



**INVESTMENT DEALERS  
ASSOCIATION OF CANADA**

**ASSOCIATION CANADIENNE DES  
COURTIERS EN VALEURS MOBILIÈRES**

# **DEBT MARKET REGULATION PROJECT**

## **REVIEW OF IDA MEMBER FIRMS**

### **FINAL SUMMARY REPORT**

**July 28, 2003**

## **I. BACKGROUND**

In 2001 the Canadian Securities Administrators (CSA) and Investment Dealers Association of Canada (IDA) began a joint review of the over-the-counter debt markets in Canada, designed to determine whether any regulatory initiatives are required in that lightly regulated market. The project was overseen by a Steering Committee with staff of the Ontario Securities Commission (OSC) and Commission des Valeurs Mobilières du Québec (CVMQ) representing the CSA.

The project was planned to proceed in three stages:

1. a survey of market participants to identify issues
2. reviews of the debt market policies, procedures and activities of selected firms in relation to the issues identified in the survey and other issues of concern to the CSA and IDA; and
3. identification and implementation of remedial measures regarding any problems uncovered in the first two stages. Such remedial measures could, depending on the nature of the identified problems, include rulemaking, more strenuous enforcement of existing rules and/or education of market participants and investors.

This report summarizes the results of the Stage 2 reviews of IDA Member firms.

### **SURVEY OF MARKET PARTICIPANTS**

After a Request for Proposals process, Deloitte and Touche LLP (“Deloitte”) was retained to conduct the survey of market participants. It obtained responses to a questionnaire approved by the CSA and IDA, some written and some oral, from a variety of participants including dealers, inter-dealer bond brokers, issuers, regulators, portfolio managers, retail clients, compliance officers and committees dealing with fixed income market issues.

Deloitte completed its report (“the Deloitte Report”) on July 16, 2002 and it was made public on December 13, 2002.

The Deloitte report contained the following general findings:

### **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 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.

## **II PURPOSE AND METHOD OF DEBT MARKET COMPLIANCE REVIEWS**

Stage 2 of the project, reviews of debt market practices at selected IDA Member firms, was designed to determine whether the findings of the Deloitte survey – based as it was on the opinions and observations of market participants – were reflected in the actual practices and records of IDA Member firms.

Mr. Michael Sharpe was retained by the IDA as a consultant to develop a separate sales compliance module on debt market trading. Mr. Sharpe was General Counsel and Head of Compliance at RBC Dominion Securities Inc. and then CIBC World Markets Inc. until 2001. He had extensive experience dealing with debt market compliance issues, both retail and institutional, and was retained by Deloitte to assist in the development of the survey and evaluation of the responses and the report.

In consultation with CSA and IDA staff, Mr. Sharpe prepared an examination program covering the following areas:

1. Supervision of Account Activity
2. Fixed Income Research
3. Soft Dollar Arrangements
4. Accounts of Individuals
5. Retail Fixed Income Desk

6. IDA Policy 5
7. IDA Policy 7 (on sale/repurchase agreements or “repos”)
8. Underwritings
9. Information barriers
10. Registration
11. Order Entry
12. Best Execution
13. Exceptions to Policies
14. Fixed Income Derivatives
15. Problems and Complaints.

Mr. Sharpe also provided initial training and guidance to IDA staff assigned to conduct the reviews.

The CSA/IDA steering committee selected five IDA Members for review: 3 large, integrated, bank-owned dealers with both institutional and retail customers, and two independent dealers – one that deals only with institutions and the other only with retail clients. The integrated dealers and the independent institutional dealer also trade inventory positions. The dealer with only retail business does not maintain fixed income inventories, trading only to or from other dealers in response to retail orders.

The reviews were conducted between November, 2002 and February, 2003. Three were stand alone and two were conducted as part of a full sales compliance review of the dealer.

