working Group organized at the request of IIAC members identified a number of conceptual and practical problems with the Notice. We request that IIROC consider the comments and recommendations put forward in this letter. The IIAC Working Group would welcome an opportunity to meet with IIROC staff to discuss practical solutions for the industry.

Over-the-counter traded security fair pricing rule and Draft Guidance Note

The Notice proposes a principles-based rule that establishes a general duty to use "reasonable efforts" to obtain a fair price for OTC securities (both fixed income and equity) in relation to prevailing market conditions. The Draft Guidance Note included as an attachment to the Notice provides members with some guidance on the general factors to be considered in determining a "fair price" and what will constitute "reasonable efforts".

Our members noted that while both "fixed income" and "equity" securities have been clearly contemplated in the drafting of the proposed rule, no mention was made regarding the application of the proposed rule to OTC derivatives, such as interest rate and total return swaps, and floating rate notes and agreements. It is unclear as to whether these types of securities would be included in the term "OTC securities", and subject to the requirements of the proposed rule. Since these OTC derivatives are, in most cases, highly tailored to the needs of the counterparties to the trade, have little or no secondary market and involve sophisticated investors, it is the IIAC's view that these instruments fall outside the scope and intent of the proposed rule.

Recommendation #1: The term "OTC security" should be more clearly defined in the proposed rule or Draft Guidance Note, specifically with regard to OTC derivative securities.

Despite the Draft Guidance Note, our members expressed deep concerns about IIROC's expectations regarding the "reasonable efforts" to obtain a "fair price", and how these expectations will affect IIROC's enforcement of the proposed rule.

In particular, members expressed concern about their ability to "canvass various parties" to source the availability and price of illiquid securities. For example, this type of action would be impossible to undertake with respect to a proprietary product that has only one source. This suggested requirement sets up a circular problem with an unacceptable resolution (i.e. canvassing the market for prices is identified as a potential solution to the problem of obtaining a fair price for illiquid securities, but the reason the securities are illiquid is because there are no other parties to canvass). There is an additional concern that canvassing the market may cause unintentional movements in the market for the security in question.

Even if other parties are available to be "canvassed", many members, and especially smaller firms, do not have the resources to engage in that type of due diligence with respect to every single OTC transaction. While such a requirement would seem to enhance fairness in principle, it would likely be impossible to implement. Members agreed that the standard of "exercising the same level of care and diligence that it would if undertaking an OTC transaction for its own account" is the only feasible requirement to ensure fair pricing, and would be flexible enough to allow members to apply it regardless of size or business model.

Recommendation #2: Language should be included in the proposed Rule and Draft Guidance Note that a presumption exists that an OTC transaction is fairly priced unless a specific complaint or other information has arisen that would reasonably rebut this presumption of fairness.

Recommendation #3: Remove the suggested requirement from the Draft Guidance Note for the member to "canvass various parties". Retain the language in the Draft Guidance Note relating to the member's standard of exercising the same level of care and diligence that it would if undertaking an OTC transaction for its own account.

The Draft Guidance Note recommends that where pricing information cannot be obtained because there are no comparable trades for the security in question, that pricing consideration "may be based on comparable or 'similar' securities". Our members identified that this situation is likely to be the case in a number of instances, especially where members conduct transactions with respect to proprietary or illiquid products. Many members expressed caution that pricing models, which are suggested as an alternative in the Draft Guidance Note, do not work effectively when valuating different products.

Members were generally supportive of IIROC's efforts to improve transparency and fairness; however, they recognized that many of the pricing factors and considerations suggested in the Draft Guidance Note must be identified as suggestions only, and cannot be enforced as strict requirements by IIROC. Both the Notice and the Draft Guidance Note make many references to the "market" for OTC securities as a standard, when in fact such a "market" may not exist for a particular security. It may also be impractical and not feasible for members to develop pricing models comparing different securities where markets for a particular security do not exist.

Recommendation #4: Remove mandatory language from the Draft Guidance Note. Include additional language recognizing that a member should provide transparency where prices can be published. A member should be required only to use its best judgment (including adherence to the member's standard of care outlined in the Draft Guidance Note) where no market exists and comparisons to other securities are not feasible. IIROC should recognize that practices will vary from one member to another, and that enforcement of the proposed Rule should take these differences into account.

