

**ALBERTA SECURITIES COMMISSION
NOTICE**

**IDA/CSA Market Survey
on the Regulation of Fixed Income Markets**

December 13, 2002

The Commission and the other members of the Canadian Securities Administrators (CSA) are publishing the results of a survey conducted by Deloitte and Touche on the regulation of the fixed income market. The Investment Dealers Association of Canada (IDA) and the CSA jointly sponsored the survey. The purpose of the survey was to ask industry participants to identify problems or issues in the trading practices of participants in the unlisted debt securities market.

The IDA and the CSA will use the results of the survey to develop and apply field examination modules for dealers trading in the debt market.

The survey results, entitled *IDA/CSA Market Survey on the Regulation of Fixed Income Markets*, and the recommendations and analysis contained in Appendix A to the survey results are attached to this notice.

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IDA/CSA Market Survey on Regulation of Fixed Income Markets

July 16, 2002

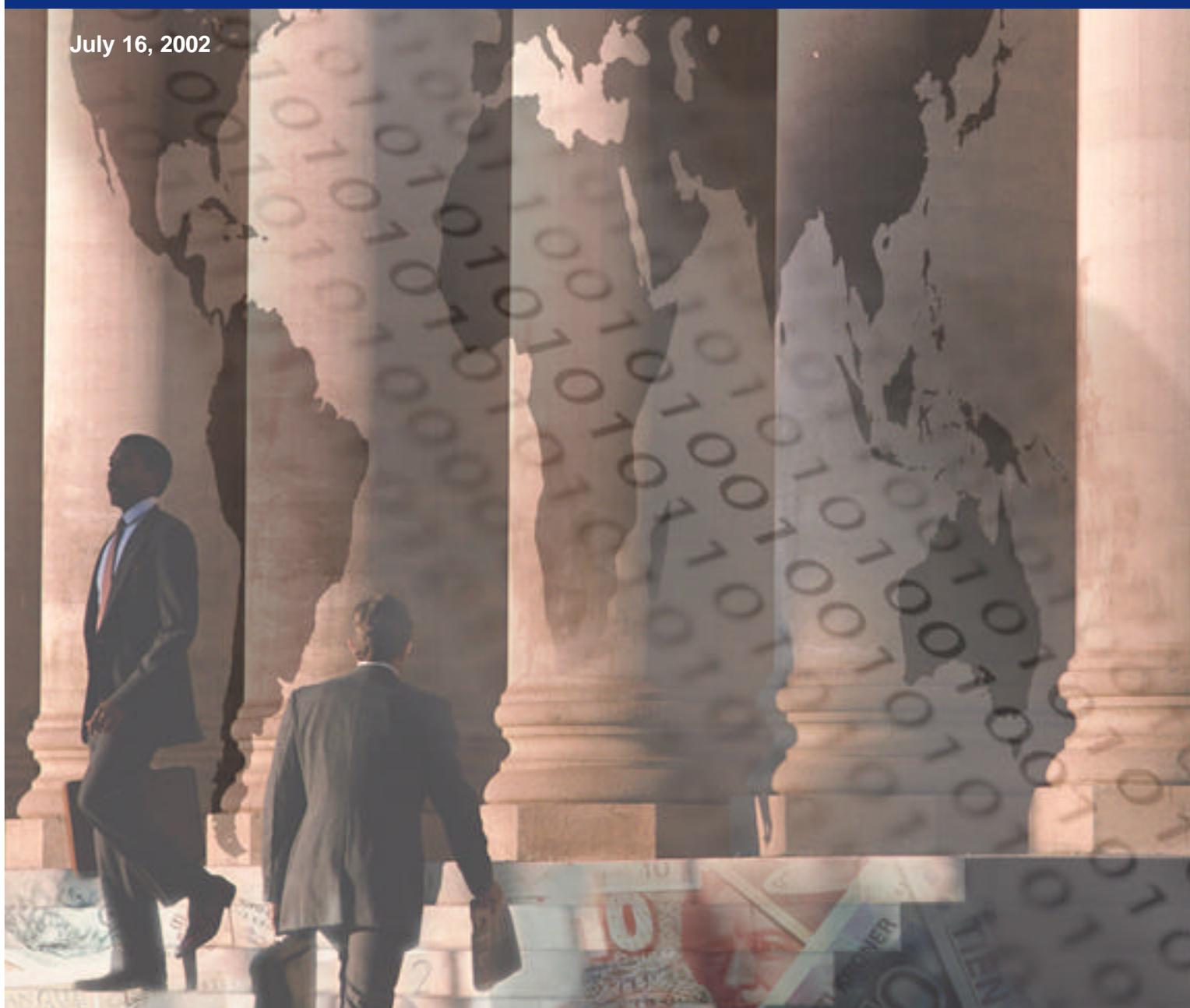


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I. EXECUTIVE SUMMARY

Objective of Survey

The objective of the survey of Canadian debt market participants and regulators is to identify whether any problems or issues exist in the trading practices of participants in the unlisted debt markets in Canada. The survey results will be used in identifying what the major regulatory issues in the debt markets are and will be used by regulators as a basis to develop field examination modules for the debt market. This report represents the outcome of the survey. It sets out market participants' views on market integrity and an appropriate regulatory framework for Canadian debt markets.

Process

To meet the requirements of this engagement, Deloitte & Touche LLP ("D&T") began by working with the Project Steering Committee ("PSC") appointed by the Investment Dealers' Association of Canada ("IDA") and Canadian Securities Administrators ("CSA") to confirm project objectives, timelines and deliverables. We then worked with the PSC to develop a survey to be used in the process of interviewing market participants and regulators. We sought the input of the Capital Markets Committee of the IDA ("CMC") and the Bond Market Transparency Committee ("BMTTC") in the development of the survey.

We sought the answers to the survey from 29 market participants and regulators through 33 surveys, interviews and focus groups. The debt market participants interviewed included representatives from securities dealers, institutional investors, issuers, inter-dealer brokers, retail market participants, industry committees, Alternative Trading Systems ("ATs") and regulators (see Section III of report for specific breakdown). For the majority of participants, we were able to conduct in person interviews. Interviewees were assured that individual responses would be kept confidential and that comments would not be attributable so as to encourage openness in the survey process.

Findings

Our findings have been categorized into two groups: Priority Findings represent the key findings in the area of market integrity and other areas that will provide focus and direction to the IDA or other regulatory body in the development of examination procedures. The second category of findings, called Secondary Findings, represents the other findings from the survey which are not directly related to the main objective of the survey, but which were raised by interviewees in response to the questions in the survey.

Priority Findings – Market Integrity

1. Overall Market Integrity

Concerns about market integrity are minor, although a minority of respondents expressed concerns about certain sharp trading practices and client confidentiality. A majority of respondents rate market integrity in the wholesale market as good, and most market participants feel market integrity has improved in recent years. A minority have some reservations about the fairness of the market, but generally do not support expanded regulation as a response.

2. IDA Policy 5

Policy 5 is seen by the majority of market participants as sufficient for regulating the wholesale fixed income markets. However, this view needs to be considered in light of how familiar market participants really are with respect to the specific details of Policy 5. Outside of some traders in the dealers, it appears that greater education and training efforts are needed on the contents of Policy 5 and any related internal policies.

3. Compliance Reviews

The IDA does not currently conduct compliance reviews focused on debt market trading, which in turn reduces the degree of focus and the resources allocated to debt market activities by in-house compliance departments. In-house compliance functions place little, if any, emphasis on debt market trading. In-house compliance procedures that do exist are not necessarily consistent across firms.

4. Surveillance of the Debt Markets

Respondents do not believe real-time market surveillance is warranted due to lack of concern over debt trading issues and the cost that would be incurred relative to the perceived benefits. A minority supported the use of off-line (after the fact) surveillance reports.

5. Retail Markets

A strong consensus exists that reforms are needed in the retail market. The primary issue is poor transparency, which is increasingly an issue in light of advances in transparency in wholesale markets. Poor transparency can lead to other problems such as unreasonable prices or mark-ups, lack of understanding of the debt markets, and clients' inability to safeguard their own interests.

6. The Complaints Process

Market participants, in particular, institutions, are not aware of any formal channels for communicating their complaints about fixed income markets, especially with respect to market integrity issues. The complaints process that exists is not transparent to market participants.

7. Derivatives

Minimal feedback was received on the derivatives market and more research is required in this area.

Secondary Findings – Market Structure and Regulatory Approach

1. Transparency in the Markets

The market welcomes incremental increases in price transparency. Many market participants believe increases in transparency reduce the need for increased regulation as it makes participants' activity more visible. Incremental increases to transparency should be staged until the optimal level (not necessarily the maximum level) of transparency is reached. Participants oppose increasing volume transparency.

2. Market Liquidity

The priority of market participants is to maintain or improve the current liquidity in the Canadian markets. Liquidity is a concern even though it is considered fairly good given the relative size of the Canadian market as compared to the US market.

3. Market Structure and Innovation

Intermediaries and dealers outside of the bank-owned firms believe that the current market structure makes it difficult for smaller dealers and foreign entrants to compete in the market. According to some interviewees, regulatory barriers and the high degree of concentration in the marketplace have reduced competition and slowed innovation in the Canadian marketplace.

4. Regulatory Approach

A strong consensus exists in favour of maintaining the current regulatory approach to the wholesale debt markets, based on establishing principles of conduct and placing primary reliance on self-policing mechanisms, and against the introduction of more extensive rules and regulatory programs. Most respondents do not see regulatory problems that would justify significant changes in regulation. Market regulation should be improved incrementally, focussing on issues as they arise. Many participants believe improvements in market regulation should begin with specific changes to the IDA's role and activities. Market participants feel that increased, unnecessary and costly regulation will have a negative impact on liquidity and that a cost/benefit analysis of proposed regulation should be performed prior to introducing additional regulation. See the Retail Markets section for comments on the regulatory approach to the retail markets.

5. Jurisdictional Issues

In considering the issue of how all participants in the debt markets might be regulated in a comprehensive manner, survey participants noted two jurisdictional or conflict issues the IDA would face if it were asked to perform such a role. If the IDA were to regulate institutional clients' compliance with market conduct rules, governance and jurisdictional issues would arise. Secondly, similar issues would arise if the IDA were to regulate electronic debt markets, which could extend the IDA's role from "member regulator" to "market regulator".

6. Regulatory Arbitrage

Practically speaking, the risk of dealers avoiding market regulation by moving trading activities into affiliated banks is low. To the extent that such activities are housed there, it appears that the banks would need to agree to be bound by any new IDA requirements, in a similar fashion to Policy 5.

Recommendations

The following recommendations are based only on the survey interview results, complemented by our own expertise. We have not attempted to validate any of the opinions expressed by interviewees. Prior to making recommendations on a broad and complex subject such as regulation of fixed income markets, we would normally conduct significantly more research in order to substantiate our advice.

IDA Policy 5

1. The IDA's rules and policies, as set out in Policy 5, should continue to formally apply only to IDA member firms. Steps should be taken to ensure that the institutional investors are familiar with the principles in Policy 5 and agree to observe them. The principles of Policy 5 should be incorporated into institutions' internal codes of ethics and compliance policies, to the extent the principles apply to the trading activities of non-dealers.
2. A process should be established for ongoing assessment of the need for changes to Policy 5. All stakeholders should be involved in the assessment, including institutional investors.

Reporting and Surveillance

3. There is no demonstrated need for real-time market surveillance. The usefulness of exception reports for market surveillance purposes based on existing trade reporting requirements should be examined, and based on the results, could be expanded as trade reporting expands with the development of electronic trading through ATs and similar trading platforms.

Retail Investors

4. The IDA should take three initiatives to address the issue of retail prices and mark-ups:
 - 4.1 The IDA should establish a process to address the need for a rule or policy on pricing and mark-ups on debt securities sold to retail clients.
 - 4.2 The IDA should amend the standards for supervision of retail accounts to specifically address sales of debt securities and mark-ups.
 - 4.3 The IDA should establish a policy requiring all member firms to have internal policies and procedures in place to govern mark-ups on debt securities, as well as procedures for the supervision of such activity.
5. The CSA and IDA should establish a process to address the need to improve transparency of debt market prices at the retail level.

Fixed Income Derivatives

6. We believe it is premature to address the fixed income derivatives market until decisions have been made on the approach to regulation of the cash markets.

Role of the IDA

7. The IDA should take steps to clarify its role in the fixed income markets, to increase its presence with market participants, and to make targeted improvements to its regulatory functions to address debt market issues.
 - 7.1 Compliance with Policy 5 should be administered by the IDA's Member Regulation Department.
 - 7.2 The IDA should expand their compliance reviews to more fully encompass the debt market activities of members, including the development of a trade desk module for fixed income trading. The IDA's reviews should address specific issues in retail sales of debt securities.
 - 7.3 The IDA should establish a clearer complaint process relating to debt market activity for institutional investors and members. The process should be clearly communicated to all market participants.

Regulatory Approach

8. We recommend that the current principles-based approach to regulating the wholesale debt markets be maintained, subject to targeted improvements that will introduce elements of a more proactive, rules-based approach in specific areas. These areas, including several set out in these recommendations, should be selected based on demonstrated need or on principles of sound regulatory oversight. We do not recommend that an expansive set of codified rules be introduced to regulate the debt markets; reliance should continue to be placed on the principles set out in IDA Policy 5. The market regulation regime adopted must also recognize changes in market structure that are occurring as a result of the introduction of electronic trading systems and on-line brokerage services. The regulatory regime needs to address the entire market, not just the traditional market structure, and should do so in an integrated fashion.
9. The CSA should engage in broader consultations with other regulators, IDA and the securities industry going forward when considering changes to regulatory requirements governing fixed income markets. The regulators should also establish a framework to analyze the cost of proposed new rules and regulatory processes so that the costs are appropriately analyzed prior to any policy decisions being made towards the implementation of new regulatory requirements.

II. PROJECT BACKGROUND & OBJECTIVE

Background

National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules were issued in final form on November 2, 2001. The rules focus on market transparency by requiring market information to be supplied to an information processor. That information processor will collect and disseminate order and trade information in real time (or close to real time) and distribute it to information vendors, news agencies and other customers. CanPX has applied to become an information processor for unlisted debt securities.

The rules also require all ATSS, inter-dealer brokers and dealers trading unlisted debt securities to enter into a contract with a “regulation services provider” to ensure market integrity and compliance with trading rules. An exemption from this requirement is in place until December 31, 2003 for those ATSS, inter-dealer brokers and dealers that comply with IDA Policy 5.