#### **FOCUS OF THE REVIEWS**

While all sections of the new program were completed at all of the selected members, for the purposes of the project and this report the following were the areas of focus:

1. IDA Policy 5
  - a. Familiarity of the Member and its debt market department staff with its contents;
  - b. Extent and contents of related, firm specific policies and procedures, with particular attention to the definition of prohibited practices such as frontrunning;
  - c. Enforcement of Policy 5 and related policies and procedures.

2. Primary Markets
  - a. Information barriers between government finance and trading;
  - b. Information barriers between underwriting and trading.
  
3. Secondary Markets – Retail
  - a. Mark-ups
  - b. Suitability
  - c. Best execution
  - d. Effectiveness of in-house compliance
  
4. Secondary Market – Institutional
  - a. Confidentiality of client orders and positions and frontrunning

The following sections of the report will deal with the findings in each of these areas across the five reviews.

### **III. IDA POLICY 5**

IDA Policy 5 was implemented in 1998. It was developed in association with the Bank of Canada and Department of Finance (Canada) “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.” It enunciates standards regarding firms’ standards and procedures, dealings with customers and counterparties, market conduct and enforcement.

#### **1. Knowledge of Policy 5**

The four Members having institutional clients and inventory trading are familiar with Policy 5. Three have integrated its contents into their firm policies, procedures and codes of conduct. One has included the text of the policy itself as a part or appendix of its policies and procedures. The retail only dealer generally had not addressed Policy 5. The discussion below regarding Policy 5 therefore generally omits the retail firm.

## 2. Training

Two firms had conducted specific training regarding Policy 5 as part of their regular training process. The three firms that integrated Policy 5 into their policies, procedures and codes of conduct collect annual attestations from employees that they are familiar with and will abide by those policies, procedures and codes of conduct. The one institutional firm that did not integrate the policy gets attestation from all fixed income traders that they are familiar with and will abide by Policy 5.

## 3. Definition of Prohibited Practices

None of the firms reviewed provided any debt market specific guidance as to what constitutes manipulative trading or frontrunning. Three had definitions of frontrunning in their policies, procedures and codes of conduct that relate to equities trading. One Member expressed the opinion that any frontrunning would be identified easily by the client, which would cease to do business with the Member, hence it is self-policed.

## 4. Enforcement

All Members doing principal business indicated that daily trading is reviewed, in two cases by the institutional compliance department and in one case by trade desk managers. One Member has a dedicated fixed income compliance officer. The retail-only Member did not conduct trading reviews in relation to Policy 5, but has now assigned a compliance officer to implement a review procedure. Other departments such as credit and risk management are also involved in some aspects.

The Members that trade as principal were asked about several specific supervision items:

- Concentration

All Members review position reports, generally from a credit or risk management perspective.

- Unusual differential in the traded yield between issues of similar maturity

While Members look at inventory pricing, they do not generally look at this kind of issue. Two Members indicated that any such differential would be caught on a real-time basis by trade desk supervisors. One indicated that any unusual spikes or spreads in Government of Canada issues would be caught by the Bank of Canada, which would request a commentary.

- Unusual gap between the repo rate and the overnight rate for the same type of securities over a sustained period of time

Other than through pricing of inventory, Members did not review for this. One Member indicated that it is self-policing, as market participants would not do business with a dealer that did not offer competitive rates.

- Unusual trading volumes in a particular issue

None of the members thought that this was something that could be looked for, because the market is driven by institutional business which is often in large volumes. Members indicated that they would not be able to define an “unusual volume.”

None of the Members was aware of any instance of a failure by the Member itself, its affiliates or its customers to comply with Policy 5.

## **Conclusions**

While the large dealer firms are familiar with Policy 5 and have incorporated it into their procedures, there is a lack of specificity or common understanding of what exactly constitutes improper conduct under the Policy. Terms that appear in the policy like frontrunning, borrowed from equity auction markets, are widely believed to have no application in the secondary debt markets. There was a general belief among compliance personnel that the institutional nature of the market prevents most improper activity and therefore makes compliance efforts unnecessary.