The Notice states that "there is no specific requirement in the proposed rule for documenting the considerations that went into the pricing of a transaction", however, the Draft Guidance Note states that IIROC "expects Dealer Members to maintain adequate documentation to support the pricing of OTC securities transactions", and that "hard-to-value transactions are likely to require additional supporting documentation". These statements are vague and somewhat contradictory, and members expressed concern about how these requirements will be enforced by IIROC, especially given the lack of resources across all firms to document transactions.

For example, the Draft Guidance Note states that "existing transaction records, including audio recordings…will therefore suffice for purposes of supporting the fairness of a

transaction". Members informed us that at many firms, audio recordings are generally not stored for longer than 90 days. IIROC should acknowledge that the additional resources required for storage of additional documentation, including audio recordings, may not be available at all firms, and may prove to be an especially onerous requirement. In addition, these requirements may entail making changes to large proprietary record-keeping systems, at a significant cost to the firm.

Recommendation #5: Acknowledge in the Notice and Draft Guidance Note that IIROC will take into account the general business models of each firm when reviewing documentation of considerations that went into the pricing of an OTC transaction.

The Draft Guidance Note also imposes responsibility on introducing brokers to review carrying brokers' prices against "other possible sources on a frequent basis (at least semi-annually)". The Draft Guidance Note states that these reviews should be documented by the introducing broker. Our members were concerned that this is a wasteful duplication of resources, especially since the Draft Guidance Note makes it clear that carrying brokers are also subject to the fair pricing requirement (and the associated documentation requirements) when executing trades on behalf of an introducing broker.

Recommendation #6: Amend the Draft Guidance Note to make it clear that introducing brokers may rely on the carrying brokers' adherence to the standard of care in completing its OTC transactions, and any associated documentation where securities are hard-to-value, or as otherwise appropriate.

Fixed income security yield disclosure to clients

The Notice states that the proposed rule will require the disclosure on trade confirmations of the yield to maturity for fixed income securities, calculated "based on the aggregate price to the client, according to market conventions for that particular security". It would also require confirmations to include notations for callable and variable rate securities.

Our members were not opposed to these proposed changes in principle, however, they identified a number of practical implementation issues that should be addressed.

Firms will need to determine if the information to calculate yield to maturity can be obtained in-house or through third party service providers such as Broadridge or IBM. While most members agreed that it would be more reliable for each member to depend upon its own database of trading confirmations, this would require highly individualized implementation of the proposed Rule, which may prove to be difficult and costly for member firms.

Recommendation #7: Member firms ask that IIROC provide flexibility on the transition period to implement the disclosure elements of the proposed Rule. Members have recommended that IIROC allow for an initial period of time for firms to engage and decide upon common terminology, and for an additional period of time (of at least one year) for the technical implementation of including the language on the confirmations.

Members expressed additional concerns about the inflexibility of the disclosure language in the Notice, and questioned the logic and necessity of strictly prescribing the words that will be included on the confirmations. There is a limit to the number of lines and spaces on confirmations. The concern of members does not arise from the requirement of disclosure so much as from the logistics of including extra information on the confirmations. This may require the cooperation of all firms and third party service providers, and time will be needed to gain consensus on the standard language to be used (*see Recommendation #7, above*).

Recommendation #8: IIROC should allow for more flexibility on the disclosure language to be included on trade confirmations, including the use of abbreviations or legends, where appropriate. IIROC should engage in a dialogue with firms and service providers to discuss technical capabilities and limitations.

Although it is stated in the Notice that IIROC may provide future guidance on how members should calculate the "yield to maturity" and what appropriate market conventions may be used in such calculations, members are concerned that the immediate lack of clarity will create confusion among firms and investors. It may be more appropriate for IIROC to discuss this issue with firms, and issue guidance along with the final Rule.

