FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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Re: Request for Public Comments – Proposed Over-the-Counter Securities Fair Pricing Rule and Confirmation Disclosure Requirements

We are pleased to provide you with the comments of the Canadian Foundation for the Advancement of Investor Rights ("FAIR Canada") in response to the above request for comments (# 09-0109 issued on April 17, 2009).

FAIR Canada is a non-profit, independent national organization dedicated to representing the interests of Canadian investors. The mission of FAIR Canada is to be a voice for investors in securities regulation and a catalyst for enhancement of the rights of Canadian shareholders and retail investors. Visit www.faircanada.ca for more information.

OVERVIEW

A wide-reaching overhaul of the Canadian fixed income market is long overdue.

Investors are best served by fully transparent markets with price disclosure – where competitive bid and offers are displayed, all transactions are executed at the best price and entered immediately, and total commissions are disclosed.

As US Supreme Court Justice Louis Brandeis said, "Sunlight is the best disinfectant and electric light the most efficient policeman." Total transparency is the best way to build investor trust. Yet the fixed income and over-the-counter markets still operate in near-complete darkness.

The fixed income market is becoming increasingly important to Canadians. Bonds have always been important to senior citizens and retirees who rely on them for income and capital preservation. Extremely low short term interest rates have turned more Canadians to the higher yields offered by longer term instruments. The crash in worldwide equity markets has re-emphasized the importance of these lower risk investments in the asset mix of all investors. Fixed income instruments play an important role in the holdings of pension funds and life insurance companies.

Canadian retail investors buying or selling money market instruments or bonds in the over-the-counter market should know that they are getting the best available price and paying a fair commission. They have the same rights to this basic information as those transacting in shares or convertible debentures on an exchange. The traditional "Trust us" response of the financial services industry is not adequate in the vastly changed investing landscape of 2009.

<u>The Canadian Fixed Income Market is Huge, Complex and Non-transparent</u>

<u>This market is huge.</u> At May 31, 2009, the Canadian fixed income market had C$1.52 trillion in outstanding bonds, and another $358 billion in the money market. The fixed income market total outstanding amount of $1.88 billion exceeded the total capitalization on the Toronto and Venture Stock Exchanges of $1.5 trillion at May, 2009. Average daily trading volumes in Q1 2009 were $8.5 billion in the money market and $8.7 billion in bonds and repos (source: Bank of Canada weekly and monthly reports).

<u>The market is complex.</u> The money market (fixed income investments with a term of less than one year) ranges from Government Treasury bills to bankers' acceptances and commercial paper. Corporate and provincial bonds (with terms longer than one year) actually have larger outstanding amounts than the federal government bonds. They are often held to maturity by pension funds, life insurance companies and retail investors, and trade infrequently. Federal government bonds account for three-quarters of total bond turnover (Hank Cunningham, <u>In Your Best Interest</u>, p. 32) and for almost half of the bond market index.

<u>The market is not transparent.</u> There is no central exchange for fixed income instruments. Transactions are not reported on a systematic basis. Commercial information providers such as Bloomberg and Thomson Reuters show indicative institutional-sized bids and offers subject to confirmation by phone. Prices for benchmark Government issues and some corporate bonds are covered in the press and on web sites. Some of the more thinly traded corporate issues can go for weeks or months without a trade.

There are only 12 primary dealers in Canadian Government bonds, and the market is dominated by the Big 6 banks. Most trading is done through principal transactions using the dealer's capital and is initiated by institutional investors.

<u>Are retail investors being served?</u>

It is hard to estimate how many retail investors are deterred by the fixed income market's lack of transparency. Most retail investors do not know enough about trading fixed income instruments to know whether they were given a fair price on a transaction – let alone where to complain should they feel inclined to do so. IIROC, the banks, and independent investment dealers do not measure or report fixed income complaints separately from those about equities and other investments.

A retail customer at a bank-owned dealer who wants to buy a bond will issue instructions to his broker. More often, the broker will suggest purchase and the customer will go along. No negotiation takes place - the customer takes the price that the desk offers, or not. Occasionally some customers are successful at negotiating for a slight uptick in yield. There is no shopping around for competitive bids. In the great majority of cases the customer (and his broker) is a captive of the firm's trading desk.