While equity auction market abuses may have no counterparts in the dealer debt markets, Policy 5 was written in consultation with market participants and the Members reviewed produced no

reasoned arguments in support of their conclusion that some of the improper activities specified in Policy 5 were either non-existent or would be identified and the perpetrators sanctioned informally by market participants withholding their business. There therefore appears to be a gap between the concerns of the authors of Policy 5 and the understanding of those at Member firms charged with implementing it.

There is also a gap in information related to trading volumes or unusual price patterns because there is no centralized data. Members expect the Bank of Canada to spot any problems in Government of Canada issues or just expect that unusual prices would be identified and corrected by the trade desk supervisors. While this may be so for government and major corporate debt issues, there is no guarantee that smaller, less widely held corporate issues are not subject to risk of manipulative activity. Special features like convertibility may add to the risk.

#### **IV. PRIMARY MARKETS**

##### **1. Government Issues**

Only one Member indicated that it has strict information barriers between the Government Finance Department and trading. Its Government Finance Department is on a separate floor from the fixed income trading area. It indicated that there is never any need to bring traders over the wall.

Generally, the other Members did not view government issues as raising information barrier issues. Government of Canada issues are sold through the auction process and Provincial government issues are priced on a spread against benchmark issues.

##### **2. Corporate Issues**

Members were more aware of information barrier concerns for corporate debt issuers, but the procedures were less rigorous than for equity issues. Three Members indicated that many corporate fixed income issues are not material. Two noted that medium term note issues for large corporate issuers are done by shelf prospectus, therefore the information is largely public and the issues are priced and placed so quickly that there is little or no reason for concern about insider trading. Two indicated that issues were arranged only by corporate finance and

syndication personnel; one reported that senior traders may be asked for their opinions on pricing but are aware of the requirement to keep the information confidential until the issue is announced.

Generally, Members indicated that the specific, formal information barrier procedures for new equity issues are not in place for corporate debt issues. Only one Member indicated that it may place securities on a grey or restricted list in relation to a debt issue; there is no record keeping regarding knowledge of the issue within the dealer. Instead, Members appear to rely on their personnel being aware of general requirements not to use or disseminate material non-public information. One dealer indicated that the only time formal procedures are implemented is when the issue relates to a significant transaction such as an acquisition or reorganization.

The three bank-owned Members all indicated that the corporate loan book is held at the bank and that there are information barriers between the bank and the dealer. One Member reported that persons with knowledge of the loan portfolio are located on the trading floor, but are not involved in trading fixed income or equity inventories. The Member is considering what information barrier procedures, if any, should be implemented, but is having some difficulty in the absence of any guidance on the issue and because information about public corporations' borrowing is in the public domain.

## **Conclusion**

In general, inside information and information barrier issues in relation to new debt issues do not appear on Members' radar screens. The Deloitte report notes that some commentators suggested that dealers may use information from underwriting/syndication departments to move markets in order to influence prices quoted to issuers for new issues. While the nature of the issuers and processes for new government debt issues make the receipt and abuse of non-public information much less likely, the Deloitte study notes that one commentator said that the problem was worse for government issues than for corporate issues. However, it is notable that neither the Association nor any dealers reviewed have ever received any complaints from issuers in this regard.

Similarly, while in many instances new corporate debt issues have no impact in either the debt or equity markets, some issues may have an impact on a corporation's financial structure sufficient to affect the price of its other securities. Some firms do not appear to have determined how and when to implement information barrier procedures with respect to upcoming debt issues, such as maintenance of records of the receipt of information and maintenance and checking of grey and restricted lists.

## **V. SECONDARY MARKETS – RETAIL**

As previously noted, one Member reviewed does institutional business only so all questions regarding retail trading were irrelevant.

