INVESTMENT *facts*

No. 2 **The Market System**

About INVESTMENT *facts*

Investment Facts is published by the Investor Learning Centre of Canada, an independent not-for-profit organization. Our aim is to help people like you become better informed about your investment choices.

The ILC works closely with the Canadian Securities Institute – the official educator of the securities industry – and other highly regarded organizations. This helps ensure our publications and programs are accurate and non-promotional.

This issue of Investment Facts is part of an ongoing series. It complements our many other national investment learning programs, including books, seminars and a walk-in-phone-in resource centre.

For more information, call one of our offices listed on the back page. We'll be happy to help!

Investor Learning Centre OF CANADA
www.investorlearning.ca

Do I need to understand how the financial markets work before I take part?

You should. It is helpful to have a grasp of the big picture before you invest. If you know how the system works, you will know who you can call for help. You will also know what you can expect to happen at each stage of the investment process.

What is the market system for securities?

The term *market system* is used to describe all the various services that together make it possible to convert savings into productive investments. The system is the process that allows governments and businesses to get hold of funds cost-effectively. It also helps investors buy suitable investments at the best price and sell them when the right time comes.

The system ensures there is no delay in the transfer of funds or securities from investors to users of capital or to other investors. It is also structured with built-in protection so that users of the system are all treated fairly.

Can you give me a quick overview of how it works?

Let's begin with a chart of the securities system showing the flow of investment dollars. This will give you an idea of the key players and organizations that make up the securities industry.

What do each of these bodies do?

Brokers, often called *investment dealers*, take orders to buy and sell securities from *investors*. They also assist *users of capital* by finding investors willing to buy their securities. Securities are bought and sold in a *market* by investment firm traders. The integrity of investment dealers and markets is monitored by *industry organizations (self-regulatory organizations)* and by *government regulators (securities commissions)*. Separate organizations called *securities clearing houses* or *depositories* keep track of securities for dealers and ensure their accounts are settled promptly. *Transfer agents* or *registrars* maintain a record of the owners of securities. If an investment dealer goes under, investors are protected from losses by an *investor protection fund*. Industry staff are trained and accredited by an *industry educational institution* to meet accepted standards.

> *The investor protection fund protects investors if their brockerage firm goes under.*

Your chart shows all orders going through investment dealers. Why is this?

Investment dealers have a long history of assisting in financial transactions. For centuries brokers around the world have made markets by bringing together buyers and sellers. The central marketplaces where they worked led to better prices for everyone. With central marketplaces governments were also able to make sure the rules were being followed because the number of players with direct access to the market was limited without putting up barriers to public participation.

In the last decade or so, governments in Canada have allowed banks and other groups to buy investment dealers. This change in ownership will not affect how you work with a broker. Today, registered dealers still have sole access to the markets.

I get confused about all the different financial services. What's the difference between a broker and an investment dealer? Or an investment advisor and a financial planner?

A *broker* tends to deal in stock. An *investment dealer* specializes in bonds or in raising money in the securities markets. By definition, a broker acts as an agent or intermediary between buyers and sellers while a dealer buys products and resells them at a profit. In our industry, most investment dealers are also brokers and vice versa. For that reason the terms are often used interchangeably.

An investment advisor is an individual who works for a broker or dealer within the securities industry, providing advice to individual clients. Investment advisors, often called IAs, are part of the regulatory system described in the Securities Industry Flowchart. Financial planners, mutual fund salespeople, insurance, bank and trust company financial advisors provide specialty services to clients, although they are not part of the system we are describing.

Investment advisors and financial planners will both provide financial advice or a service for a commission or fee. However, to buy or sell the full range of securities products, a registered IA working for an investment dealer or brokerage firm must carry out the transaction. You may buy some securities from non-SRO financial advisors. Mutual funds, for instance, are sold by registered mutual fund representatives as well as by IAs.

I'm just a small investor. How do I find an investment advisor? And what services will I get?

Most retail brokerage firms are staffed by investment advisors who specialize in serving individual investors. Ask your friends and relatives for a reference and then interview several promising candidates. Find out about the firm's investment specialities and whether it is a member of one of Canada's stock exchanges or the Investment Dealers Association. This will help you identify what is acceptable business practice for the firm. Ask about services and commissions, and about the IA's track record. Only use an advisor who makes you feel comfortable.

