

# INVESTMENT *facts*

No. 5

Investor Protection

## 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!

### **I'm worried about investing in securities. I'm afraid I might lose everything if I'm not careful.**

There is no way to guarantee that all your investments will make money. Although few investments can promise the same return that the stock market does over time, it is the nature of securities markets that while they go up, they also go down.

Free markets are the heart of our capitalist economy. They must be able to respond in an instant to changes in market conditions. That means investors and users of capital should not face too many roadblocks. At the same time, everyone must have the same access to the markets, enough timely information to make wise choices about investing, and confidence that the system is not peopled by crooks. Investor protection in Canada is designed to ensure this happens.

The Canadian securities industry is a well-balanced system of checks and obligations, helping to provide a safety net for all investors. It's pretty effective in preventing problems and in resolving any that do come up. But being careful with your investments is still important.

### **Who is primarily responsible for investor protection?**

In Canada the various provincial governments have the last word on investor protection. Each province has a *securities commission* or administrator which oversees a provincial securities act. This act is a set of laws and regulations which outlines what players in the market can do and cannot do.

All the securities acts are based on the principle of full and plain *disclosure*. Any information that will affect investors must be available to all investors in a timely fashion. Usually the onus is on the issuer to disperse information. However, just because a company meets a regulator's requirements for

disclosure does not mean its securities have investment merit. Potential investors should keep this in mind.

Securities commissions also require *registration* of all organizations and sales staff involved in the investment business. There are different categories of registration – investment dealer, registered investment advisor, mutual

fund salesperson and so on. Before registration is allowed, basic standards must be met. These include minimum capital requirements for a firm and minimum educational qualifications for personnel.

The Acts also specify broader responsibilities for investment advisors and their relationships with clients. They are obliged to deal fairly, honestly and in good faith with clients.

### **That sounds good but what standards of behavior can I really expect from my investment advisor?**

Most securities acts require that investment advisors make recommendations that are appropriate for you and conform to prudent business practices. In the industry, we call this *suitability* or the *Know Your Client Rule*. When you first open an account, your advisor will fill out an application form based on information from you on your personal and financial situation. This provides the foundation for the advice your advisor will give.

There are lots of specific rules that guide advisors which you should know about. You must receive a confirmation of any trading in your account as well as full, detailed, and regular account statements. Securities you have paid for must be kept apart from any other securities owned by your dealer. You can expect your dealer to tell you when it is acting as a principal on a trade with you, to discuss

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with you the special investment characteristics of strip bonds, to tell you about limited voting rights for any shares you might be considering, and to provide you with a copy of the firm's Conflict of Interest Policies when you become a client. Your advisor cannot do a trade without consulting you unless you grant your firm permission in writing.

You cannot be sold new securities which do not have a prospectus unless the securities are exempt from this requirement. Your broker cannot promise to resell or repurchase a security and cannot promise to refund the purchase price unless you have a written agreement. Your broker cannot tell you that a stock is guaranteed to go up or down in price.

As well, your advisor cannot promise you that a security will be listed on an exchange or that an application for listing has been made unless the regulator consents in writing. Under no circumstances can the advisor tell you that the investment merits of any security have been approved by the provincial regulator.

These are just some of the specific rules and regulations guiding an investment advisor. There are many others, as well as an industry-wide Code of Ethics. However, the relationship of trust your advisor has with you stands behind all the rules. Should there ever be a problem not covered by a regulation, the test used to measure wrongdoing is whether your investment advisor or firm has met the standards of practice expected of a prudent investment advisor. There are lots of precedents to help resolve this question.

## What kind of teeth do the Securities Acts have?

The various securities administrations have many of the powers of the courts. They can investigate, undertake prosecutions for violations of the Acts, carry out hearings and compel the attendance of witnesses. They can take evidence, seize documents, and freeze funds or securities. They cannot compel money to be paid back nor interfere in internal disputes of company shareholders.

However, they can suspend registrations and order trading in a security to cease. Sometimes the regulator can prevent appointments to the boards of public companies. They can give public reprimands and levy fines. They can also recommend that a charge be laid in the criminal or civil courts.

## Who else sets rules that will affect me?

Because securities regulation is a provincial matter, the various Canadian securities commissions and administrators have formed a national group to work towards making securities regulations compatible across Canada. This group is called the *Canadian Securities Administrators*. From time to time, this group issues national or provincial policies. One national policy on *shareholder communication* ensures that all shareholders who wish to will receive company information such as annual reports.

In addition, many important rules governing industry practices and standards are set by the *Self-Regulatory Organizations*, which include the Canadian Venture Exchange (CDNX), the Toronto Stock Exchange, the Montreal Exchange and the Investment Dealers Association of Canada. In fact, a lot of the regulatory and compliance functions have been delegated to the SROs by the provincial securities administrators. These organizations oversee the brokers and investment dealers, as well as the markets themselves.