### **1. Mark-ups and Commissions**

The three Members who have inventories generally fill retail orders out of inventory. In one case registered representatives have direct electronic access to enter orders against inventory at prices set by the institutional trading department for institutional clients; at the other two there is a separate retail inventory marked up from the institutional inventory. At both of those firms registered representatives enter electronic orders directly against the retail inventory at the quoted prices. At one firm, if the issue is not carried in inventory, the retail desk will go to other dealers to fill the order. At the other, while the retail desk can also go to outside dealers for bonds not in inventory, it will first suggest to the registered representative a comparable issue that is in inventory.

All of the dealers reported that prices are set by the institutional trading department based on benchmark issues. Two Members have guidelines regarding mark-ups and monitor for compliance with those guidelines. The Member whose registered representatives can trade directly against institutional inventory reported that any trade outside its mark-up guidelines would automatically be routed to a trader before execution for enquiries as to the reason for the price.

All three Members also have minimum and maximum commission guidelines and exception reports that are used to review any commissions outside those guidelines. The commission is set by the registered representative and is negotiable, but is included in the overall price to the client

rather than as a separate, added commission. The price to the client can therefore include a mark-up and a commission or both. One member indicated that it has encountered more problems with commissions discounted below the minimum guideline than with those above the maximum guideline. Another showed generally lower commissions on sell transactions, and reported that the commissions were usually discounted and often none were charged because the proceeds were being used to buy a different issue and commissions were charged on the buy.

Exceptions to mark-up or commission guidelines were handled by different supervisors at different Members, including branch managers, head office retail supervisors and trade desk supervisors.

The retail-only Member that does not trade from inventory also has mark-up and commission guidelines, but prior to the review had not monitored adherence to the guidelines. It has reported that it is now starting to do.

All of the Members reported that the same processes were used to supervise mark-ups and commissions on strip bonds and residuals as for other fixed income products.

Exception and trading reports were reviewed at the three Members having them. The exception reports worked as described. Trading outside of the mark-up and commission guidelines were identified at one Member in an exception report and questioned, but were not generally reversed. These frequently related to low volume orders in which minimum commission levels put the percentage commission above the guidelines.

The rates on all of the commission matrices vary with term to maturity between \$0.10 and \$1.00 at one dealer, \$1.50 at another and \$2.00 at the third. Actual totals were obtained from one dealer on 2,461 retail trades over a five day period. The average mark-ups were \$0.516 on buys and \$0.616 on sells. In terms of percentage of the cost the trade the average was 0.62% on buys and 0.71% on sells.

Trades in the same issues on the same days by retail and institutional clients at one dealer were compared. All were within the dealer's mark-up and commission guidelines. Trades by retail clients in the same issues on the same days were compared between the three dealers. Price differences were found to be minimal – well below the mark-up and commission amounts.

## Suitability

Members did not separate fixed income suitability reviews from general retail account reviews, which look at overall portfolio suitability. One Member noted that these reviews tend to focus on equities, where the risks tend to be higher. All Members have exception reports for fixed income trades over \$100,000 in retail accounts, as required under IDA Policy 2, which are reviewed on a daily basis.

Samples of accounts at each Member trading in fixed income products found no suitability issues with respect to the debt portion of the portfolios, which tended to contain plain vanilla products. The one except was an account in which the concern related more to the age of the client than the stated investment objectives of 100% high risk. In that case the client appears to be related to the registered representative. The account was brought to the Member's attention for further review.

### 3. Best Execution

None of the Members considered best execution an issue. The institutional-only firm reported that its clients get prices from various dealers and will trade with the firm offering the best price. The retail firm reported that it has access to prices from several live trading systems, including those of major dealers and alternative trading systems and will go to the source offering the best price.

The three Members that do both retail and inventory trading indicated that trades to retail customers are generally from inventory at prices set by the institutional trading department for institutional customers, which have to be competitive. They are set against benchmark issues and the institutional trading departments monitor prices at other dealers and inter-dealer bond brokers to ensure that they are competitive. They indicated that the institutional market is highly competitive so they cannot allow their prices to get out of line with the competition.