An IA will then open an account for you. Your advisor will want to get to know you because he or she is legally obliged to recommend investments that are suitable for you. You will be asked to describe your financial position and your investment objectives; that is, what you hope to realistically achieve from investing – other than to become a millionaire! Many people want regular income from their investments while others can afford to take on more risk in the hope of making more money. These are the kinds of things to discuss with your IA when you first open your account.

If you're a very small investor, your advisor probably won't call you regularly. However, feel free to call when you have something in mind or wish to change your investment objectives. If the firm produces investment research, ask for relevant copies.

The IA will advise you on your investments, take your orders to buy or sell securities and carry them out in the market. It will keep track of your account, hold your securities and issue regular statements. Other specialized services and products may also be available.

Some kinds of brokers, called *discount brokers,* do not provide investment advice. They tend to offer lower fees or commissions than *full-service brokers, and* will only execute orders.

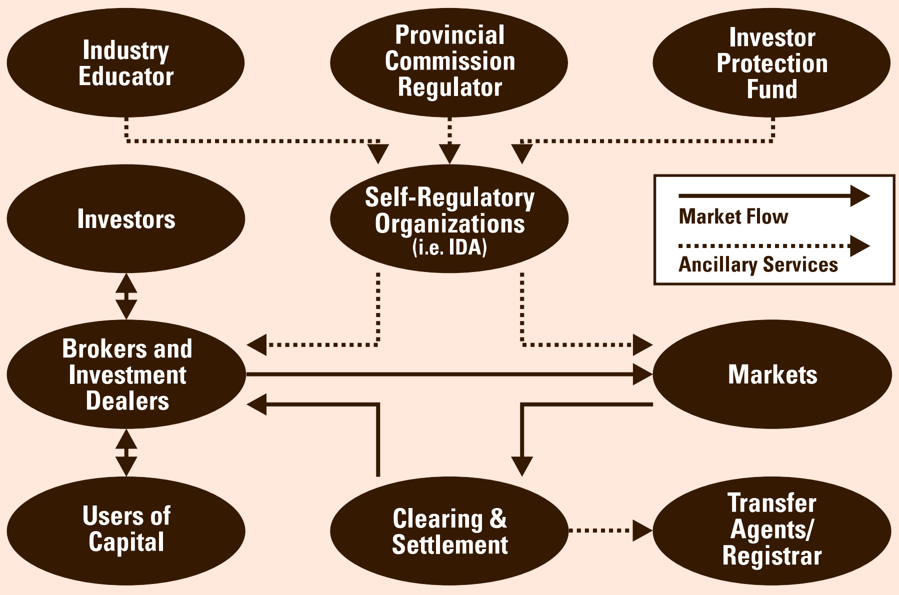
Discount brokers are useful for knowledgeable and experienced investors who know what transaction they wish to make. Full-service brokers provide advice as part of a range of services that includes investment research, helping investors to make appropriate choices when they do not have the time, interest or knowledge to invest on their own.

Do investment dealers provide different services for larger investors?

In every business larger clients will get more attention than smaller ones. In the securities business the largest investors are institutions such as pension funds. Most dealers lower their commissions for big orders. Larger clients will also be called more often when opportunities come up because they are more likely to be interested. However, your investment advisor will be serving investors like you and not large institutions which are serviced by a different department. You won't have to fight for attention!

Lots of people believe small investors can never beat the big institutions. But there are safeguards in the market system which help to ensure smaller investors are not penalized for their size. Mechanisms like trading halts allow time for important information that might affect the price of a security to get out broadly. It is important that all investors have equal access to information that could affect the market.

Securities Industry Flowchart



How do investment dealers assist companies in raising money?

Investment dealers help a company that needs capital decide whether it's better to borrow through bonds or to sell ownership through equity or stock. They offer advice on factors in the marketplace that might affect this decision. They can also give a company an idea of what price and terms would be attractive to investors.

Once prices and terms are established, dealers may act as agents in finding markets for these securities. Different firms may get together to locate investors. Sometimes an investment dealer or group of firms may buy all the securities themselves and resell them to investors. When this happens, they are said to be acting as *principal.* The process of getting new securities to market through the use of an investment dealer is called *underwriting* or the *primary market.*

How do dealers help governments borrow?

When the federal government decides to borrow by issuing bonds, it may consult with investment dealers and banks on how much it wants to borrow and on what terms. Then the government takes competitive tenders for the issue from a selected group of dealers and banks. These *primary distributors* tender a bid to buy some or all of the bonds at a price they think is competitive. The dealers that are successful then find investors to repurchase the securities at a slightly higher price.