Until the date on which the exemption expires, the CSA and the IDA are working with debt market participants to evaluate an appropriate structure for the regulation of the Canadian unlisted debt market. The CSA and IDA decided to conduct a survey of market participants and other stakeholders to identify and address any market integrity issues for input into the determination on additional steps that may need to be taken to regulate the unlisted debt market effectively.

The CSA and IDA engaged D&T to carry out the survey of market participants to identify market integrity issues and/or problems in trading practices in the Canadian debt markets. D&T was selected as an impartial third party engaged to collect and report on the information obtained from market stakeholders.

Objective

The objective of the survey of Canadian market participants and regulators is to identify if any problems or issues exist in the trading practices of participants in the unlisted debt market in Canada. This report represents the outcome of the survey. It sets out market participants’ views on market integrity and an appropriate regulatory framework for Canadian debt markets.

The focus of this exercise and report is on the secondary bond markets; in particular government and corporate bonds. Although not the focus, comments were also received on the primary markets and derivative markets. However, virtually no comments were received about short-term instruments such as commercial paper and money market instruments.

The survey focused on the activities of all market participants, not just the activities of regulated dealers. The debt market participants interviewed included representatives from securities dealers, institutional investors, issuers, inter-dealer brokers, retail market participants, ATSS, industry committees and regulators. The IDA, the CSA and the two bond market committees were all involved in selecting the appropriate cross section of interviewees and determining survey content.

This report identifies priority and secondary findings and perceived problems with respect to market integrity and the regulation of the debt markets in Canada.

III. SURVEY AND REPORTING PROCESS

Approach

To meet the requirements of this engagement, D&T utilized the following four-step process:

Step 1 - Planning

In the planning phase, we worked with the appointed PSC to confirm project objectives, timelines, and deliverables.

Step 2 – Survey Development

We utilized a consultative approach in the development of the survey. We worked directly with the PSC and obtained input from the CMC and the BMTC to develop a survey that identifies and addresses the market issues from multiple perspectives.

Step 3 - Market Research

We utilized a structured interview approach to survey the market participants. We assured all interviewees that interview results would be kept confidential so as to encourage a frank, open discussion on potential issues in the market.

Step 4 – Reporting

This report compiles our findings and identifies key themes and perceived risks with respect to market regulation of the debt markets in Canada.

Profile Of Those Surveyed

	No. of Participant Organizations	No. of Survey Responses	Departments
Buy Side	5	5	– Portfolio Managers
Sell Side	7	11	– Traders – Compliance – Management/Directors – Private Client Group Management
Committees	3	3	– Capital Markets Committee of the IDA – Bond Market Transparency Committee – Legal and Compliance Committee of the IDA
Inter-Dealer Brokers	1	1	– Management – Broker
Retail*	5	5	– Management of online broker(s) – Private Client Group Management – Individual retail investors – Compliance Officers
Issuers	3	3	– CFO – Directors
Regulators	5	5	– Various
Total	29	33	

* Note: During the survey process, we were able to obtain a significant amount of information on the retail perspective through interviews with wealth management staff, in-house compliance staff and on-line brokers in addition to the retail investor interviews conducted.

Note: Two of the regulators and one retail investor answered the survey in writing as opposed to a formal interview.

IV. SURVEY FINDINGS

Introduction

The following survey findings are grouped into two categories. The first category of findings, called Priority Findings, represents the key findings in the area of market integrity and other areas that will provide focus and direction to the IDA or other regulatory body in the development of examination procedures. The second category of findings, called Secondary Findings, represents the other findings from the survey which are not directly related to market integrity, but that were widely raised by interviewees in response to the questions in the survey. Secondary findings are mainly in the areas of Market Structure and Regulatory Approach.

Priority Findings – Market Integrity

1. Overall Market Integrity

The focus of the survey process was to identify whether market integrity issues exist in Canadian secondary fixed income markets. Based on the results of our interviews, a majority of market participants view market integrity as good, although a minority expressed concerns about specific trading practices, as noted below. Very few examples of abuses or violations of market integrity were cited in the interviews. Market integrity problems seem to be irregular events rather than frequent or ongoing problems.

Some of the smaller dealers and one of the buy side participants hold an opposing view to the one above. However, upon probing the issues it was determined that these parties are generally more concerned with the fairness of the market in terms of their relative market power. They cited market structure issues such as transparency, conflict of interest issues relating to the IDA, access to the IDB market and the dominance of the large banks, over actual market integrity issues. These issues are described in the section on Market Structure.

Large dealers tend to see market integrity as good and improving, as did most institutions. Most were willing to comment on perceived problems such as frontrunning, and problems that existed in the past, such as cornering of markets, which are no longer seen as issues.

To some degree, how the market treats participants seems to vary based on a participant's size and market power. The larger a participant is, the more weight it carries in the market, and the easier it is to impose business sanctions on other market participants in the event it is not treated fairly. For instance, for a period of time, firms may refuse to give business to a dealer, or dealers may give less favourable quotes to an institution, whose practices they object to. Larger players also have access to more information, both on screens and through word of mouth, and so are more aware of market prices and trends, as well as the activities of other participants. Superior information yields more market power and better enables a firm to safeguard its own interests in the marketplace.

1.1 Specific Market Integrity Issues

Interviewees were asked whether there are any market integrity issues or practices related to government and corporate bonds that concern them. As stated above, very few concerns were cited in the interviews.

Allocation of fills, priority of client orders, honouring quoted prices and best execution (except on the retail side) were not considered to be issues.

Only two issues were highlighted in the interviews as possible areas of concern:

- Possible occurrence of frontrunning by the dealers, and
- Confidentiality of client orders and positions.

Comments were also made regarding games on broker screens and market manipulation; however, very few interviewees saw problems in these areas.

1.1.1 Frontrunning

Many respondents commented on the issue of frontrunning, although it is not seen as a systemic problem in the market. Interviewees said that it might occur occasionally, but that it is very difficult to differentiate the practice of frontrunning from good risk management on the part of the dealers. Respondents did not provide a clear definition or interpretation of frontrunning, but appear to see it as a market maker using knowledge of a customer's trading intentions or position when making trades or changing quotes. Whether such practices technically constitute frontrunning is unclear, since the term is not defined in Policy 5.

The sell side feels they are accused of frontrunning even when they are not engaging in such activities. The buy side indicated that if you "shop the street" for price quotes, you face the risk of getting frontruned (or having the dealers trade on the basis of the information provided to them). Also, institutional investors feel that self-policing actions are fairly effective in curbing occurrences of frontrunning, so that it is not a prevalent practice anymore.

It was also stated that with increased transparency in the market, buy side accounts are able to detect frontrunning more easily, should it occur. Therefore, instances of frontrunning should decline as transparency increases.

"Traders are pushing prices up or down based on client calls for quotes or expressions of interest."

When clients ask for a quote or express an interest in a bond it is not equivalent to placing an order; however, this is useful market information that traders may use to position themselves for a possible move in the market. Such positioning can easily occur in a substitute security at the same point on the yield curve. Positioning can be viewed as both acting against the interests of the customer and risk management of the trader's position. The interpretation of the prohibition on frontrunning in Policy 5 is an issue that regulators and the industry (both the buy and sell side) may need to address, based on the feedback received.

Through the course of interviews, it became evident that there is a lack of consensus on whether frontrunning does or does not occur. Participants are also not clear on whether certain dealer actions constitute frontrunning or are really just a function of good risk management on the part of the dealers. Some specific comments made about frontrunning in the interviews were:

"Traders often size up a client and ask if you are a buyer or a seller. During the conversation, the trader goes and takes up the offering on the screen and he calls a market that is a bit higher (in the

Inter Dealer Broker (“IDB”) market). Dealers claim that if they are aware of a client interest, they need to take a position in the security in order to ensure the ability to provide a fill to the client.”

“If a trader isn’t in position to fill an order, frontrunning does happen, but then self-policing on the part of clients also takes place to punish the dealer.”

“It’s a thing of the past.”

“Frontrunning may happen in the corporate market, but self-policing kicks in and make the dealers prove their innocence to the buyer, or else the dealer will lose the client.”

“It’s hard to prove frontrunning, but it seems to happen often. It varies by institution and sometimes by trader.”

“Frontrunning does occur, but not consistently. It’s hard to determine whether a dealer is trying to manage their risk or is playing games.”

“Frontrunning exists as a defensive tactic more than anything else, but it’s on the decline because customers realize you cannot call too many dealers for quotes anymore.”

In summary, as frontrunning is not formally defined in IDA Policy 5, market participants are left to their own perceptions of what constitutes frontrunning. Additionally, if they believe frontrunning occurs, buy side accounts can use self-policing mechanisms to punish perceived offenders.

1.1.2 Client Confidentiality

Client confidentiality refers to dealers and their traders maintaining the privacy of their clients’ identity on orders and trades, and their clients’ positions in the market. Interviewees’ opinions differed on whether maintenance of client confidentiality is an issue, with some seeing a high number of breaches of confidentiality and others not. Buy side interviewees generally take the position that if you wish to maintain confidentiality about your business, then you should tell the dealers as little as possible and be careful not to “shop the street”. As such, it seems buy side clients anticipate confidentiality being a problem if they disclose too much to the dealers. They respond by not disclosing too much, which limits the scope of the problem.

“... a pension fund north of the 401 has a huge exposure to this part of the curve...”

“ You hear too many names being dropped.”

One dealer indicated that dealers do not need to violate client confidentiality because they can tell who holds and who trades what bonds based on the fact that they know the markets so well. Dealers also indicated that a breach of client confidentiality is a fireable offence in their organizations.

It must be noted that dealers are not the only parties to violate the duty of confidentiality. Some dealers indicated that buy side accounts are the worst offenders in that they pressure dealers to disclose information about the other side of the transaction or previous trades. Both large and small dealers indicated that they refuse client requests to break confidentiality.

1.1.3 Games on Broker Screens

A few interviewees commented that they cannot always trust the prices on the “broker screens” in that the price may be the price the trader/dealer wants the market to react to. In posting such prices, a dealer runs the risk that the bonds will get “lifted”, but may still take the chance in an attempt to move the market. There is another check on such activity – if other traders’ prices do not change as well, then the trader attempting to influence the direction of the market will appear out of line.

“CanPX is a “portrait” system, where you can paint a picture so that your competitor doesn’t know what you are up to...”

1.1.4 Market Manipulation

Significantly, very few interviewees provided examples of market manipulation and the almost unanimous view is that manipulation is a thing of the past. Past problems with market corners were noted by some respondents.

A couple of isolated examples of manipulative actions were cited. One interviewee said dealers sometimes make trades to force the price of an underlying bond through an options exercise price, thus enabling the call holder to exercise their option to buy the bonds at that price. Otherwise, the call would have expired worthless. Another example provided was the practice of a dealer widening the spread between similar Canada and US bonds so the dealer can obtain greater profit when a client’s hedge position is rolled forward (it costs more for the hedge due to a wider spread). The dealer would claim to be managing risk but this could also be viewed as manipulation.

1.2 Other Issues

1.2.1 Complaints Received by Dealers

Complaints from institutions are generally dealt with as a business issue by the dealers, and not dealt with by the compliance department. Dealers reported they rarely receive complaints on the institutional side and when they do they usually relate to disputes about trade details. Most large dealers use tapes so that they can be reviewed in the event of a complaint. However, it was stated that tapes don’t often prove useful, as in a client-focused market such as the debt market, the client wins, whether right or wrong.

1.2.2 Primary Markets

Several people commented on information flow from the syndication/underwriting side of the dealers to trading, resulting in traders moving markets to influence prices quoted to issuers for new issues. They said that Chinese walls between trading and investment banking are not effective in debt securities. One interviewee said regulation was needed in this area. Only one interviewee commented on a difference between government and corporate finance, indicating that the problem is much worse in the government finance area.

“Basically, there is full disclosure between government finance and trading”.

Other than the preceding quote, respondents did not make a distinction between government financing and corporate underwriting, indicating the problem arises in both areas. As such, this issue may require further investigation.

Summary

Market integrity is not seen as a problem by a majority of market participants. Some gamesmanship appears to continue in quoting markets in order to influence market moves or to improve the trader's position. It is unclear whether market makers' positioning and risk management actions in response to expressions of interest by clients are a violation of Policy 5 or not, because frontrunning is not defined in Policy 5.

Concerns about the confidentiality of clients' orders, trades and positions exist in the market, although it appears that most buy side participants have found their own methods of dealing with potential breaches of confidentiality. Concerns about client confidentiality in the primary market may warrant further investigation.

2. IDA Policy 5

The degree of familiarity with Policy 5 varies, but overall its specific provisions are not well known in the debt markets. Dealers' traders, industry committees and regulators are aware of Policy 5 and are generally familiar with its contents. Most sell side traders seem knowledgeable about the general principles of the Policy, as opposed to specifics. Most buy side institutions are aware the Policy exists, but are not aware of its contents.

It is important to note that the buy side is not very familiar with Policy 5 notwithstanding that Policy 5 states that clients of the dealers are expected to co-operate and abide by its principles.

“...previous attempts were made to encourage the Association for Investment Management and Research (“AIMR”) and the Pension Fund Association to incorporate Policy 5 into their policies for members, but little response was received...”

The following feedback on the effectiveness of Policy 5 was obtained from the limited number of respondents who were familiar enough with the Policy to provide an opinion.

The majority of these respondents feel it is a sufficient code of conduct and is an effective tool for regulating the wholesale debt markets. The general principles and guidelines listed in Policy 5 appear to be well-accepted industry practice.

“...Policy 5 is sufficient on the basis that, if you are controlling the ethics of dealers, you are controlling the market.”

Four interviewees suggested that Policy 5 would be effective only if enforced by the regulators. Such enforcement of Policy 5 would require the regulators, particularly the IDA, to impose tougher sanctions for serious violations of Policy 5, similar to action that would be taken by the National Association of Securities Dealers (“NASD”) or the Securities and Exchange Commission (“SEC”) in the United States for violations of US regulations.

However, responding to calls for stronger enforcement of rules where serious violations occur could be difficult due to the vague nature of a number of provisions of Policy 5. Concepts such as frontrunning and market manipulation may require interpretation or definition if they are to be successfully enforced

using formal disciplinary processes. If an effective principles-based regulatory model is to be maintained, regulators will be required to strike a careful balance in this area.