The same three Members reported that they contribute to a weekly survey conducted by the Canadian Depository for Securities, which gives them reports on the high, low and mean prices of trades in various issues, and they seek to ensure that they have been "somewhere in the middle" as one Member put it.

#### 4. Effectiveness of In-house Compliance

As noted with regard to each specific item above, no retail debt market problems were uncovered in the reviews.

Three of the dealers reported that their fixed income operations are subject to internal audit. None of the audits had uncovered any issues regarding retail debt market trading. The Members were also asked about client complaints regarding fixed income trading and none reported receiving any. Complaint logs were reviewed and supported that contention.

### **VI SECONDARY MARKETS – INSTITUTIONAL**

#### 1. Confidentiality of Client Orders and Positions and Frontrunning

The policies, procedures and codes of conduct noted in Section III (regarding Policy 5) above all include sections requiring strict confidentiality regarding client orders and positions. However, as described in that section none of the Members reviewed viewed frontrunning as a debt market issue because of the nature of the market. One Member noted that any use by a dealer of knowledge of a client order in its own trading would quickly be identified by an institutional client and would result in loss of business.

Three of the five firms require pre-approval of all personal trades by fixed income department employees. The proposed trades are reviewed against grey and restricted lists. These firms also reviewed all trades in employee accounts to ensure that pre-approval was received. The only reports of violations of the rules related to pre-approval rather than the nature of the trade. At one firm these result in a warning letter on first offence. Another firm reported only one incident of improper trading in 4 years: the employee had put the trade through a discount broker and was suspended for three days without pay.

All firms also reviewed all employee trading according to the terms of IDA Policy 2, which requires disclosure of all accounts outside the firm and reporting of all trades in any external accounts.

One firm has a sophisticated review system that checks employee trades to determine patterns of trading ahead of clients or deals.

## **VII. RECOMMENDATIONS**

The reviews did not find any evidence of serious problems in debt market trading at the selected Members. There were no customer complaints and no evidence of retail customers being charged exorbitant mark-ups.

What was found was inattention to some aspects of debt trading compliance, a feeling that the market is self-policing and that there simply are no issues of concern, combined with a general lack of focus on identifying what risks or exact types of improper activity might be worthy of attention.

Based on the reviews, IDA Sales Compliance makes the following recommendations.

1. Policy 5 should be reviewed and revised to try bring more specificity to the types of improper conduct that can occur in the debt markets and how they should be prevented. The results could take the form of a revision to the policy itself, definitional and best practice guidance for Members, or both. Both debt trading experts and Member compliance staff should be involved, as there is clearly a problem with a Policy noting issues that none of the Members reviewed seem to understand.
2. The IDA should conduct similar detailed debt market reviews on all Members. It is evident that some firms were not paying close enough attention to part or all of their compliance responsibilities with regard to debt trading activity, generally as a result of complacency. The reviews will both call attention to the requirements and provide a baseline of information on retail pricing practices.

The reviews should ensure that Members involved in underwriting and distribution of corporate debt issues have a process for making a determination whether knowledge of a particular negotiation, proposal, underwriting or distribution might have an impact on the market – debt or equity – so that appropriate procedures are put in place in those instances, however few, where non-public information about the issue is material.

The reviews should further ensure that Members have methods of reviewing for unusual concentration or trading activity in debt issues, although reviews may be limited to those issues or types of issues that present a risk of manipulative activity.

3. While there was no evidence of an urgent need for consolidated price and volume information across the market, the gaps in its availability make both internal and regulatory compliance reviews more difficult and time-consuming and render the results less certain. Easy availability of better market information would help retail clients ensure that they are being given reasonable prices, but the reviews found no evidence that current pricing is uncompetitive or unreasonable. The development of better market information, already underway, should be encouraged.