Recommendation #9: Further guidance must be provided on how members should calculate the "yield to maturity" to avoid confusion. We refer IIROC to the IIAC's publication titled 'Canadian Conventions in Fixed Income Markets', available on the IIAC website.

Remuneration disclosure statement to retail clients

The Notice states that the proposed rule will require members to disclose, on confirmations for all OTC transactions for retail clients, a mandated statement regarding the dealer's remuneration. It is pointed out in the Notice that the proposed statement is similar to the text mandated by FINRA in the United States. The rule will only apply to OTC securities transactions where the amount of any mark-up or mark-down, commissions and other service charges are not disclosed on the trade confirmation sent to retail clients. The Notice also states that for fee-based accounts, the statement will be required on confirmations for OTC transactions "if in fact there is a mark-up or mark-down, commission or other service charge relating to the transaction specifically."

Members have been critical of the above requirement and have expressed some concerns. The proposed requirement is criticized for not taking into consideration other industry regulatory initiatives including registration reform and IIROC's Client Relationship Model (CRM) proposal. For example, under CRM, a dealer is required to outline the "conflicts of interest" that occur in the course of business and remuneration could be covered as part of that disclosure and/or in a separate fee disclosure made to the client at the time of account opening.

In addition to the operational concerns, including the limited availability of space on the trade confirmation, our members have concerns about the lack of clarity in the Notice regarding when the disclosure language should appear, especially in relation to fee-based accounts. The Notice seems to indicate that for fee-based accounts, where there is no mark-up or mark-down, there is no requirement to include the disclosure statement on the trade confirmation. We would appreciate receiving more guidance confirming this interpretation.

Recommendation #10: IIROC should revisit the proposed remuneration disclosure requirement taking into consideration other industry regulatory initiatives. Should IIROC proceed with the proposed remuneration disclosure requirement more guidance is required by members as to when disclosure statements are to be included on trade confirmations, especially in relation to fee-based accounts.

Members also expressed concern that because OTC transactions, particularly those relating to fixed income securities, are facilitated through principal trading with firm inventories, greater clarity is required to determine what is meant by "mark-up" or "mark-down", given that inventories can and often do acquire fixed income securities at varying values. Depending upon the interpretation, a mark-up or mark-down could be viewed as the difference between the originating value and the value charged to or paid to the client. Most firms interpret a mark-up or mark-down to mean the difference in value between the market price and the cost to the client. Naturally, these two interpretations may vary greatly.

In the first interpretation, when a security is sold to either an institution or a retail client depending on market prices, there may or may not be a mark-up or a mark-down, and it would be difficult to make this determination at the time of sale if the securities were frequently turned over through the inventory. The retail broker obtaining a fill for a client would not be in a position to know if a mark-up or mark-down was embedded in the cost, and the development of a more complex reporting system would be required to provide this level of detail. Using the second interpretation, the calculation of mark-ups and mark-downs are more difficult to determine for illiquid securities or for those where the firm is the market maker.

Recommendation #11: IIROC should provide more clarification on what constitutes a "mark-up" or "mark-down", to ensure consistency in the application of the proposed rule across all member firms.

Members also suggested that IIROC allow for more flexibility in the language to be included on the trade confirmation, including language stating that remuneration "may" have been added or deducted. This flexibility would allow for easier technical implementation and would avoid an incorrect statement appearing on a confirm when uncertainty exists as to the existence of a mark-up or mark-down.

Recommendation #12: Consider more flexible language to be included on all trade confirmations, instead of strictly prescribing language as set out in the proposed Rule.

Conclusion

We recognize that the proposed amendments' purpose is to enhance the fairness of pricing and transparency of OTC market transactions. However, our members are concerned that compliance with these new requirements, some of which are not operationally feasible, and the possible enforcement of these new requirements, will pose challenges and may result in significant hardship to dealers – mitigating the benefits that the changes are designed to achieve.

We would like to meet with you on this matter to discuss these issues and how they might be addressed, and to provide you with any information you require that could assist in the further development of more practical guidance on implementation. Please contact Jack Rando, the IIAC's Director of Capital Markets (jrando@iiac.ca or 416-687-5477) with any questions or meeting requests.

Yours sincerely,