Suggested improvements to Policy 5 were limited. The following reflect one-off suggestions by interviewees:

- Be more definitive in terms of practices it prohibits,
- Expand to include the derivatives market,
- Require the taping of internal communications,
- Require record retention and audit trails, and
- Refine indicia of market manipulation.

An interviewee from one of the large dealers feels the general nature of Policy 5 makes it a more effective tool than it would be if prohibited practices were defined. In their view, the broad nature of the document prohibits unethical behaviour in any form (i.e. intent) rather than prohibiting specific actions. The broad principles provide guidance for the market, and more detailed rules of conduct should be covered by internal dealer policies and procedures. Frontrunning was cited as an example. Because frontrunning is difficult to define, it is better to prohibit the whole objective of frontrunning rather than specific trading practices.

“...there would be ways of frontrunning, such as through the use of proxies and interrelated products, that would fall outside the specific definition of frontrunning and hence allow it to go as a non punishable offence...”

The counterview is that by defining specific trading practices that constitute frontrunning, it would be much easier to hold a dealer accountable for frontrunning.

Summary

Policy 5 is seen by the majority of market participants as sufficient for regulating the wholesale fixed income markets. However this view needs to be considered in light of how familiar market participants really are with respect to the specific details of Policy 5. Outside of some traders in the dealers, it appears that greater education and training efforts are needed on the contents of Policy 5 and any related internal policies.

3. Compliance Reviews

3.1 IDA Compliance Reviews

Many member interviewees indicated that the IDA does not review trading desk compliance on the debt side, in contrast to extensive compliance reviews that are performed on the equities desk. Two traders indicated they thought the IDA was supposed to develop such a program for bond desks, but it has not happened. Several members said that they would appreciate increased contact with the IDA, from a regulatory or policy standpoint. Communication with the Bank of Canada is much more extensive.

“...there was an intent that IDA would perform trade desk reviews and dealer reviews for compliance with Policy 5, but it was never carried out.”

Some members acknowledged that bond trading and positions may come up in the IDA's standard financial and sales compliance reviews, and could be subject to further investigation; however, there are no procedures specific to debt market trading except a review of policies and procedures under IDA Policy 5.

3.2 In-House Dealer Compliance

In-house dealer compliance departments do not see debt market trading as a high-risk area, unlike equities, and therefore few dealers have detailed compliance policies or dedicated compliance resources in the fixed income area. One reason given for debt trading's relatively low risk status is that there are more regulations and examinations on the equity side. The nature of the product is also a factor: equities are inherently riskier products. Additionally, the IDA's lack of presence in monitoring and enforcing rules and standards for debt markets results in a lack of focus on debt market trading activities by compliance.

Compliance officers stated that some review procedures are performed on the debt market trading activities of their firms, but these procedures were not performed consistently across all firms. Internal enforcement of policies and procedures and related supervisory obligations are also a concern, particularly in smaller dealers where documented procedures and risk management systems in this area may be non-existent.

Compliance procedures that are currently being performed by some dealers include:

- Tracking closing prices for the same bond across different inventories,
- Monitoring personal trading,
- Monitoring positions and closing prices,
- Ensuring traders are properly registered,
- Reviewing trade blotters/previous day's trading,
- Looking for large bid/offer spreads,
- Looking for differences in how bonds are marked to market at end of day,
- Performing internal audits of the debt area,
- Appointing compliance officers responsible for trading desks, and
- Testing audit trails for accuracy.

The lack of industry minimum standards for internal compliance procedures, including areas such as books and records requirements for orders and trades and mark to market procedures, may contribute to compliance departments' lack of attention to debt markets. Internal procedures and compliance monitoring appear to vary widely. The development of industry standards or guidelines in this area might be useful.

Sophisticated risk management systems and programs at the major dealers are reducing such problems in areas such as ticketing and record-keeping by making it more difficult to circumvent procedures. The issues are probably greater in smaller dealers with limited risk management and compliance systems in place.

Compliance departments do not represent the full compliance function in a dealer. Risk management and middle office functions must be considered as the reports that the risk management function examines often cover management of trading and market risk and compliance with internal procedures required to measure such risks. Dealers agreed that internal procedures problems are being eliminated through

automation of processes and the more sophisticated risk management systems in the bank-owned dealers, including development of electronic audit trails.

A couple of interviewees with experience working for major US dealers indicated that the compliance programs of the Canadian dealers pale in comparison to those in the US dealers.

Summary

The IDA does not currently conduct compliance reviews focused on debt market trading, which in turn reduces the degree of focus and the resources allocated to debt market activities by in-house compliance departments. In-house compliance functions place little, if any, emphasis on debt market trading. In-house compliance procedures that do exist are not necessarily consistent across firms.

4. Surveillance of the Debt Markets

All but two interviewees saw no need for market surveillance. They felt market surveillance would not be effective in markets that trade on the basis of yield and that insufficient evidence exists of problems that could be identified by market surveillance. In addition, on-line market surveillance would require a trade reporting system, which is viewed as a technology project with a potentially huge price tag. Development of rules and systems necessary to support a market surveillance program is considered to be a very significant, industry-wide investment.

The general market consensus is that any need for market surveillance can be addressed by increased transparency, because with increased transparency participants will be more readily able to identify trading issues on their own. A few interviewees thought that in-house monitoring by internal compliance for certain problems would serve as an effective alternative to external market surveillance.

Additionally, some regulators indicated that they already could obtain most of the data required to construct an audit trail for investigative purposes.

Summary

Respondents do not believe real-time market surveillance is warranted due to lack of concern over debt trading issues and the cost that would be incurred relative to the perceived benefits. A minority supported the use of off-line (after the fact) surveillance reports.

5. Retail Markets

The most prevalent theme in the Canadian fixed income markets based on our interview findings is that the institutional and retail fixed income markets differ significantly in terms of issues. The perception of a need for additional regulation, tailored for the retail market, to address such issues is widespread.

The concerns that were raised regarding the retail markets include:

- Suitability/sales practice issues for the retail investor,
- Concerns over unreasonable prices and/or unfair mark-ups, including lack of disclosure of mark-ups and commissions charged on retail bond sales,
- Lack of transparency in market prices, and
- Lack of understanding of debt markets, including pricing, trading mechanisms and investment risk associated with corporate bonds.

When interviewees were asked about the need to regulate different segments of the fixed income markets differently, the only area where people said separate regulatory frameworks are needed is in the retail markets, primarily in the area of sales practices. IDA Policy 5 is in place as a code of conduct to regulate trading in the wholesale debt markets. Of course specific regulation on conducting business with retail investors exists today, in terms of securities regulation, IDA rules and policies, and IDA member compliance policies and procedures. However, these standards were developed mainly in relation to equity market products and issues, and compliance programs focus mainly on them.

5.1 Suitability

Compliance officers noted that historically, suitability has not been much of an issue in selling debt products to retail clients. However, due to new factors, such as the decrease in government debt issuance and related increase in corporate bond activity, and the desire of retail investors to balance their portfolios with more debt content, suitability may become increasingly important. The institutional bond markets are made up of sophisticated investors who have the technical market knowledge to select appropriate investments to meet their needs and evaluate risk. The retail investor is generally much less sophisticated. The more retail investors invest in fixed income products, the more important suitability will become to the retail investor. With the advent of on-line brokerage services for fixed income products, retail participation is increasing.

For example, one retail investor indicated that bonds are seen as safe havens and uses them for retirement income. However, in the view of this retail investor, after seeing the price on one of his corporate bonds drop significantly, he does not feel that the risk of investing in corporate bonds was adequately explained or reflected in the interest rate on the bond. Additionally, reviews with his broker did not involve as much detail on the bond investments as on the equity investments. The impact of the price decline was increased by the fact that the retail investor does not have access to bond pricing information in order to monitor the price of his bonds and thus protect his own interests. The broker failed to notify this investor of the price decline in a timely manner.

This view was corroborated by one of the dealer respondents, who indicated that with the increase in the variety and complexity of bond products (e.g. foreign bonds) suitability is becoming more important for the retail investor. The retail investors said that to the extent that dealers offer investors advice on corporate bonds, they should be held to higher standards. Two interviewees with specific responsibilities for retail bond sales suggested that higher standards and training in the area of bonds and the debt markets would help to ensure Investment Advisors are better qualified to recommend bond investments to retail investors.

5.2 Price Transparency

Retail investors do not have access to any meaningful level of price transparency or comparative retail price information on bonds. They rely on the prices quoted by their retail brokers. As indicated above, retail investors generally cannot check the prices on bonds on a daily basis as they can with equities. This lack of price transparency contributes to the problem of lack of transparency on mark-ups to retail investors. Retail investors don't know the price of their bonds before the mark-up and therefore cannot determine what the mark-up or commission on their bond is. It also leads to problems with ongoing valuation of bonds owned by the retail investor. If the retail investor does not have access to ongoing price information, they cannot independently determine the market value of their bond investments and

Dealer compliance staff said that it is not necessary for a broker to call clients to advise them of changes in stock prices because clients can track them on their own, but clients cannot track fixed income prices because they are not readily available. Retail investors using on-line brokerage services often have access to prices of certain bonds, but they do not see prices across the whole market, just the price quoted by the dealer. Retail investors do not have general access to bid/offer quotes or trade prices in the market. (There is one ATS that is an exception to the extent that several dealers contribute to its prices.)

As retail participation in the bond markets increases, retail investors will be looking for the ability to obtain more timely valuations on their bond investments, such as end of day pricing. Access to timelier price information will help enable retail investors to safeguard their assets and take immediate action should the value of their bonds decline.

5.3 Mark-ups

Interviewees felt that mark-ups on retail bond sales may require some sort of regulatory intervention. A number of interviewees felt that the current mark-ups being charged are excessive. However, this was more a general impression than a case of having specific evidence. One retail investor interviewed indicated that he is not aware of what the mark-ups and/or commissions on bonds are. Another more sophisticated retail investor felt that mark-ups may be excessive because bonds are marked up at each stage of the transaction process and these mark-ups are not visible to the retail investor.

“There is no risk taken by dealers for the transactions in the retail markets, so why should the costs for retail investors be so high?”

From the perspective of the sell side, certain fixed transaction costs must be covered on the sale of a bond, regardless of the size of the sale, and these costs are covered by the mark-up. Therefore, on the sale of smaller denominations of bonds, these transaction costs account for a greater percentage of the cost of the bond.

Since retail investors do not have access to any meaningful level of price transparency, they cannot determine either the dealer’s inventory cost or the current wholesale price of a bond. Retail investors cannot determine the amount of mark-up or commission since trades are confirmed on a net basis and mark-ups and commissions are not disclosed to the retail investor. As a result, retail investors cannot effectively negotiate pricing or mark-ups.

Mark-up grids appear to be in place in a number of larger dealers to provide guidance on mark-ups to Investment Advisors. These grids provide a guideline on mark-ups and are not strictly enforced in-house. The firms generally centralize responsibility for monitoring mark-ups charged in comparison to the mark-up grids. However, grids were not being used in all dealers interviewed. The purpose of the mark-up grids is to communicate minimum, maximum and recommended mark-ups on bonds for Investment Advisors to follow. The suggested mark-ups vary based on the value and term of the bond. One interviewee also stated that his organization provides a choice to the retail broker of charging a commission or a mark-up.

“It’s important just to let the retail investor know that mark-ups are not regulated and show the retail investor the wholesale bid/ask vs. the retail bid/ask.”

Several compliance officers indicated that mark-ups are reviewed daily by the head of retail sales, the bond desk, or compliance and exception reports may be utilized. Mark-ups may also be reviewed via

retail branch reviews and retail compliance surveillance reviews that are intended to cover all client activity.

5.4 Best Execution

Retail investors are purchasing bonds from dealer inventory, and best execution duty is generally not addressed or considered to apply. Retail/wealth management interviewees indicated that there is always the option to go outside their own dealer to purchase bonds for retail clients, but practically speaking, this doesn't occur.

Some of the members' compliance representatives indicated that competition exists on the retail side as retail brokers need to provide the best priced products (yield) or the customers will go elsewhere or buy an alternative product, such as a GIC. Additionally, Investment Advisors may negotiate better prices for bonds on behalf of their clients. However, the principle of best execution is not complied with in the retail markets as bonds are expected to be sold from dealer inventory and as such, no real competition exists.

“Every dealer is a market, so an obligation to canvass other dealers for better prices doesn't exist.”

5.5 Complaints

Regulators indicated that complaints from retail investors are rare and when made generally concern suitability issues with respect to high-risk securities.

In the opinion of the dealers, complaints regarding debt market activities generally arise because retail investors do not understand the market and how bonds are priced. Some causes of complaints identified in the interview process included:

- Changes in bond ratings not being properly explained to retail clients,
- Bond mutual funds not being explained properly to retail clients (i.e. investors not understanding why they don't get 5% on the bond fund when the underlying bonds are paying 5%),
- Retail investors not understanding the risks associated with bond funds and income trusts, and
- Retail investors not understanding what they are paying to conduct a transaction (i.e. mark-ups and commissions).

Based on the above observations, interviewees suggested that increased transparency for the retail investor and some further investigation on the issue of retail mark-ups should be considered as part of this exercise.

“...the retail investor may be paying too much for corporate bonds and the average retail investor may not be holding a balanced portfolio that includes bonds due to the lack of price transparency.”

Summary

The issue of mark-ups and commissions on bonds for retail investors is an area at risk for abuse. The problem seems to stem primarily from the lack of price transparency to the retail investor. Interviewees recognize this and agree that the concerns over mark-ups should be examined further. It may be possible to encourage self-policing of mark-ups if the prices of bonds, and mark-ups/commissions are visible to the retail investor. However, just how to make prices transparent to the retail investor is an issue in itself.

In summary, the risk of abuse in the retail sector is materially increased by several factors, encompassing market structure, trading practices and sales compliance such as:

- Lack of transparency for retail investors,
- Lack of transparency for retail brokers,
- Lack of compliance with best execution duty,
- Lack of focus from compliance and internal risk management (see Compliance Reviews Section),
- Lack of focus in IDA regulatory activities (see Compliance Reviews Section).

6. The Complaints Process

The large dealers see the IDA's CMC as a useful forum to discuss issues and problems in the bond markets. Institutional clients generally do not raise issues to the CMC, according to members of this committee.

One institution interviewed had raised a complaint to the CMC, which addressed the issue by making a policy change. Apparently the matter was never referred to the IDA Member Regulation Department. After the CMC addressed the matter, the IDA failed to communicate its resolution back to the institution. This case and general feedback on the survey illustrates the lack of a clear process for handling institutions' complaints at the IDA. Suggestions that a better complaints process be instituted at the IDA were received.