The trading desks of independent dealers often act as agency traders rather than using their own capital. They might offer a selection of bonds from various dealers, with some ability to check other quotes. But the entire independent sector in the fixed income market probably only equals the size of one of the big banks.

Independent analysts and journalists encourage fixed income investors to maintain more than one brokerage account in order to receive more than one bid. Even if retail customers try to compare prices, they might not be able to find the same bond – the bond market is too diverse for firms to hold a full assortment in their inventory. Certainly no institutional bond manager would consider trading before checking the market for alternative offers.

Retail activity is concentrated in smaller issues and structured products that offer higher yields – and higher commissions to their sponsors. Many retail investors are pushed into bond mutual funds that promise to decode this arcane market for them. However, a world of short term rates approaching 0% and long term interest rates of 3% to 4% makes it very difficult for most high-fee funds to match their underlying index after fees. The average management expense ratio for bond funds is 1.9% (Source: Andrew Allentuck, <u>Bonds in Canada</u>, p. 157.)

The do-it-yourself segment of the market is growing in popularity. Most of the on-line investment dealers offer a varied assortment of bonds. These investors are often reasonably knowledgeable about fixed income fundamentals and bond trading strategies. However, they remain vulnerable to lack of disclosure of commissions and spreads.

Fixed income Exchange Traded Funds (ETFs) are growing rapidly. Offering much lower fees than bond mutual funds, they are the most rapidly growing segment of industry leader iShares Canada, whose six fixed income funds now total $3.7 billion. Many Canadian investors also buy U.S. and international fixed income ETFs from foreign suppliers and from iShares' competitors Claymore and Horizons Betapro.

The Goal: Complete Transparency on an Exchange

The long term goal for regulators to best serve the interests of investors should be for fixed income instruments to trade on an exchange with live buy and sell offers, best execution and immediate reporting of trades. We recognize that there are political difficulties to accomplishing this goal. Bond markets have traded Over the Counter since the dawn of recorded financial history. No major international market, to our knowledge, has forced all bonds to trade on an exchange – although some bonds do trade on the New York Stock Exchange and on other markets. Defenders of the current Canadian system claim that it has met the needs of corporate issuers and institutional buyers like pension funds and life insurance companies, while also serving individual investors.

Other observers dismiss the technical and other difficulties as political and self-serving. As one of our sources (who understandably preferred to remain anonymous) put it:

I have considered the arguments for maintenance of the opaque bond market to be pretty self serving ones advanced by a lushly compensated family compact of bond traders. Trading bonds on an open, posted market just like equities is not that difficult – look at the listed convertible debt of income trusts, for example. One reason there has not been more demand for it is that most retail investors have been well trained to believe that only the big boys (who of course need to be protected only from themselves) can trade bonds. So if you don't have a bond desk, which unfortunately you cannot buy at IKEA, better just give your money to someone who does.

Recognizing some of the deficiencies in the market, the U.S. implemented reporting systems for municipal bonds and corporate bonds (called TRACE) in the mid-2000s. The TRACE system is now being extended to less liquid corporate bonds and mortgage-backed instruments. But these reporting systems do not cover the more active Government-bond market.

The U.K. and the European Union are taking steps towards greater disclosure, but have not centralized disclosure of recent transactions.

IIROC'S PROPOSALS ARE A STEP IN THE RIGHT DIRECTION

Until a truly transparent bond market comes to Canada, the Over-the- Counter fixed income market must be regulated to ensure that customers are dealt with fairly. FAIR Canada supports IIROC's proposed OTC fair pricing rule and disclosures as significant steps in the right direction.

1. Fair Pricing Rule.

Requiring Dealer Members to fairly and reasonably price securities traded over the counter is an important specific step. Current rules do not apply specifically to the Over-the-Counter market. This statement of principles should be universally acceptable. The proposal's guidance provides a long list of factors permitted to influence fixed income securities pricing.