Provincial and municipal governments tend to borrow more like businesses by choosing an investment dealer to underwrite and sell their securities.

Are securities markets actual places?

Sometimes. You probably have heard about stock exchanges which are places where stocks are traded, especially stocks which have already been issued and which are now being bought and sold among investors *(the secondary market).* However, no market has to be a physical place. A securities market is really any network connecting brokers and dealers who have orders. In all markets, information is exchanged regarding prices and amounts so that dealers who want to buy or sell a security can find it at the best price for the right size of order. Today, securities markets are becoming more and more computerized. Computers are ideal for gathering and organizing complex information. With modern communication networks this information can be relayed instantly. New technology is already challenging the way trading in stocks has traditionally been done on a trading floor with traders calling out orders to buy and sell. On Canadian exchanges, the computer is already the meeting place.

An investment advisor (IA) can buy and sell securities and also give financial advice.

Who does the actual buying and selling?

Investment firm traders do. Once an order is taken from an investment advisor, it is sent to a firm's trading room. Often an investment firm has two trading rooms – one for bonds and debt instruments and another for stocks. With stocks, investors' orders may be traded by computer, over the phone, or on a stock exchange. If the order goes to the stock exchange, traders execute it there on your behalf.

Bonds are traded by phone in the trading room. Experienced traders are allowed to buy and sell bonds and stocks on behalf of their firm to build up an inventory. This means that the dealer always has a range of securities products to satisfy investors' needs. If the dealer doesn't have the security you are looking for, the firm will find it for you and obtain it as your agent.

What is a Self-Regulatory Organization?

Exactly that – an organization that regulates itself or its members. In Canada the securities industry has a lot of responsibility for regulating itself. This is done through the stock exchanges and the Investment Dealers Association of Canada which are also called Self-Regulatory Organizations or SROs*. They have been delegated responsibility by provincial governments to ensure that the brokers and dealers which are their *members* meet agreed-upon standards. These standards are written into provincial laws governing securities.

The Self-Regulatory Organizations oversee markets and trading as well as member firms and their practices.

* The IDA is not recognized as an SRO in Quebec.

What is the main job of securities commissions?

The securities commissions play a very important role. They make sure that the capital markets work properly and that investors are protected. They do this in three basic ways. First, all the people and companies that trade securities have to meet certain requirements and be registered with the commissions. Second, the commissions set rules to make sure that all relevant information about securities and their issuers are available to the public. And third, the commissions have special powers to investigate and prosecute those who break the law.

Securities commissions and the like are government bodies. To save money and time, much of the actual work in regulating the market is done by the Self-Regulatory Organizations. However, commissions pay very close attention to how well the SROs do this job.

What exactly are clearing corporations and why are they needed?

Clearing corporations, often called depositories, play an important role. First of all, they ensure prompt payment for securities. The transfer of securities and funds is called *clearing.* Second, they speed up the movement of securities between buyers and sellers and minimize the chance of losing securities.

Today, you will find that most securities, especially shares, are locked up in huge concrete and steel vaults of a clearing corporation/depository where they are safe. That means you won't receive a certificate when you buy a stock unless you ask for it. You own it and your account records are your proof of ownership, but you never see it. Instead of being registered to you, the securities are registered to your broker on your behalf. This is called registering your shares in *street name.* Bonds have recently come to be treated the same way.

A modern clearing corporation/depository uses computers to keep track of all purchases and sales of securities that are *immobilized* in its vaults. At the end of every trading day, transactions between firms are added up for every security. The depository sends a tab to each dealer of the total amount owed by every other firm. Dealers then *settle* by sending a cheque to the clearing corporation for deposit in other firms' accounts.

Securities are transferred by *book* or computer entry.

Firms in Canada have three business days to settle day's stock and most bond transactions. In turn, you also have three days to hand over your securities when you are selling (if you actually have them in your possession), or to pay for them if you are buying.

What are the main clearing corporations I should know about?

In Canada there is one major clearing corporation for stocks and bonds; the Canadian Depository for Securities (CDS). It serves members of the Toronto Stock Exchange, the Montreal Exchange, CDNX and various banks and trust companies.

What is the role of the transfer agent and registrar?