Several respondents indicated that they turn to the Bank of Canada with a complaint before turning to the IDA. The Bank often receives the first call from market participants when there is an issue to be resolved in the market (such as complaints on repo transactions, complaints from individual traders, etc.). Market participants indicated that this occurs because the Bank is seen as independent, knowledgeable and consultative in their approach to resolving market issues. The IDA is seen as the voice of the large dealers and is used as a forum to engage the dealers in an issue.

One retail investor we spoke with was unaware of a process for complaints outside complaining directly to his broker or dealer. He was unaware that an issue could be taken to the IDA.

Summary

Market participants, in particular institutions, are not aware of any formal channels for communicating their complaints about fixed income markets, especially with respect to market integrity issues. The complaints process that exists is not transparent to market participants.

7. Derivatives

Very few interviewees commented on the derivatives market. Those that did comment indicated that one must be a sophisticated investor to deal in derivatives. It was also stated that bond market derivatives players are currently not being held to the same standard as the smaller cash players – it is a “buyer beware” environment. Derivative transactions can have an impact on the cash markets but the impact is only visible to players knowledgeable in the derivatives markets.

Certain market integrity issues were identified such as:

“...mini-manipulation may go on in the derivatives market in order to push prices up to the exercise price of derivatives contracts.”

“...dealers may attempt to influence spreads by widening spreads between similar Canadian and US bonds so that the dealer can obtain a greater profit on a client’s hedge when the position is rolled forward.”

One of the market committees suggested that Policy 5 be expanded to cover the derivatives markets.

Summary

Minimal feedback was received on the derivatives market and more research is required in this area.

Secondary Findings – Market Structure and Regulatory Approach

1. **Transparency in the Markets**

1.1 **Price Transparency**

Price transparency varies depending on the type of security and on the type of market participant. Government bonds are seen as having good price transparency, but the more illiquid the bond, the less price transparency that exists. The less price transparency, the more sophisticated the investor needs to be to participate in the particular market and the greater the potential for abuse in that market. Survey respondents noted problems with transparency in illiquid issues.

The consensus view, described more fully below, is to increase transparency incrementally to benefit the market in the long run, but without exposing the dealers to too much additional risk, which would likely hurt liquidity.

“As a general rule, when the bond is less liquid, as an investor, you need to be more sophisticated.”

“Essentially, the less liquid the bond, the more magnified any problems in the market get.”

“Publishing the prices on benchmark bonds would be okay but illiquid bonds are hard to price and are all over the map so trying to quote prices will be too confusing to the investor and often will be quoted in error (for example, the quotes they show in the Globe and Mail are often incorrect)”.

Transparency levels also vary based on type and size of participant. For the large dealers, for example, market prices are quite transparent due to access to the IDB market and a range of screens, in addition to information garnered by traders on the phone. Transparency levels diminish through various levels of dealers and institutional investors. At the other end of the spectrum, retail investors have access to minimal, if any, price transparency (as discussed in the Retail Markets section).

The need for increased price transparency was identified as one of the top concerns of about 25% of interviewees. A majority believe that transparency could be further enhanced without a negative impact on liquidity, although large dealers tend to be more satisfied with current levels. All participants agreed that increasing transparency must be carefully managed to gauge the impact on liquidity. Such an improvement in transparency would also result in improved market integrity and ability to self-police the market, and reduce the need for intrusive regulation.

Interviewees often stated that the optimal level of transparency was not necessarily full transparency and that small steps should be taken when increasing transparency so that the effect on the market and the dealers' risk positions could be measured, and to avoid potential damage to the markets by increasing transparency too much. This is particularly true for the corporate bond market, which is already viewed as an illiquid market.

1.2 CanPX and Price Transparency

Opinion is split 60:40 as to the usefulness of CanPX for providing price transparency to the markets. The large dealers are actually less confident than investors that CanPX displays accurate market prices. For instance, prices vary based on the size of order, but CanPX only shows a price for minimal size. If the price on the screen is better than what would be offered for the actual volume to trade, a market maker may be pressured to trade at or close to the price on CanPX, even though the CanPX price is based on a different volume.

Institutional investors and issuers applaud CanPX as being a good source of price transparency and say that market prices are less volatile with CanPX. They like the ability to compare the price a dealer will commit to, to the displayed price. Investors and issuers clearly find the information available today via CanPX much better relative to the situation prior to its introduction. However, statements were made that CanPX only provides partial visibility and may not reflect the current market on a security.

1.3 Volume Transparency

Displaying volume is seen as a barrier to trade. Both sides feel that the buy side will use the telephone market if they are required to disclose trade volumes via an electronic reporting system.

Summary

The market welcomes incremental increases in price transparency. Many market participants believe increases in transparency reduce the need for increased regulation as it makes participants' activity more visible. Incremental increases to transparency should be staged until the optimal level (not necessarily the maximum level) of transparency is reached. Participants oppose increasing volume transparency.

2. Market Liquidity

The top priority issue among market participants is a concern over liquidity in the Canadian debt markets. The Government of Canada bond markets are seen as liquid, provincials less liquid and most corporate bonds as illiquid. A number of interviewees stated that the bond markets are becoming commoditized and that the dealers are not putting as much capital into the market due to narrowing spreads and declining profitability. The increased consolidation in the industry is cited as one of the main causes for decreasing liquidity.

Nevertheless, in relative terms, liquidity in the Canadian market is seen as good given the limited size of the market in Canada compared to the US market. Several participants advocated a move towards increased transparency as a means of improving liquidity and trading volumes, as long as transparency is increased incrementally. On the other hand, a move towards increased regulation of the debt markets concerns many interviewees because they feel it would only serve to reduce liquidity as increased market scrutiny would lead to increased costs and decreased profits, and thus to decreased trading and decreased liquidity.

Summary

The priority of market participants is to maintain or improve the current liquidity in the Canadian markets. Liquidity is a concern even though it is considered fairly good given the relative size of the Canadian market as compared to the US market.

3. Market Structure and Innovation

The Canadian bond markets are dominated by a small group of large dealers or market makers. Some smaller dealers and certain others expressed concerns about the degree of market power exerted by the big market makers. They cited instances of anti-competitive action being taken by the large dealers which makes it difficult for other players and new entrants to gain entry to the market or to obtain the infrastructure needed to become one of the “inside players”. An example cited is that smaller dealers cannot gain access to certain ATSs and the IDBs because of the costs of entry and other requirements established by the major dealers.

“Big dealers tried to keep the small dealers from getting access to the screen because the small dealers don’t position.”

Several interviewees suggested that the development of CanPX was delayed because it was not in the competitive best interests of the large dealers and therefore, the large dealers through their dominant position in the IDA, erected barriers to the development of CanPX. One interviewee commended the OSC for finally pushing this initiative ahead. In contrast, the large dealers see the current market making system working well for customers.

An interesting comment made by about 25% of the participants was that the Canadian bond markets lack innovation in comparison with other markets, especially the US market.

“...the whole movement to “e” platforms has been slowed down by bank-owned dealers...”

A number of disincentives to innovation were noted. For example, consolidation in the industry reduces large dealers’ incentives to invest in innovation because they can maintain their dominant positions and profitability in the market without making such commitments. Those willing to invest in innovation would need to forecast a sizeable return on investment, but would need to break into the “inner circle” of dealers that dominate the marketplace in order to successfully capitalize on such investments. However, such comments contradict with major dealers’ commitments to ATS and their strategies for increasing automation.

One regulatory interviewee believes that the current regulatory structure in Canada has had a negative impact on innovation in the debt markets.

“The ATS rules, which were intended to be forward looking and helpful, turned out to be an impediment to the development of the market and actually make it more difficult to operate an ATS in Canada.”

Additionally, some participants, especially foreign entrants, feel that the regulatory burden in Canada is disproportionate to the perceived opportunity here because of duplication and overlap in the roles of the provincial securities commissions, which creates excessive complexity and regulatory costs.

Summary

Intermediaries and dealers outside of the bank-owned firms believe that the current market structure makes it difficult for smaller dealers and foreign entrants to compete in the market. According to some interviewees, regulatory barriers and the high degree of concentration in the marketplace have reduced competition and slowed innovation in the Canadian marketplace.

4. Regulatory Approach

4.1 Roles of Regulators in the Debt Markets

For the purposes of categorizing respondents and maintaining the confidentiality of responses, we have grouped the Investment Dealers Association, the securities commissions, the Bank of Canada and the Department of Finance as “regulators”. It is recognized that the federal institutions are not regulators, but they are widely viewed as important institutions in establishing market standards.

Investment Dealers Association of Canada:

The IDA is seen as the most knowledgeable regulatory body in the debt markets, however market participants, including IDA members, do not view the IDA as a proactive regulator of the bond markets. For instance, IDA compliance examinations do not focus on debt trading. The firms we spoke to do not remember being subject to a trade desk review, and traders say they have virtually no exposure to IDA staff.

Survey respondents described the IDA’s current regulatory approach as reactive, with complaints and issues addressed only as they arise. Problems appear to be dealt with from a policy, as opposed to a regulatory, point of view – for instance, through discussion at the CMC.

Members are split on the IDA’s approach: most agree that the IDA’s mandate is not to act as a hands-on market regulator, and do not see a need to change its mandate significantly. On the other hand, the majority feel the IDA should increase its presence in the market and that its regulatory activities should address the fixed income market.

Ten respondents made comments specifically about the conflict of interest between the IDA’s SRO responsibilities and its industry association status. Institutions and small dealers feel the IDA needs to do a better job of managing this conflict. The large dealers see the IDA as quite effective in its role as currently defined.

In spite of these concerns, 75% of those interviewed who have an opinion on the matter, believe the IDA would be the most suitable regulatory body to regulate the debt markets in Canada if or to the extent that expanded market regulation is needed. The consensus however, is not to expand regulation. The main

strengths of the IDA are that the organization understands the market, and that it is a national body. (It is not a recognized SRO in Quebec but nevertheless plays an active role there.)

Bank of Canada (“the Bank”):

The Bank of Canada is almost universally well respected amongst bond market participants for its market knowledge and consultative approach, as well as ongoing communication with traders and executives in keeping track of market activity and trends. The Bank’s market monitoring activities rely significantly on this two-way communication and relationships with participants. The Bank conducts market research, closely monitors market activity and developments and applies their knowledge and understanding to help solve market problems. Almost all market participants feel comfortable turning to the Bank as the first resource when issues arise in the market. While the Bank is interested in overall market trends and any unusual activity or market issues, their focus is naturally on the market for Canada bonds.

Department of Finance (“Finance”):

For the purposes of this survey, the Department of Finance is considered in terms of its oversight responsibilities for the Canadian debt markets and not in its role as issuer. Finance maintains an interest in the Canadian fixed income markets similar to that of the Bank, but its presence is less visible. Interviewees did not have regular dealings with Finance, and hence do not see Finance as a major influencer.

The Bank and Finance rely heavily on informal and “behind the scenes” actions, namely moral suasion, to address problems such as market integrity concerns. Consequently, the regulatory process can appear discretionary; it lacks clarity in the rules and transparency in the process. Some market participants feel this approach favours the major market players.

Canadian Securities Administrators:

Apart from the transparency and ATS initiatives, respondents do not feel the commissions play a visible role in the markets. People consider their job mainly as protecting the retail investor. The commissions are not considered to be knowledgeable or experienced in the debt markets. A comment heard frequently is that the CSA has attempted to apply equity market principles to the debt markets.

Many interviewees expressed concerns about the CSA’s failure to consult other stakeholders adequately when addressing issues and developing proposals. However, it was noted by some that the CSA is now striving to be more consultative with the market.

4.2 Regulator Best Suited to Take on Lead Role as Regulator for the Debt Markets

The survey asked what regulatory body is best suited to take a lead role as regulator for the debt markets. A majority of respondents (2/3 of those who provided a direct response) favour the IDA as the primary front-line regulator of the debt markets, if an organization is to be designated to perform additional market regulation services. The two main reasons given to support this view were:

- The IDA is a national organization, and
- The IDA understands the debt markets.

The direct involvement of participating firms in the IDA’s process was mentioned as a significant source of expertise and practical solutions to problems. A few interviewees favoured the Bank or the CSA for the lead role, but acknowledged this wasn’t really practical for various reasons.

A number of participants, especially on the buy side and among small dealers, stated that the IDA must deal with its conflicts of interest in order to become an effective regulator of debt markets. Comments in this area suggested that the IDA has not recognized these conflicts in its processes for handling debt market issues; i.e. there is a perception that its industry association and regulatory policy functions are not separate with respect to debt markets.

It was generally recognized that the CSA, the Bank of Canada and the Department of Finance should continue to be involved in market regulation issues as each has a useful role to play in this area.

The majority of participants and regulators expressed concerns over standards of investor protection for retail investors, and recognized that regulation of the retail side of the bond markets may need to be enhanced. Since the IDA plays the primary front-line role in retail sales compliance, this view reinforces the preference for relying on the IDA to carry out any expanded supervision. The issues surrounding this are discussed in more detail in the Retail Markets section of this report.

4.3 Self-Policing Mechanisms

Over 85% of those who responded indicated that the wholesale debt markets in Canada are largely self-policing and that this mechanism is reasonably effective for regulating the markets. These respondents represent all parts of the institutional fixed income market, including buy side accounts. The only dissenting views on this model came from smaller dealers in the market, which is likely a function of their size – the larger the participant, the greater the ability to employ a self-policing approach by “punishing offenders” by withholding business. Many of the buy side accounts reported withholding business from one or more dealers in the past, but it is not a regular occurrence.

Consolidation in the industry is seen by some as facilitating the self-policing regulatory model in that the fewer the players, the easier it is to identify unethical behaviour in the market because the actions of all players are more visible. In addition, activity is concentrated with major intermediaries that employ advanced risk management and compliance programs. Increased transparency for the wholesale market is also considered to facilitate the effectiveness of self-policing, by making trading activity more visible.

4.4 Regulatory Approach to the Debt Markets

Market participants and the majority of regulators (as defined for this Report) are satisfied with the current regulatory approach to the debt markets. Market participants do not feel sufficient market integrity issues exist to warrant increased regulation. Concerns are widespread over the increased regulatory burden and costs that would flow from the adoption of additional rules and regulatory monitoring and oversight. During interviews, people frequently commented that they did not see any issues or problems that would justify expanded regulation.