Implementing this statement of principles will be much more telling. We understand that IIROC is now working on new rules and methods of surveillance and enforcement, to ensure that members honour these commitments in practice as well as in principle. Investors will look for frequent and in-depth examinations of dealer practices to ensure compliance. Where abuses are discovered, substantial penalties are necessary to act as deterrents.

2. **Yield Information Disclosure.**

We agree with IIROC's proposal to require all firms to disclose the yield to maturity of fixed income instruments. This seems like a good first step to provide retail investors with sufficient information to see if they are getting a fair price. It would allow consumers to compare other yields available in the market through live quotes or recent transactions reported on newspaper or investment dealer websites or through information providers. A number of firms already offer fixed income markets for institutions. There is even a small but growing electronic market called CBID where private investors can transact.

Small differences in bond terms, covenants, supply or liquidity could often cause discrepancies between reported and offered yields. Such discrepancies could lead to a productive discussion between broker and retail investor, and to a more informed decision.

3. Remuneration disclosure statement to retail clients.

FAIR Canada believes that the IIROC proposal to require members to disclose on a trade confirmation that "remuneration has been added to the price in case of a purchase and subtracted in the case of a sale" is a necessary start. In our view, this proposal should be considered the very bare minimum, not an end goal.

Investors have the right to know not only that a commission and any other remuneration are being charged, but the absolute amount – period. If the dealer is unable to calculate the remuneration on a transaction, perhaps that dealer shouldn't be in the business of dealing with retail clients. Even though the dealer might claim that no commission is being charged, the spread between bid and offer (usually quite wide at the retail level) provides generous compensation to the dealer.

FAIR Canada believes that obstacles in the way of disclosing total remuneration can be overcome. In the interim, the alternative (discussed and rejected as too complex in the IIROC call for comments) of disclosing the investment advisor portion of the commission would be a useful halfway measure. We recognize that such disclosure could cause some distortions between those broker-dealers with in-house fixed income desks and those who rely on liquidity providers and outside desks. That seems a small price to pay for the added benefits of real, hard information about costs in the hands of retail customers.

Some investment dealers complain that providing such information is too difficult, too inconsistent, too expensive, and that there is not enough space on the confirmation paper. These are the standard industry objections every time such a change is proposed. We believe that investor rights to know such basic information trump those concerns – and that the actual costs of implementation will not be quite as daunting as some industry players suggest.

OTHER ISSUES

Greater focus on less liquid segments

Thinly traded segments of the market require greater regulatory attention and more effort by dealers. Strips, corporate bonds, and especially structured products which are often traded only by the sponsoring dealer pose particular dangers to investors and should be watched closely. Even the more liquid benchmark government debt must rely on the dealers' fair treatment.

Educate retail investors

It is not enough to provide retail investors with the proposed limited additional disclosure if they are not sophisticated enough to use the disclosure. Surveys across the developed world reveal that most retail investors still do not grasp fixed income fundamentals such as "bond prices go down when interest rates go up," let alone the intricacies of the opaque OTC market. Along with the improved disclosures, we strongly suggest that IIROC follow the FINRA example of making available a fixed income primer on their website. FINRA's requirement to refer to such information on confirmation slips is a good idea.

Level the playing field

All investments should be treated the same, regardless of their regulatory jurisdiction. FAIR Canada calls on the federal and provincial regulators of the banks, life insurers, and other financial services companies to ensure that the same levels of disclosure apply to all fixed income investments. This would include Guaranteed Investment Certificates, structured products, investment-oriented insurance products, and the like.

Some IIROC members have expressed concerns about regulatory arbitrage. They fear that some investors will seek out alternative investments that do not have to disclose commissions and broker compensation.

Such concerns should not be a reason to have a race to the bottom of less disclosure. More disclosure across all products will benefit investors. And more informed investors will ultimately benefit markets and financial service providers.

CONCLUSION

The IIROC proposals are a significant step in ensuring that retail investors are fairly treated in fixed income markets. Any steps towards greater disclosure and transparency should attract more retail investors. Moving to a fully transparent bond market with price disclosure could attract more participants, provide greater liquidity and reduce spreads, thus improving market efficiencies.

We would be pleased to discuss our comments with you in more detail at any time.

Sincerely,

Canadian Foundation for Advancement of Investor Rights

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