A transfer agent is a trust company appointed by a corporation to keep track of its shareholders – who they are and where they live. This information is important should a company need to send out dividend payments and to make sure eligible shareholders know about annual meetings and their right to vote. The registrar checks on the accuracy of the transfer agent's work and keeps track of the status of a company's shares.

What happens if my investment firm goes under?

The securities industry, through the Canadian Investor Protection Fund (CIPF), offers the investing public protection against loss due to the financial failure of any firm that is a member of either the Investment Dealers Association, the Toronto Stock Exchange, the Montreal Exchange or the Canadian Venture Exchange. These organizations are referred to as Sponsoring Self-Regulatory Organizations (SSROs). If you experience a loss due to the insolvency of a firm that is a member of an SSRO, CIPF provides coverage of up to $1 million for losses related to securities and cash balances. You should understand however that CIPF does not cover losses that result from making a bad investment.

CIPF's coverage is paid for by the firms which belong to the SSROs. There's more information on this valuable coverage in Investment Facts No. 5 – Investor Protection.

How do I know if my investment advisor is well-qualified?

The person you deal with must be legally registered to sell securities. To be registered, he or she must have passed The Canadian Securities Course® (CSC™). You can find out if an investment advisor is registered by calling your provincial securities regulator.

However, if your IA is employed by a member of Canada's Self-Regulatory Organizations, more qualifications are often required. They must pass exams on rules and regulations, and ethics and conduct. Before they can give advice to clients, IAs must also complete a three month training course.

To further protect investors' interests, newly registered IAs are strictly supervised for six months by their branch managers. Within two and a half years of being licensed, they are required to complete an advanced course in financial planning or investment management. In addition, member firms may put new IAs through their own training programs.

Is everyone who sells securities in Canada part of this system of checks and balances?

No. Some brokers called *broker-dealers* or *securities dealers* are not members of Canada's SROs (the stock exchanges and the IDA) but are still allowed to sell some types of securities. They are regulated by provincial commissions, but the securities they sell are often very risky. Your accounts also will not be protected by the Canadian Investor Protection Fund. Some provinces require broker-dealers to pay money into contingency funds, but these are much smaller than the CIPF and don't offer as much coverage.

Discount brokerages charge lower fees, but don't offer advice and other services.

Another group of professionals outside the SRO system are financial planners. Financial planners may offer general financial advice for a fee but they are not authorized to sell or advise you on securities. Their access to most markets must be through a member of a stock exchange or the Investment Dealers Association. Mutual fund salespeople are registered to sell mutual funds only. They cannot sell you individual securities like stocks and bonds.

Your accounts with the financial planner or the mutual fund salesperson are not covered by the CIPF, although they may have alternative coverage. If you deal with them, ask what protection is in place.

I see how the system works, but I don't know what to do next!

In Investment Facts No. 3 and No. 4, you can learn more about the stock market and the bond market. These will explain more about what you should look for before you invest.

® Registered trademarks of the Canadian Securities Institute.
™ Trademarks of the Canadian Securities Institute.

CANADIAN SECURITIES INSTITUTE
www.csi.ca

Investor Learning Centre OF CANADA
www.investorlearning.ca

The Investor Learning Centre of Canada is Canada's only independent not-for-profit organization solely dedicated to providing non-promotional investment information to the general public. It is funded through revenues from its low-cost programs and by an endowment from the Canadian Securities Institute, the national educator for the securities industry.

ILC Toll Free Number: 1-888-452-5566

ILC Resource Centres

Toronto
121 King St. W., Ground Floor
Toronto, ON, M5H 3T9
Tel: (416) 681-2193 Fax: (416) 364-3262

Calgary
Suite 200, W.R. Castell Central Library
616 Macleod Trail S.E.
Calgary, AB, T2G 2M2
Tel: (403) 269-9923 Fax: (403) 269-9924

CSI Offices

Toronto
121 King St. W., 15th Floor
Toronto, ON, M5H 3T9

Vancouver
650 West Georgia St., Suite 1350
P.O. Box 11574
Vancouver, BC, V6B 4N8

Calgary
355 – 4th Ave. S. W., Suite 2330
Calgary, AB, T2P 0J1

Montreal
1 Place Ville Marie, Suite 2840
Montreal, PQ, H3B 4R4

Halifax
1791 Barrington St., TD Centre, Suite 1620
Halifax, NS, B3J 3K9

M-01-01-226