In response to the question of whether the current scope of regulation is about right, the majority agreed that it is. A minority stated that improvements could be made. No one felt the markets are over-regulated and only two said they are under-regulated. Several regulators support the position of market participants and view the fact that very few complaints are received from the markets as a sign that all is well. Certain regulators do not support the adoption of new regulations until a persistent problem arises in the market that must be addressed, based on the belief that additional regulation can have unintended consequences for the efficient functioning of the markets and may unnecessarily increase the cost of regulation.

Even those who expressed greater concern about the fairness of the market did not view regulation as an effective response, preferring to rely on structural improvements such as greater transparency and encouraging competition and innovation.

One regulator indicated that the dearth of complaints might be due to the lack of transparency in the market combined with the absence of a central database of prices to compare transactions to.

4.5 Improving the Regulatory Process

Respondents suggest that the current regulatory approach could be improved through:

- Increased consultation with the market participants
- Increased understanding of the debt markets among the securities commissions, and
- Increased contact among the regulators and the dealers.

The last suggestion is primarily aimed at increasing the IDA's involvement with the markets and dealers. Three dealers and two of the committees interviewed specifically suggested that the IDA visit dealers more and take on a more proactive role in keeping tabs on the markets. They also feel the IDA should increase monitoring of compliance with current regulations and rules, and solicit feedback from the market on their performance as a regulator.

4.6 Regulatory Structure in Canada

A prevalent theme expressed by interviewees is their dissatisfaction and concern with the current fragmented regulatory structure in Canada. They are frustrated with duplication and overlap among the provincial securities commissions and strongly favour a national regulator. Interviewees felt that the current regulatory structure in Canada adds costs and complexity to operating in Canada (for example, in the areas of reporting and registering). If one provincial commission signs off on compliance or approves a registration, there is no guarantee that the other provincial commissions will follow suit. This can serve as a barrier to entry and at a minimum increases costs of entry.

A number of respondents commented that the burden is higher for innovative new businesses such as TradeWeb because the practical application of new regulations, such as the ATS rule, is unclear and subject to multiple interpretations. Many see TradeWeb's departure as illustrative of problems with the system.

4.7 Enforcement

Several interviewees stated that market regulation would benefit from increased enforcement action when serious violations are identified. These people view informal and non-public remedies and sanctions as inadequate responses to issues such as market manipulation. Failure to take strong action when "real issues" arise encourages a lax approach to compliance, in their perception.

"The problem in Canada is that there are no criminal charges involved when you break the regulations – you just pay a fine and you're back in business."

"To date there is very little or no disciplinary action on debt trading (e.g. wrist slapping). The OSC is the one who has the disciplinary power but doesn't have the knowledge."

The individual dealers have disciplined their own people but not the IDA. Serious violations should be dealt with seriously.”

“We need a regulator with the standing machinery and penalizing power to punish those parties that violate.”

4.8 Regulatory Burden¹

The cost of additional regulation is a concern for many debt market participants; for example, if action is taken as a result of this project to increase regulation of the debt markets. The cost of additional regulation refers not only to the direct implementation and operational costs that would be incurred, but also the negative impact on liquidity in the market and the number of players in the market. Essentially, the view appears to be that higher regulatory scrutiny and costs will lead to reduced trading and profitability, leading to decreased liquidity and market efficiency.

In addition, the risk of over-regulation was often cited as a regulatory risk, because of the detrimental effects it may have on the market such as reducing liquidity and driving business out of the country.

“...there is a need to have a quantitative economic analysis (cost/benefit analysis) done of any proposed change to regulation and any regulation should be based on market based incentives rather than be prescriptive regulation.”

Summary

The IDA is seen as a knowledgeable but not proactive regulatory body in the debt markets. The Bank of Canada is highly respected for its knowledge of the debt markets and consultative approach to addressing issues and helping to solve market problems. The Department of Finance is seen in much the same light as the Bank, however, much less involved directly in the debt markets. The CSA are seen as having little knowledge and experience in the debt markets.

The current regulatory approach is reactive rather than proactive and principles-based rather than prescriptive. This approach is supported in concept by most regulators and most market participants. Most interviewees do not see a need to change the current regulatory approach to the bond markets (although specific improvements were suggested). The market’s self-policing mechanism is considered to be reasonably effective.

Market participants feel that increased, unnecessary and costly regulation will have a negative impact on liquidity and that a cost/benefit analysis of proposed regulation should be performed prior to introducing additional regulation.

According to the majority of respondents, the IDA is the regulatory body best suited to take on any increased regulatory role in the debt markets, if it is determined that more regulation is needed. The fact that Canada currently lacks a national regulator for the capital markets is viewed as a major concern by

¹ Note: A report by Conference Board of Canada is expected to be released in September regarding the cost of regulation of the debt markets in Canada and should be consulted when released.

market participants. Some participants would also like to see increased enforcement of current regulations.

5. ***Jurisdictional Issues***

The issue of whether the rules and principles set out in Policy 5 should apply to institutions trading in the wholesale markets, as well as to member dealers of the IDA, arose in discussions with survey respondents. Some representatives of dealers are of the view that standards of conduct imposed on participants should apply equally to all participants in the wholesale markets, especially since dealers act primarily as principal, not as agent.

However, all recognize that the jurisdiction of the IDA is limited to its member firms, and that any proposal to extend its jurisdiction to non-member participants such as institutional investors would raise complicated issues, including the question of whether the IDA would be the appropriate regulatory body to fulfill such a role. Most participants felt that the IDA could not assume jurisdiction over non-dealers without making fundamental changes to its organization and governance structure, including addressing the perceived conflict of interest between its role as an industry association and its role as a self-regulatory organization.

“The IDA needs to increase their responsiveness to the concerns of institutional accounts.”

“The buy side would need input into the IDA governance structure.”

Respondents noted that the IDA’s role as a self-regulatory body in the Over-The-Counter (“OTC”) debt markets is different than a regulator of a centralized market like an exchange. The IDA is regulating the dealer participants in the market (as well as firms performing an agency broker role), as opposed to a central marketplace. As such, its regulatory mandate and activities are different – the rules apply mainly to dealers’ conduct. A full-fledged code governing the operation of the marketplace does not exist.

“As long as the IDA is responsible for member regulation, then things work well, but if they deal with market regulation, the IDA’s role would be far more compromised and conflicted.”

Summary

In considering the issue of how all participants in the debt markets might be regulated in a comprehensive manner, survey participants noted two jurisdictional or conflict issues the IDA would face if it were asked to perform such a role. If the IDA were to regulate institutional clients’ compliance with market conduct rules, governance and jurisdictional issues would arise. Secondly, similar issues would arise if the IDA were to regulate electronic debt markets, which could extend the IDA’s role from “member regulator” to “market regulator”.

6. ***Regulatory Arbitrage***

At the outset of the project, the issue was raised as to whether intermediaries could avoid provincial securities regulation by the CSA and/or IDA regulation of its member firms by moving trading activities from securities dealers into federally regulated institutions. The issue pertains mainly to the banks, which carry on securities-related activities in both the bank and a dealer subsidiary. If jurisdiction shopping did occur, the result would be regulatory arbitrage that would limit the effectiveness of efforts to enhance market regulation.

Very few survey respondents are concerned about regulatory arbitrage. The general view is it is quite unlikely that trading activities would be moved simply in order to circumvent regulatory requirements. In any event, certain banks carry out many fixed income market activities within the bank itself today. Capital requirements, but not securities regulation, are currently a factor in locating capital-intensive operations. One of the market committees interviewed did indicate that trading activities could be moved if costly and excessive regulations were adopted.

As a practical matter, it is important that Policy 5 has the backing of federal regulators. This backing has legal force in the terms of participation for Government of Canada auctions, which require adherence to the code of conduct in Policy 5 for Government Securities Distributors. The Bank of Canada and the Government may impose sanctions for violations, as stipulated in the document. It appears that similar backing from federal regulators or other arrangements would be necessary if additional market regulation requirements are introduced at the SRO level.

Although capital requirements are the driving force behind decisions to locate certain debt trading or inventory positions in federally-regulated institutions, other factors such as SRO sales compliance issues relating to suitability requirements and registration requirements may be factors too, to the extent that these requirements are applied only to registered securities dealers.

Summary

Practically speaking, the risk of dealers avoiding market regulation by moving trading activities into affiliated banks is low. To the extent that such activities are housed there, it appears that the banks would need to agree to be bound by any new IDA requirements, in a similar fashion to Policy 5.

2. Explain your overall impression of the market integrity (i.e. fairness or ethics) of the debt markets in Canada.
3. In your view, should different segments of the debt market be regulated differently? Please explain why or why not. (Institutional vs. retail, corporate vs. government)
4. What incentives exist to trade debt securities in one part of your organization as compared to another?
5. If there is identified to be a need, do you think administrative arrangements or agreements could be made to ensure uniform regulation of the debt markets across all participants? By whom and covering what areas? Please explain.

Trading Activities

6. In your view, what works well about the Canadian debt markets? What doesn't?
7. Are there any issues or practices related to government and corporate bonds in the debt markets that concern you?
Can you provide specific examples?
Have you encountered these things directly or have you witnessed them?
How often do these practices occur?

Prompts for Questions 7: [raise each in turn]

Trading practices (presence of deceptive or manipulative practices?)

Transparency – in terms of both price and volume (sufficient or lacking) [purpose – relates to CanPX, are there any issues in the market caused by or related to transparency?]

Frontrunning of client orders

Client confidentiality (failure to maintain it?)

Retail Trading Only

Allocation of fills among clients in the secondary market (equitable?)

Priority to client orders in the secondary market

Honouring quoted prices

Price mark-ups (wholesale? retail?)

Best execution obligation (acting as agent)

Compliance and Regulators Only

Quality of records of orders and trades (audit trail)

Quality of compliance policies and procedures (by regulators, firms)

Quality of compliance monitoring and review (by regulators, firms)

Supervision of trading desk

Appropriateness and effectiveness of current regulatory requirements

Regulation

8. Are you familiar with the IDA's current policies and regulatory activities relating to the debt market?
Are you familiar with the roles of other regulatory bodies in the regulation of the debt market?
Primary auction and secondary trading?
9. From a risk management standpoint, what would you say are the major/significant regulatory risks in the debt markets today?
10. How do you manage these risks? In your opinion, how prepared is the industry to manage these risk and why?
11. Generally, what is your impression of the IDA's role in regulating the bond markets? Explain how effective their regulatory requirements are?
12. Generally, what is your impression of the OSC's (or other Provincial Securities Commission as applicable) role in regulating the bond markets? Explain how effective their regulatory requirements are?
13. Generally, what is your impression of the Bank of Canada's role in regulating the bond markets? Explain how effective their regulatory requirements are?
14. Generally, what is your impression of OSFI's role in regulating the bond markets? Explain how effective their regulatory requirements are?
15. What is your opinion of the scope and the quality of regulatory oversight of the debt markets by each regulator mentioned above?

Prompts:

Too little / too much?
Focus of oversight?
Effective monitoring, surveillance and enforcement?

16. How familiar are you with IDA Policy #5?
(i.e. never heard of it, know of it, read it, know its contents well).
17. How has your organization implemented the guidelines specified in Policy #5? How do they monitor compliance with Policy #5?
18. How sufficient is Policy #5 for regulating the debt market trading? Why?
19. In your view, what improvements to Policy #5 are needed, if any? (*Note: refer back to the problems or issues that they raised previously, if any.*)
20. What additional steps, if any, do you think regulators should take to ensure the proper functioning of the market and to prevent against the issues and risks raised above (if any)?

21. Do you think market surveillance of debt market trading is needed or would be beneficial? Please explain why or why not.
If you think market surveillance is needed, what approach would be most effective?
(For example, on-line surveillance, real time, off-line review of exception reports, spot checks, regular trade desk reviews.)
22. In your view, what regulatory body is best suited to take a lead role as regulator for the debt markets? Why?
23. Is there anything else you feel we should know?

Specific Stakeholder Questions

Regulators Only:

1. Please explain your regulatory role. Where does your jurisdiction come from? What is your mandate?
2. What is your exposure to the debt markets and what work do you do in the debt markets?
3. To your knowledge, have the regulators developed or discussed potential solutions to ensure uniform regulatory standards apply in the debt markets?
4. In order to ensure uniform regulatory standards apply to all debt market participants, do you think it is important to co-ordinate the regulation of debt market participants? In what areas? Could/should the regulation of all debt market participants be subject to the oversight of one regulator?
5. In your opinion, who should be the regulator(s) on the debt side?

Compliance Only:

1. Are there specific types of issues or concerns in the debt markets that you are aware of or that you feel need addressing given your compliance background?
2. What are the major kinds of complaints your firm receives about the debt markets side of your business? Approximately how many complaints do you get annually in this area? From whom?
3. How does your organization supervise its bond trading desk?

Issuers Only:

1. Are investors in debt securities adequately protected by the existing regulation of the market?
2. Are there any practices in the market that affect the liquidity or trading of your bonds?

APPENDIX 2

IDA Policy 5



**Investment Dealers Association
of Canada**

Policy No. 5

***Code of Conduct for
IDA Member Firms Trading
in Domestic Debt Markets***

March 2002

IDA CAPITAL MARKETS COMMITTEE

Chairman

Phipps Lounsbery
Managing Director,
Debt Marketing Group
CIBC World Markets Inc

Mark Caplan
Executive Managing Director,
Capital Markets
BMO Nesbitt Burns Inc.

Roger G Casgrain
Executive Vice President
Casgrain & Company Ltd.

David Page
Director
Deutsche Bank Securities Ltd.

Kenneth Knowles
President & CEO
JP Morgan Securities
Canada Inc.

Donald Paterson
Managing Director
National Bank Financial Inc.

Richard Van Nest
Managing Director,
Institutional Bond Trading
RBC Capital Markets

John Madden
Managing Director
Scotia Capital Inc.

Loretta Marcoccia
Director, Debt Markets
Merrill Lynch Canada Inc.

Mark Wisniewski
Managing Director
Global Sales Head
TD Securities Inc.

Jon Cockerline
Director, Capital Markets
Investment Dealers
Association of Canada

IDA PRIMARY DEALER MONEY MARKET COMMITTEE

Chairman

Gregory P. Smith
Managing Director, Money Market Global Trading
Scotia Capital Inc.

Gaston St. Georges
Money Market Manager
BLC Valeurs Mobilières Inc.

