

Appendix A

IDA/CSA Market Survey on Regulation of Fixed Income Markets Recommendations and Analysis

Confidential

July 16, 2002

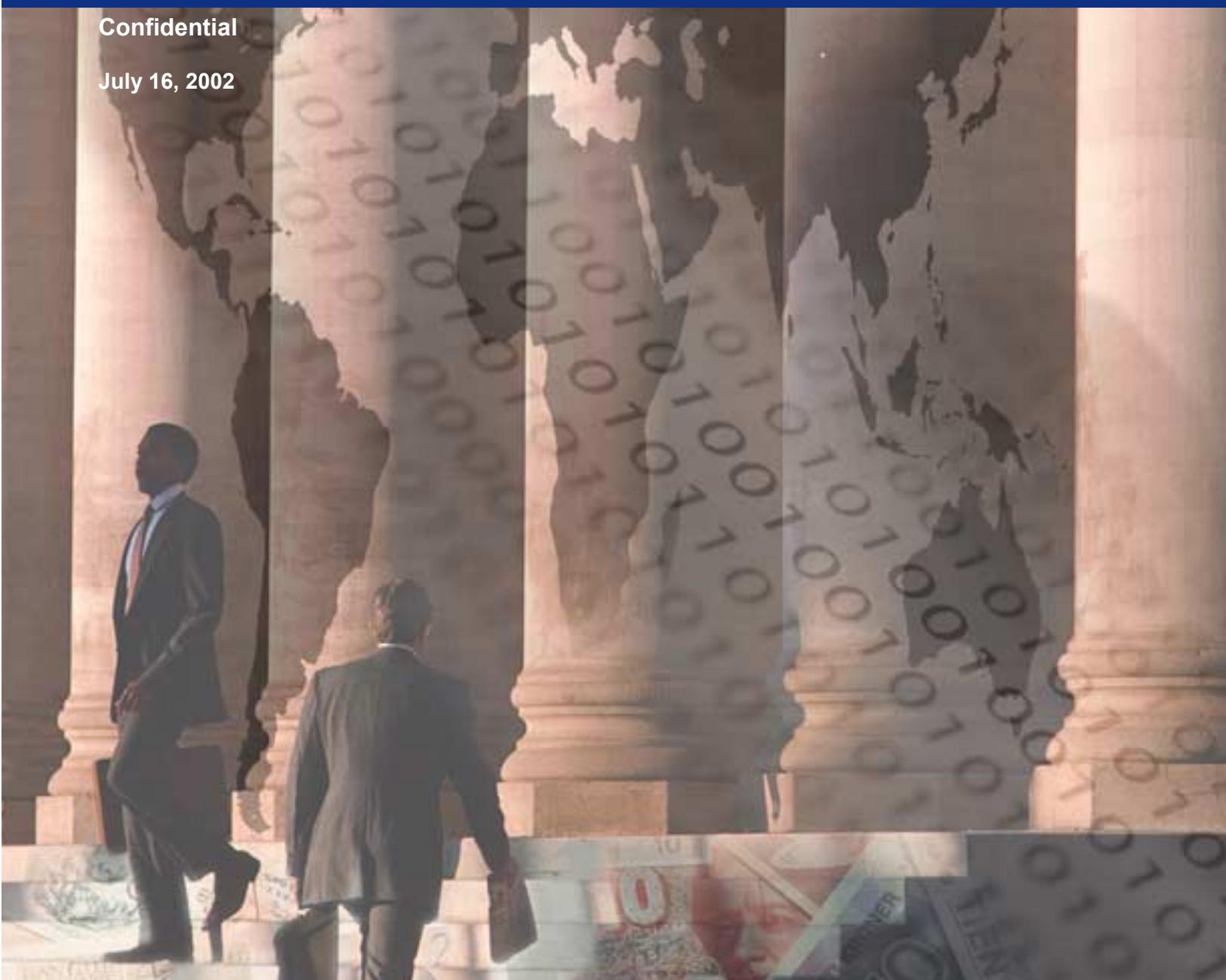


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I. BACKGROUND

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 (“BMTC”) 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 (“ATSS”) 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 ATSs 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.