Michael Edey
Manager,
Money Market Division
National Bank Financial Inc.

Ian Currie
Vice President,
Debt Capital Markets
BMO Nesbitt Burns

Peter Dymott
Managing Director,
Money Markets
RBC Capital Markets

Natalie Davidson
Managing Director,
Global Capital Markets & Debt Capital Markets
CIBC World Markets Inc.

Martine Irman
Managing Director, Global Foreign Exchange &
Money Market
TD Securities Inc.

David Nicholls
Vice-President,
Money Markets &
Derivatives
Deutsche Bank Securities Ltd.

Jon Cockerline
Director, Capital Markets
Investment Dealers
Association of Canada

Craig P. Aubrey
Senior Vice-President & Director, Fixed Income
Merrill Lynch Canada Inc.

The Investment Dealers Association is Canada's national self-regulatory organization for the securities industry. The Association regulates the business activities of securities firms dealing with the public, and the selling practices and proficiency requirements of registered Investment Advisors. The Association is also the trade association of the Canadian securities industry and represents the interests of IDA member firms to legislators, regulators, government officials, the Bank of Canada and the general public. In carrying out its regulatory and trade association mandate, the Association plays a constructive role in promoting the liquidity and integrity of Canada's capital markets.

IDA Policy No. 5, the code of conduct for dealing in domestic debt markets, will make an important contribution to the federal Department of Finance and Bank of Canada initiatives to maintain the integrity of Canadian fixed income markets. The development of Policy No. 5 is an example of how the IDA can integrate its self-regulatory responsibilities and industry expertise to produce effective regulation for the benefit of issuers and investors in capital markets.

2 January 2001

PREFACE

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. The initiatives included new rules for bidding at Government of Canada securities auctions and an increase in the Bank of Canada's monitoring activities in the Government of Canada debt market '*Proposed Revisions to the Rules Pertaining to Auctions of Government of Canada Securities and the Bank of Canada's Surveillance of the Auction Process – Discussion Paper 2*' and a revised Terms of Participation agreement '*Proposed Terms of Participation in Auctions for Customers*' for Primary Dealers and Government Securities Distributors.

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 declining issue size, the Investment Dealers Association worked closely with the Bank of Canada and Department of Finance to develop a formal code of conduct for dealing practices in domestic debt markets. This code of business conduct, embodied in IDA Policy No. 5, would apply in principle to all participants in domestic markets and is designed to be an integral part of the federal initiative to safeguard the liquidity and integrity of domestic markets.

The IDA Board of Directors voted on 30 June 1998 to implement IDA Policy No. 5 and on September 25 the Ontario Securities Commission formally approved the Policy for use at IDA member firms, pursuant to the procedures required for recognized self-regulatory organizations in Ontario.

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

The policy was prepared by a sub-committee of the IDA Capital Markets Committee and Bank of Canada Jobber Committee chaired by Jerry Brown, Managing Director, Salomon Smith Barney Canada Inc. In developing IDA Policy No. 5, the sub-committee referred to similar regulatory documents in other jurisdictions, such as *The London Code of Conduct* (Bank of England), *Principles and Practices for Wholesale Financial Transactions* (Federal Reserve Bank of New York and Public Securities Association), and compliance policies and procedures manuals prepared by individual IDA member firms.

In December 1999 the Investment Dealers Association was requested to clarify the practices and procedures for the disclosure of confidential information in connection with public offerings of government debt securities. After thorough review of the responsibilities of member firms participating as syndicate members in public debt offerings, the IDA Capital Markets Committee agreed that formal clarification of the confidentiality requirements of a member firm was warranted and, as a result, the Committee developed a specific confidentiality rule related to material information provided to syndicate members in public debt offerings.

IDA Policy No. 5 was amended by including a new provision in the Policy, Section 2.4(i), stipulating that information provided in confidence by an issuer to a member firm must be kept confidential. This amendment to IDA Policy No. 5 was passed by the IDA Board of Directors and subsequently

approved by the Ontario Securities Commission in December 2000 in accordance with the requirements for a recognized self-regulatory organization.

In March 2001 the Investment Dealers Association reviewed the surveillance requirements of the Policy, particularly the examples of situations that could signal manipulative activities and the process for alerting regulators to the existence of non-functioning markets. Section 5.2 was rewritten and approved by the IDA Board of Directors in October 2001 and approved by the Ontario Securities Commission in March 2002.

Interested parties with questions or comments on any aspect of IDA Policy No. 5 should contact Jon Cockerline, Director, Capital Markets, Investment Dealers Association of Canada (416-943-5787).

INVESTMENT DEALERS ASSOCIATION
OF CANADA

POLICY NO. 5

TRADING IN DOMESTIC DEBT MARKETS

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1. **GENERAL**

1.1 **Purpose**

This Policy No. 5 of the Investment Dealers Association of Canada is intended to describe the standards for trading in wholesale domestic Canadian debt markets expected of Members of the Association, their affiliates and the customers and counterparties with whom such Members deal. The Policy has been developed in consultation with the Bank of Canada and Department of Finance (Canada). The purpose of the Policy is to promote public confidence in the integrity of Canadian debt securities markets and to encourage liquidity, efficiency and the maintenance of active trading and lending in such debt markets.

1.2 **Application**

This Policy applies to Members of the Association and all related companies of Members. Affiliates of Members (other than related companies as defined in the Rules), customers of Members and counterparties with whom Members deal are not legally subject to the terms of the Policy; however, aspects of the Policy anticipate the co-operation of affiliates and customers, i.e. in reporting and certain disclosure, and Members are expected to conduct their business in a way that will encourage compliance by affiliates, customers and counterparties with the Policy to the extent applicable. For the purposes of the Policy, the term “affiliates” refers to organizations who can reasonably be viewed as having a common business interest with a Member in respect of trading in the Domestic Debt Market. In addition, the Policy, or some or all of the principles and practices reflected in the Policy, may be subscribed to or recognized by non-Members, other associations and regulatory or governmental bodies.

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 or related company to sanctions pursuant to the enforcement and disciplinary By-laws of the Association. These sanctions are in addition to any recourse or actions taken by other authorities including the Bank of Canada, the Department of Finance (Canada) and provincial securities commissions having jurisdiction.

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.

1.3 **Association and other Regulations, Laws, etc.**

The Policy is intended to supplement, and not to replace or modify, applicable statutes, governmental regulations, exchange or self-regulatory organization rules and codes of conduct, including the other Rules of the Association. Notwithstanding the foregoing, in the case of any inconsistency between the terms of this Policy and any other Rules of the Association, the terms of this Policy will prevail.

The specific requirements of the Policy may also be referred to and relied upon by the Association, its staff, Board of Directors, District Councils and their committees in determining compliance with other Rules of the Association.

1.4 Definitions

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

“Applicable Laws” means the common law of any jurisdiction in which Members and their affiliates trade in the Domestic Debt Market, any statute or regulation thereunder, 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 affiliates, customers and counterparties.

“Domestic Debt Market” means an over-the-counter, 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, fixed income or derivative securities issued by any government in Canada or any Canadian institution, corporation or other entity and includes, without limitation, repo, security lending and other speciality 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. FIRM STANDARDS AND PROCEDURES

2.1 Policies and Procedures

Members should have written policies and procedures relating to trading in the Domestic Debt Market and the matters identified in this Policy. Such policies and procedures should be approved by the board of directors of the Member or an appropriate level of senior management and be available for review by the Association. The policies and procedures must be established and implemented by senior management including periodic review to ensure that they are appropriate to the size, nature and complexity of the Member’s business and 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 adopted pursuant to paragraph 2.1 to ensure that trading in Domestic Debt Markets by the Member is in accordance with Applicable Laws and this Policy.

2.4 **Confidentiality**

(i) Offerings in Public Markets

In offerings of debt securities in domestic public markets, Members shall ensure material information provided by the issuer, which is provided to them in confidence, is kept on a confidential basis. Except with the express permission of the issuer concerned or as required by Applicable Law, the Rules or this Policy (including requests for information or reporting by the Association or by the Bank of Canada), Members and their employees in possession of material confidential information related to the course of action of a forthcoming public offering shall not disclose or discuss or act upon, or request that others disclose or discuss or act upon, this material information with any customer or counterparty.

(ii) Dealings in Secondary Markets

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, the Rules or this Policy (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 should 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, confine trading to restricted office areas and designated personnel and encourage the use of secure 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 maintain adequate resources and operational systems and safeguards to ensure that their trading activities in the Domestic Debt Market can be 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

Regulation 1300.1 of the Association requires that Members use due diligence to learn the facts relative to every customer to ensure that the acceptance of any order is within the bounds of good business practice and to ensure that recommendations are appropriate for customers and their investment objectives. This Regulation is supplemented by the Policies of the Association and applies to Members dealing with all customers who trade in the Domestic Debt Market.

3.2 Conflicts of Interest

Good business conduct as referred to in section 4 of this Policy 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 fulfilment 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.

3.3 Application of Policy to Customers and Counterparties

While this Policy applies directly to Members and their related companies and their respective personnel, the standards and principles of good practices and fairness reflected in the Policy are those which can be expected of all participants in the Domestic Debt Market. Accordingly, it is intended that dealings between Members, their related companies, affiliates, customers and other counterparties shall 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 should not condone or knowingly facilitate conduct by their affiliates, customers or counterparties which deviates from this Policy and its purpose of promoting public confidence in the integrity of the Domestic Debt Market. Subject to Applicable Law, 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 is expected under the surveillance requirements of this Policy.

4. MARKET CONDUCT

4.1 Duty to Deal Fairly

By-law 29.1(i) of the Association requires that Members shall observe high standards of ethics and conduct in the transaction of their business. This requirement imposes on Members significant responsibilities to the extent that they deal in the Domestic Debt Market which is over-the-counter and not generally subject to the rules and discipline of organized or exchange markets. Participation

by Members in the Domestic Debt Market requires that Members act fairly, honestly and in good faith when marketing, entering into, executing and administering trades in the Domestic Debt Market.

4.2 Public Interest

By-law 29.1(ii) of the Association requires that Members shall not engage in any business conduct or practice which is unbecoming or detrimental to the public interest. Liquid and efficient Domestic Debt Markets are of critical importance to Canada and Members are expected to conduct themselves in a manner that is consistent with that public interest.

4.3 Manipulative Practices

Members should not engage in any trading practices in the Domestic Debt Market that constitute fraudulent, deceptive or manipulative acts or practices as determined in accordance with any Applicable Laws or under the Rules of the Association or this Policy.

4.4 Bribes, Illegal Payments, etc.

By-law 29.6 of the Association prohibits Members or their personnel or shareholders from giving, directly or indirectly, any benefit or consideration to a customer, or its personnel or associates, in relation to the business of the customer, without the prior written consent of the customer. In addition, Applicable Laws may make it an offence to offer bribes or other kinds of payments or consideration in respect of the conduct of certain activities. The policies and procedures of the Member should describe the standards of conduct required for Members and their personnel.

4.5 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 Department of Finance (Canada) whether or not such directives or requirements are binding or have the force of law.

4.6 Misrepresentations and False Remarks

A Member should not spread, or acquiesce or assist in the spreading, of any rumours or information that the Member knows or believes, or reasonably ought to know or believe, to be false or misleading. In addition, a Member should not disseminate any information that falsely states or implies governmental approval of any institution or trading.

4.7 Market Conventions and Clear Communication

Members should use clear and unambiguous language in their trading activities particularly in 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 should, prior to engaging

in any trading, familiarize itself with that type of trading's terminology and conventions. Members should ensure that customers understand the unique features of the relevant markets and products. In addition, no Member should abuse deliberately market procedures or conventions to obtain an unfair advantage over, or to unfairly prejudice, its counterparties or customers.

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 laid out in this Policy are achieved. Due to the nature of the Domestic Debt Market, Members and their affiliates have the responsibility to self-monitor their conduct. In this regard, Members should 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. Alleged breaches of the Policy should be reported to senior officers of the Association or the Bank of Canada by the executive responsible for the debt operations of the Member. In addition, the Association's own investigative powers and resources will be applied to review market activity in order to identify irregular conduct.

As part of the surveillance, the Association may require the Member and their affiliates 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 inventory holdings of securities that could have allowed a Member to have undue influence or control over the Government of Canada, provincial or corporate debt markets.

The circumstances that could trigger a request for Members to file a Net Position Report include all activities deemed to be detrimental to the liquidity and integrity of the Domestic Debt Market. Market integrity concerns may be manifested in any one of, but not limited to, the following ways: an unusual concentration of holdings in certain outstanding securities, whether directly by a Member or in concert with others (holdings which exceed 35 per cent of the outstanding supply may be one example of unusual concentration); an unusual differential in the traded yield between issues of securities of similar maturity; an unusual gap between the repo rate and the overnight rate for the same type of securities for a sustained period of time (a gap greater than 200 b.p. may be one example of an unusually large differential); or unusual trading volumes in particular securities. The foregoing are only examples of circumstances where reporting may be required or investigations instituted; they are not intended to define thresholds of acceptable conduct or practices. Reporting may be required or an investigation instituted if, in any particular situation, the principles and standards of this Policy have, in the opinion of the IDA or the Bank of Canada been contravened.

The results of a Net Position Report, and associated information requested to clarify individual Member's reports, will be used to determine whether any follow up investigation is required. The

Association and the Bank of Canada will base this decision on whether large holdings of securities reported in the Net Position Report had been used to influence market direction for the Member's gain in a manner detrimental to the liquidity and integrity of the Domestic Debt Markets. The Association in collaboration with the Bank of Canada will promptly inform Members of the results of the Net Position Report survey and whether an investigation will proceed.

5.3 **Sanctions**

The disciplinary Rules of the Association provide for a wide range of sanctions against Members and their personnel who are in breach of the Rules including this Policy. Such sanctions include fines of up to \$1,000,000 per offence or (in the case of a Member) triple the amount of the benefit from the breach, reprimands, suspension or termination of approval or expulsion. Notice of such sanctions shall be given to the public or other government and 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 commissions 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.

5.4 **Other Public Authorities**

The Domestic Debt Markets and trading by Members and their affiliates, customers and counterparties in such markets may be subject to, or affected by, other government or regulatory authorities in Canada and elsewhere including both the Bank of Canada and the Department of Finance (Canada). The Association expects to co-operate with such authorities in connection with the monitoring and regulation of the Domestic Debt Markets and the conduct of Members in them. Likewise, it is expected that Members will co-operate with the Association and other such authorities in maintaining the integrity of the Domestic Debt Markets and the standards required of Members in connection with this Policy, the Rules of the Association and Applicable Law. Such co-operation will include, but not be limited to, compliance with the reporting and position limits of the Bank of Canada and any directives of the Bank or any requirements for voluntary action.

To the extent that this Policy refers to any government or regulatory authority other than the Association, the effect or interpretation of such reference shall be restricted to matters within the jurisdiction of such authority. In particular, to the extent that this Policy refers to the Bank of Canada or the Department of Finance (Canada), the Policy relates to Government of Canada securities only. Nothing in this Policy shall derogate from the authority of the Association under its rules or Applicable Law.

**Investment Dealers Association
Net Position Report
for Government of Canada Securities**

In compliance with Section 5.2 of Policy No.5 Code of Conduct for IDA Member Firms Trading in Domestic Debt Markets, please submit your net positions in the following security:

Name of IDA Member: _____

Security (ISIN/CUSIP): _____

Maturity Date: _____

Position as of the close of (date): _____

Government of Canada Security (par value, \$ millions to one decimal point)	Net Position
Trading Position:	
a. Cash holdings	
b. When-issued positions	
c. Forward contracts	
d. Futures contracts that require delivery of the specific issue	
e. Holdings of the residual component of a stripped security	
f. Options contracts that require delivery of the specific issue weighted by the probability of exercise	
g. Any position in the security not covered by the above types of contracts, including "guaranteed" trades	
h. Net trading position (a+b+c+d+e+f+g)	
Financing Position	
i. Securities Received (loaned) through repos	
j. Securities borrowed (loaned)	
k. Pledged collateral for financial derivative and other securities transactions	
l. Net financing position (i+j+k)	
Fails Position	
m. Fails to receive less fails to deliver	
Net Overall Position (h+l)	

Prepared by: _____	Tel: _____
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**Please return completed survey by fax to: (416) 943-6753
Attention: Louis Piergeti, Vice President, Financial Compliance**

Appendix A

IDA/CSA Market Survey on Regulation of Fixed Income Markets

Recommendations and Analysis

Confidential

July 16, 2002

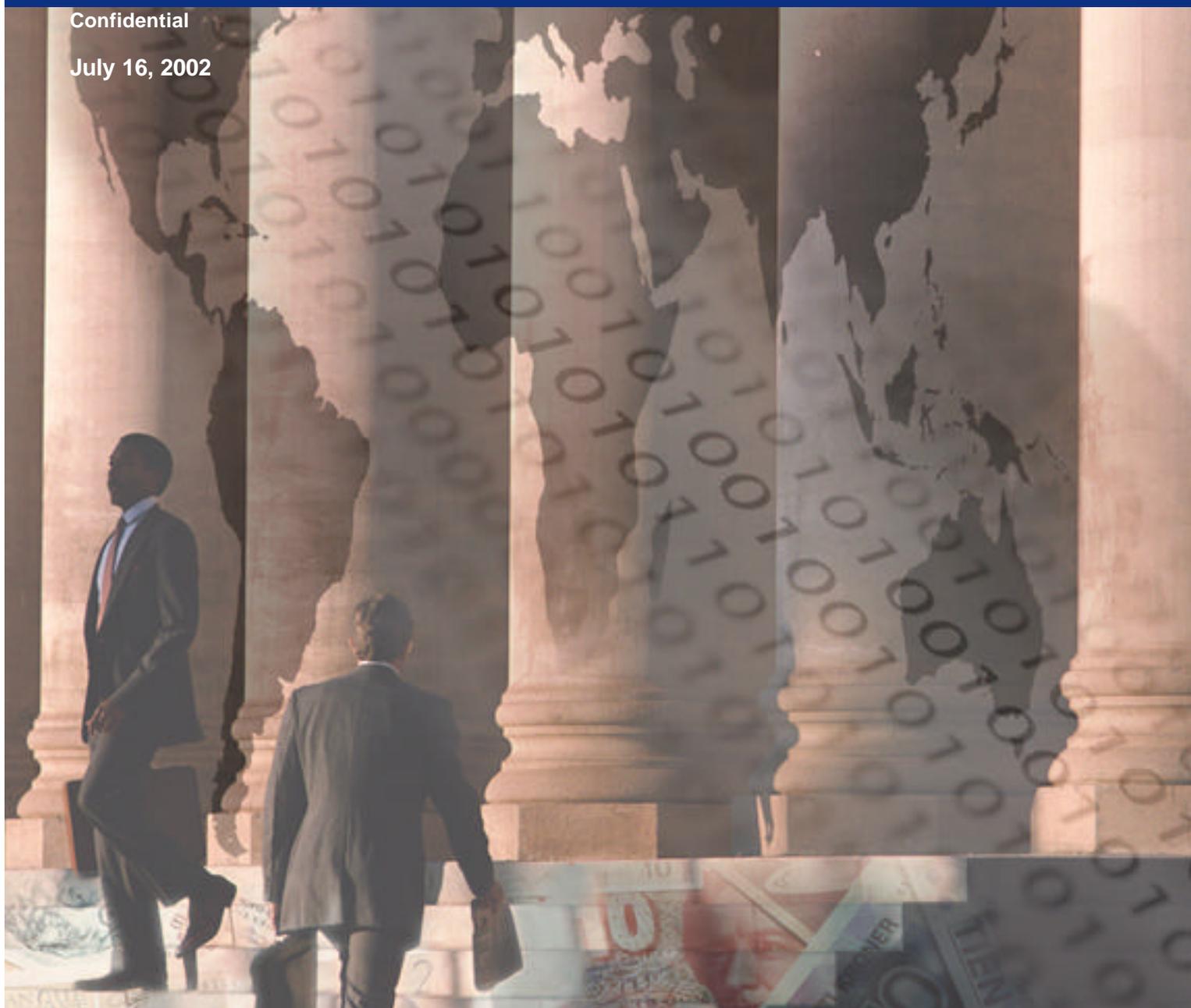


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I. BACKGROUND

Objective of Survey

The objective of the survey of Canadian debt market participants and regulators is to identify whether any problems or issues exist in the trading practices of participants in the unlisted debt markets in Canada.

This appendix represents the major recommendations that have arisen based on the results of the survey, combined with our expertise. It should be read in conjunction with the final report titled IDA/CSA Market Survey on Regulation of Fixed Income Markets dated July 16, 2002, which provides a detailed analysis of the survey objectives, process and findings.

Process

To meet the requirements of this engagement, Deloitte & Touche LLP (“D&T”) began by working with the Project Steering Committee (“PSC”) appointed by the Investment Dealers’ Association of Canada (“IDA”) and Canadian Securities Administrators (“CSA”) to confirm project objectives, timelines and deliverables. We then worked with the PSC to develop a survey to be used in the process of interviewing market participants and regulators. We sought the input of the Capital Markets Committee of the IDA (“CMC”) and the Bond Market Transparency Committee (“BMTTC”) in the development of the survey.

We sought answers to the survey from 29 market participants and regulators through 33 surveys, interviews and focus groups. The debt market participants interviewed included representatives from securities dealers, institutional investors, issuers, inter-dealer brokers, retail market participants, industry committees, Alternative Trading Systems (“ATs”) and regulators. For the majority of participants, we were able to conduct in person interviews. Interviewees were assured that individual responses would be kept confidential and that comments would not be attributable so as to encourage openness in the survey process.

II. RECOMMENDATIONS AND ANALYSIS

The following recommendations are based only on the survey interview results, complemented by our own expertise. We have not attempted to validate any of the opinions expressed by interviewees. Prior to making recommendations on a broad and complex subject such as regulation of fixed income markets, we would normally conduct significantly more research in order to substantiate our advice, including in-depth interviews with regulatory staff, review of regulatory programs and records, review of available reports and papers on the market, and benchmarking against programs in other markets.

IDA Policy 5

- 1. The IDA's rules and policies, as set out in Policy 5, should continue to formally apply only to IDA member firms. Steps should be taken to ensure that the institutional investors are familiar with the principles in Policy 5 and agree to observe them. The principles of Policy 5 should be incorporated into institutions' internal codes of ethics and compliance policies, to the extent the principles apply to the trading activities of non-dealers.*

Supporting Analysis

Given the complexities of IDA jurisdiction, the conflicts of interest issues that would arise if its jurisdiction were to be extended to non-member market participants, and the fact there is no self-regulatory body for institutions, the consensus was that Policy 5 should not be formally applied to institutions by placing them under IDA jurisdiction. We agree that this is the most practical approach, and recommend that Policy 5 continue to formally apply to IDA member firms. The level of concern over market integrity and the conduct of institutional investors does not merit pursuing the kind of wholesale changes in the regulatory system that would be required in order to formally subject institutions to the rules and policies of the IDA or of Policy 5 alone.

Policy 5 currently states:

“Affiliates of member (other than related companies as defined in the Rules), customers of Members and counterparties with whom Members deal are not subject to the terms of the Policy; however, aspects of the Policy anticipate the co-operation of affiliates and customers; i.e. in reporting and certain disclosure, and Members are expected to conduct their business in a way that will encourage compliance by affiliates, customers and counterparties with the Policy to the extent applicable. ... In addition, the Policy, or some or all of the principles and practices reflected in the Policy, may be subscribed to or recognized by non-Members, other associations and regulatory or governmental bodies.”

The Policy goes on to state that any IDA sanctions on Members “are in addition to any recourse or actions taken by other authorities including the Bank of Canada, the Department of Finance (Canada) and provincial securities commissions having jurisdiction”. The references to affiliates appear to be primarily aimed at banks that own securities dealers.

Therefore, the Policy clearly contemplates wide-ranging application of its principles beyond IDA member firms. However, these expressions of good intent are worded vaguely, both as to the

applicability of the Policy to non-members, and as to the scope of the provisions that might apply. In our meetings with non-members, respondents were only vaguely familiar with the Policy, if at all, and certainly did not view the Policy as applicable to their activities as market participants and customers of dealers. It therefore appears that part of the original intent of the Policy has not been achieved.

Consequently, in order to 1) clarify the degree to which the Policy applies to non-member market participants; 2) increase institutions' knowledge and familiarity with the Policy; and 3) increase compliance with the standards of conduct promoted in the Policy, we make several recommendations:

1. The CSA, IDA, Bank of Canada and Department of Finance, working with institutional and retail investors, should develop a process to identify the specific provisions of Policy 5 that are considered applicable to the trading activities of institutional investors and that should be observed. Currently this area is quite unclear because the Policy is aimed at securities dealers, while it suggests that "aspects of the Policy anticipate the co-operation of affiliates and customers".
2. The stakeholders should also develop a process to educate institutional investors on the rules and standards of conduct set out in Policy 5 that apply to their activities. These efforts should cover executives responsible for fixed income programs, fixed income traders and compliance staff of institutions. The process should include continuing education to ensure this knowledge is maintained and imparted to new staff.

Institutional investors should agree to incorporate the applicable rules and standards of conduct into their internal compliance policies and procedures. This step would go a long way to ensuring a consistent approach to standards of behaviour amongst buy side participants, as well as ensuring that standards conform to Policy 5 and the standards imposed on dealers and other participants. Further, if such standards are incorporated into internal policies, it will improve knowledge of the rules and policies, as well as compliance with them. Compliance can also be strengthened if institutions utilize internal audit or risk management controls to monitor compliance with certain standards.

The benefits of this approach are:

1. Jurisdictional issues and problems do not need to be resolved because the current approach to jurisdiction will be maintained. Attempts to redraw jurisdictional lines, whether between governments or at the self-regulatory level, would inevitably be bogged down in political and legal conflicts that would significantly delay, if not prevent, implementation of beneficial changes. The survey results do not demonstrate a need to redraw jurisdictional boundaries at this stage.
2. Reliance on informal cooperation and information sharing among regulators has been effective so far, and we believe these informal processes can be maintained and expanded.
3. The development of electronic trading systems and the entry of ATs is much better served by avoiding introduction of significant new uncertainty about regulatory requirements for fixed income markets. Concerns already exist about the complexity of the requirements under the ATs rules, and both the business and the regulators are still digesting and in the process of determining the practical application of these requirements.

2. *A process should be established for ongoing assessment of the need for changes to Policy 5. All stakeholders should be involved in the assessment, including institutional investors.*

Supporting Analysis

Given the likely need to reassess the provisions of Policy 5 periodically, we recommend that all of the stakeholders agree on a process to address market integrity issues and amendments to Policy 5. Since Policy 5 is the basic regulatory instrument governing bond market trading, it affects all market participants, and therefore all participants should have input to the process. This includes institutional investors, who are also expected to observe the standards of conduct set out in the Policy, even though it does not formally apply to them.

Reporting and Surveillance

3. *There is no demonstrated need for real-time market surveillance. The usefulness of exception reports for market surveillance purposes based on existing trade reporting requirements should be examined, and based on the results, could be expanded as trade reporting expands with the development of electronic trading through ATs and similar trading platforms.*

Supporting Analysis

The need for some form of market surveillance program was raised by the sponsors of the study and the question was specifically asked in the survey. The overwhelming majority of participants felt that surveillance would not be helpful, especially the kind of real-time surveillance employed in equity markets. The reason for this is people do not see problems in trading practices that could be identified through market surveillance. The consensus is that the cost of surveillance, especially real-time monitoring, would be greatly disproportionate to its benefits.

Some participants saw a useful role for follow-up exception reports highlighting pricing and other anomalies in trading patterns. The databases created and populated as a result of transparency and electronic trading initiatives could be employed for regulatory purposes going forward, as the need arises. One place to start would be to develop exception reports to identify, in an after-the-fact batch reporting process, significant price or other market anomalies in liquid issues, as a means of identifying significant trends or changes in market activity. The usefulness of follow-up surveillance reports and analysis could be tested in this manner.

It was also suggested that the IDA could use the summary trading information currently collected to flag significant trends or anomalies. A further suggestion was that the IDA should start collecting data on derivatives market activity.

Generation of an adequate data feed of quotes, orders and/or trades is an obvious pre-requisite to surveillance activities, especially for real-time surveillance. Participants were strongly of the opinion that the costs of developing and maintaining this type of audit trail, and the associated trade-reporting

regime, would be prohibitive, and the benefits would be very small. Consequently, we recommend that a trade reporting system and audit trail requirement not be imposed for market surveillance purposes. Improvements in trade reporting and databases of trading activity should result from developments in transparency and electronic trading systems, as well as installation of internal order management systems by the dealers.

Retail Investors

4. *The IDA should take three initiatives to address the issue of retail prices and mark-ups:*
- 1) *The IDA should establish a process to address the need for a rule or policy on pricing and mark-ups on debt securities sold to retail clients.*
 - 2) *The IDA should amend the standards for supervision of retail accounts to specifically address sales of debt securities and mark-ups.*
 - 3) *The IDA should establish a policy requiring all member firms to have internal policies and procedures in place to govern mark-ups on debt securities, as well as procedures for the supervision of such activity.*

Many survey respondents, including people involved in the wholesale market, expressed concerns about the efficiency and transparency of the retail market and the impact on fair treatment of retail investors, as noted in our findings. The concerns focus on the prices of fixed income securities sold to retail investors, including mark-ups, relative to prices in the wholesale market. Many consider such mark-ups to be excessive, but virtually all respondents were of the view that the lack of transparency in the market at the retail level makes it impossible for retail investors, and often retail brokers, to assess the reasonableness of a price. The lack of a visible market or benchmark price, such as an exchange price, makes it very difficult for investors to understand the bond market, let alone safeguard their own interests.

In order to provide better service to retail investors, improve the visibility of prices, and provide stronger incentives for self-policing of mark-ups or commissions, we recommend that the regulators take 3 steps.

- 4.1 The IDA should establish a process to address the need for a rule or policy on pricing and mark-ups on debt securities sold to retail clients.*

Supporting Analysis

In order to ensure that mark-ups on fixed income securities sold to retail clients from a firm's inventory as principal are reasonable, it may be necessary to establish a policy in this area to limit mark-ups to a predefined amount and /or ensure fairness. Prior to bringing in such a rule, in-depth research and analysis on the need for such a rule must be conducted, as well as on the benefits, costs, substantive wording of any rule, and finally the implementation issues. The IDA should establish a process involving member firms and other stakeholders to examine the need for such a rule in the industry. The process should examine the current policies on retail pricing and mark-ups in place at member firms, as well as the internal compliance checks, controls or supervision of the same.

4.2 The IDA should amend the standards for supervision of retail accounts to specifically address sales of debt securities and mark-ups.

Supporting Analysis

The industry has established minimum standards for supervision of retail accounts through the IDA in order to ensure a uniform basic level of monitoring of member firms' retail brokerage activities. We recommend that the standards be re-examined in order to determine whether it would be helpful to add standards to specifically address sales of debt securities by retail brokers, including the mark-ups or commissions charged to clients.

4.3 The IDA should establish a policy requiring all member firms to have internal policies and procedures in place to govern mark-ups on debt securities, as well as procedures for the supervision of such activity.

Supporting Analysis

Even if the IDA does not adopt a rule or policy on mark-ups, we believe there is a need to ensure that all member firms that sell fixed income securities have established internal policies and procedures to govern mark-ups or commissions charged to retail clients by the firm's brokers. A firm's policies should establish parameters for such mark-ups for different categories of fixed income securities to ensure that they are reasonable, in the context of the price in the wholesale market, the size of the trade, the liquidity of the issue and the term to maturity. A firm's procedures should ensure that prices and mark-ups charged to clients are reviewed for compliance with the firm's policies, and that any exceptions or problems are addressed.

5. The CSA and IDA should establish a process to address the need to improve transparency of debt market prices at the retail level.

Supporting Analysis

As noted in our findings, a widespread consensus exists that transparency of the fixed income markets is poor for retail investors and needs to be improved. Significant improvements in the visibility of prices and trading at the wholesale level have not filtered down to the retail level. Certain dealers now offer visible prices on many fixed income securities as part of their on-line brokerage services, and for clients using such services this is a significant development. However, the prices posted for debt securities are the firm's internal prices, as opposed to an independent market price. The only exception to this is Collective Bid's BondMatch™ service, which collects prices from several participating dealers.

A data feed of benchmark prices, ideally prices established in the wholesale market, is needed. However, it is not clear what data feed is appropriate for retail investors – some feel that retail investors will be confused by the difference between wholesale and retail prices – and how such prices can be disseminated efficiently to retail investors. We recommend that the CSA and IDA establish a process to address the need for improved transparency at the retail level, with a view to determining what price feeds should be made available and how to provide investors with access to the information.

Fixed Income Derivatives

6. *We believe it is premature to address the fixed income derivatives market until decisions have been made on the approach to regulation of the cash markets.*

Supporting Analysis

Because very few respondents commented on the OTC derivatives market, little information exists on which to base recommendations. The market is generally viewed as a professional market for sophisticated players, where “buyer beware” should be the rule. The OTC market is also highly concentrated. Exchange markets (the Montreal Exchange in Canada) attract a much wider range of participants, but are fully regulated.

The issue is also complicated by the fact that OTC fixed income derivatives are only a component of a diverse market for OTC financial instruments, so the question of how to regulate them is much bigger than fixed income products. Equity OTC derivatives are unregulated notwithstanding the fact equity markets are heavily regulated. Stock market regulators have minimal information about OTC derivatives in spite of the fact they impact prices in the cash market. The OSC has previously attempted to regulate the OTC derivatives market but the proposal was withdrawn as a result of objections based on the complexity of the issues. At the same time, the OTC derivatives market in the US has been substantially deregulated.

Role of the IDA

7. *The IDA should take steps to clarify its role in the fixed income markets, to increase its presence with market participants, and to make targeted improvements to its regulatory functions to address debt market issues.*

Our specific recommendations regarding the IDA’s role and its SRO activities are set out below.

7.1 Compliance with Policy 5 should be administered by the IDA’s Member Regulation Department.

Supporting Analysis

Many respondents, especially on the buy side, commented on the conflict of interest that arises in the IDA’s governance structure: the IDA represents its member firms and is an industry lobby group, as well as a SRO. In the past most of the IDA’s activities relating to debt markets have been the responsibility of its Capital Markets group, particularly policy development and the collection and distribution of trading data. It is important to note that the Capital Markets group is part of the IDA Trade Association and not part of the regulatory side of the IDA. The role of the Member Regulation Department has been ambiguous, given the bond market’s largely self-policing nature, and the fact the IDA has not focused on this market in its regulatory activities. Regulatory and policy issues have usually been addressed by the IDA’s Capital Markets Committee.

However, Policy 5 is a regulatory instrument and as such, we recommend that it be administered by the Member Regulation Department. Specifically, the Department should be responsible for administering compliance examinations as they relate to the Policy, responding to complaints, and investigations of potential violations. We note that other areas of the IDA, including Capital Markets, should continue to be involved in policy development and proposed changes to the Policy. The IDA and its member committees will continue to play an important role in the development and promotion of efficient and competitive fixed income markets, apart from their self-regulatory role.

7.2 The IDA should expand their compliance reviews to more fully encompass the debt market activities of members, including the development of a trade desk module for fixed income trading. The IDA's reviews should address specific issues in retail sales of debt securities.

Supporting Analysis

Member respondents commented that the IDA's organizational presence in the fixed income markets is limited, particularly from a regulatory standpoint. From the members' perspective, sales compliance reviews do not address fixed income issues, except to ensure Policy 5 is reflected in a firm's policies. A trade desk compliance program focused on bond desk activity has not been developed. (Trade desk reviews are primarily carried out by Market Regulation Services, but its mandate is limited to equity markets.) Members commented that the Bank of Canada's presence and level of communication with market participants is much higher.

In response to these concerns, we are recommending that the IDA expand its regulatory program in the fixed income arena to ensure that the basic principles of its self-regulatory mandate encompass its members' activities in this field. Specifically, we believe the IDA should develop compliance review modules focused on fixed income sales and trading. Compliance reviews should examine retail sales compliance, and a trade desk module should be in place to test trading compliance at firms with bond trading operations. As with all compliance examinations, the extent of the review process at a particular firm will depend on the scope of the firm's fixed income sales and trading activities, as well as its risk profile in these areas. One component to be considered in the risk profile will be the presence of and functions performed by the middle office in terms of in-house trading compliance and supervision.

These enhancements to the IDA's compliance program would improve the IDA's presence and visibility as the SRO responsible for regulating members' bond market activities. It would increase interaction between IDA staff and bond market participants, which over time would increase IDA staff's level of knowledge and expertise on fixed income markets and issues. In addition, it would help to improve member firms' knowledge and understanding of regulatory requirements. The overall result should be a higher level of compliance with IDA rules and policies, and likely a more active role for members' compliance departments in the fixed income markets.

7.3 The IDA should establish a clearer complaint process relating to debt market activity for institutional investors and members. The process should be clearly communicated to all market participants.

Supporting Analysis

It was evident from our interviews that participants do not feel there is a clear process to file complaints with the IDA, particularly if the complaint is about regulatory compliance, as opposed to a policy issue. Institutional investors were especially unclear about whether it is appropriate for them to file complaints with the IDA, or if so, what the process is. Member firms see the Capital Markets Committee (although part of the Trade Association side of the IDA) as a forum for raising any regulatory or market policy issues, and the Industry Relations and Representation Department (formerly the Capital Markets Department) at the IDA as the staff group responsible for liaison with bond market participants.

Market participants do not see the Member Regulation Department as having a role in addressing bond market issues or complaints.

We suggest it would be beneficial for the IDA to establish a clear process for any participant in the fixed income markets to file a complaint or raise an issue, from either a regulatory or policy perspective. This process should be available to the buy side, as well as to member firms, and the IDA should communicate what the process is so it is well known in the industry. Complaints about regulatory compliance; i.e. potential violations of rules or policies, should be filed with the Member Regulation Department.

The IDA currently administers a complaints process for retail investors through Member Regulation and this program should suffice to handle complaints from this customer group. The IDA may wish to examine whether there is a need to increase public awareness of the IDA's role in regulating fixed income markets through public relations or education initiatives.

Regulatory Approach

- 8. We recommend that the current principles-based approach to regulating the wholesale debt markets be maintained, subject to targeted improvements that will introduce elements of a more proactive, rules-based approach in specific areas. These areas, including several set out in these recommendations, should be selected based on demonstrated need or on principles of sound regulatory oversight. We do not recommend that an expansive set of codified rules be introduced to regulate the debt markets; reliance should continue to be placed on the principles set out in IDA Policy 5. The market regulation regime adopted must also recognize changes in market structure that are occurring as a result of the introduction of electronic trading systems and on-line brokerage services. The regulatory regime needs to address the entire market, not just the traditional market structure, and should do so in an integrated fashion.***

Supporting Analysis

The current approach to regulating the wholesale debt markets is based on general principles of conduct. Many survey participants commented on the possibility of moving to a more prescriptive and proactive form of regulation, along the lines of equity market regulation.

The survey shows a strong consensus in favour of maintaining the current regulatory approach. The great majority of participants, including most regulators, do not feel that significant market integrity or compliance issues exist that would justify a more complex, costly and intrusive regulatory program. Even those who have concerns about market integrity do not believe expanded regulation is the right response.

Participants are concerned with the additional costs that would be imposed by a rules-based model, given the size and scope of the Canadian fixed income markets. In a concentrated market with declining liquidity, higher levels and costs of regulation are considered to be a potential threat to the liquidity, competitiveness and profitability of the market. The resources of both regulators and market participants can more profitably be directed to market development initiatives, such as fostering innovation, encouraging new entrants and developing an optimal level of transparency.

The small number of participants in the wholesale market was cited as another reason that a complex rulebook is not needed. Detailed “rules of the road” are not needed in this environment, which enables the market’s self-policing mechanisms, based on business incentives and market disciplines, to work effectively.

While a detailed Rulebook is not required in our view, this does not obviate the need to consider introduction of specific rules or policies to deal with issues that arise from time to time. This principle has been recognized in the past – for example, in addressing issues such as market corners and primary auctions of Government bonds.

In making this recommendation, we recognize it is necessary to strike the right balance between reliance on market disciplines and self-policing on the one hand, and observing sound standards of regulatory oversight on the other. Since the fixed income markets are a core component of the securities markets regulated by the CSA and the IDA, appropriate minimum standards of regulatory supervision should be defined and put in place at both the government and SRO levels, based on general principles of sound regulation.

It should also be recognized by all participants that acceptance of a principles-based model does not mean that regulators will not formally investigate allegations of serious violations, and take enforcement action as required. Serious breaches of fundamental principles or standards of conduct, including fraud, market manipulation and abusive sales practices, must be dealt with strictly. However, enforcement may be difficult in the absence of clear rules, so again a balance must be reached.

Finally, the regulatory regime must reflect the changing market structure. It is unlikely that the bond market will simply consist of an OTC dealer market going forward; it will likely incorporate dealers, alternative trading systems, dealers’ electronic systems and perhaps even exchanges in the future.

Currently, at least 13 electronic bond trading systems operate in the US and European markets, comprising inter-dealer, multi-dealer and cross-matching systems. In addition, numerous on-line brokerage services offer trading in debt securities to retail customers. The Canadian market is likely to follow this trend.

9. *The CSA should engage in broader consultations with other regulators, IDA and the securities industry going forward when considering changes to regulatory requirements governing fixed income markets. The regulators should also establish a framework to analyze the cost of proposed new rules and regulatory processes so that the costs are appropriately analyzed prior to any policy decisions being made towards the implementation of new regulatory requirements.*

Supporting Analysis

Many participants, including other regulators, were critical of the CSA's lack of consultation in formulating regulatory policy relating to fixed income markets, such as the development of the ATS rules and transparency requirements. While some respondents have noticed an increased willingness on the part of CSA staff to consult and take advice, some feel that a stronger commitment to openness and responding to the comments and advice of market participants is required. We suggest that the CSA take additional steps to formalize their approach to consultations with the industry. An agreement with stakeholders on a consultation process will ensure that consultation occurs on proposals in a manner that meets participants' expectations.

Many participants mentioned the cost of expanded regulation, and the implications for the liquidity, competitiveness and degree of innovation in Canadian markets, as a significant concern. It was noted that regulators do not rigorously examine the real costs of implementing new rules or regulations, or regulatory programs, before proposing them.

Given the level of concern over costs and regulatory duplication, we recommend that the CSA and IDA establish a framework for analyzing the projected costs of regulatory proposals that can be employed as future proposals are brought forward. Such a framework should address the direct financial costs of implementing a proposal for the CSA, SROs, broker-dealers and other participants. In addition, potential indirect costs, such as the impact on liquidity and efficiency of the markets should also be examined. The costs should be analyzed against the demonstrated need for and the projected benefits of the proposal, with both costs and benefits being quantified to the greatest degree possible.