## Does this mean the industry polices itself? What about self-interest?

To a large extent the industry does police itself. However, all regulatory responsibilities are carried out under the watchful eye of provincial regulators. Every by-law and rule created by an SRO and every single complaint is reviewed by the securities administrators. This ensures that the public interest is paramount. In addition, public governors sit on the Boards of all the SROs to monitor the public interest.

The Canadian securities industry, as with most professional bodies, highly values its self-regulatory status. Being able to regulate yourself is a privilege which must be earned every day. If the industry did not take this responsibility seriously, the privilege would be quickly lost. The industry understands that creating a system to serve only its own

*The investor protection fund protects investors if an investment firm goes under.*

interests could not survive. Governments would step in. Serving the public interest is, in fact, in the best long-term interest of the industry.

Self-regulation also has real advantages for the public at large. For one, it is much less costly than a government bureaucracy. Right now the industry shoulders the very high cost of regulation and compliance. If it didn't pay the bill, the taxpayer would have to. Secondly, it works better. Those who know the markets are more able to make practical rules and are more aware of potential loopholes and compliance problems. In turn, the industry is more likely to comply with rules of its own making.

Some people will always be suspicious of self-regulation. Yet it has worked remarkably well in providing sound and cost-effective regulation in the Canadian securities markets.

## What do Self-Regulatory Organizations do to protect the public?

SROs have two major responsibilities: to oversee the markets and to oversee the brokers and investment dealers who operate in the respective markets.

They do that in a variety of ways. First of all, they create standards that participants must meet prior to employment. They also create rules governing how the markets must operate and extensively investigate suspected infractions. And, they examine brokerage firms and dealers on a regular basis to ensure firms are solvent and following all the rules.

## Do all the SROs do the same thing?

Not exactly. The Investment Dealers Association monitors the bond and money markets while each of the stock exchanges looks after its own market, be it for stocks, options, futures or all three! All of the exchanges are responsible for market regulation and the IDA is solely responsible for member regulation (with the exception of some small Quebec companies regulated by the ME). Member regulation is comprised of sales compliance and financial compliance.

The *market regulation* area is more likely to be different at each SRO, reflecting the different kinds of markets each oversees. Stock markets are *listed* markets, often with

direct public participation. Stock exchanges spend a great deal of time qualifying companies before they can be listed and in monitoring stock performance. Price performance in equities is very closely linked to the day-to-day life and performance of the company which issued the stock. To make sure these markets are fair, stock exchanges set rules to ensure *material* company information gets out to shareholders so that everyone trades on an equal footing. They can stop trading in the market to make sure that happens. Stock exchanges have many other rules to make the market more open and fair.

The bond market, however, is an *unlisted* market, generally for *professionals*. That does not mean that the market is regulated less strictly. Companies that are active in the bond markets must provide regular disclosure in addition to the extensive disclosure required before a new issue. The focus, however, is on ensuring visibility, fair access, and honest prices among dealers so that the investing public who are buying and selling in the bond and money markets can benefit.

## How do SROs make sure brokers and dealers comply with the rules?

Every firm that is a member of an SRO binds itself to follow the rules and regulations of the SRO upon qualifying for membership. Every investment dealer has a senior-level compliance department. This area's task is to make sure the rules and by-laws are followed in letter and spirit, compliance is also responsible for filing regular financial and operational reports to the SROs to provide an early warning system for problems.

The IDA works with compliance departments and monitors all reports. In addition, all brokers and dealers must submit to at least one external audit a year, one surprise visit and one surprise financial questionnaire.

What is the IDA searching for? For one thing, every member must maintain adequate capital in accordance with the nature and volume of business it conducts. If it falls below this level, the IDA can require action to correct the deficiency or to suspend the member's trading privileges. The IDA might also be looking to see that customers' fully paid-for securities are kept apart.

The SROs also employ staff who

investigate complaints and infractions. The stock exchanges and the IDA have the authority to prosecute individuals who are suspected of wrongdoing and to exact penalties in the form of fines or suspensions.

## How do you make sure listed companies are not selling investors a fake bill of goods?

Over 200 years ago in Britain, investors happily bought shares in a company whose product was "yet to be revealed" - even to itself! Today, companies like this would be drummed out of business. But lots of perfectly legitimate companies offer little more than promise. Should these companies be allowed to sell shares to the public?

One of the biggest challenges facing regulators and stock exchanges is how to strike a balance between protecting investors and ensuring valid ventures have access to capital. The company which shows little more than promise today may deliver results tomorrow. Or, it could go out of business. If a stock exchange sets too stringent listing standards to help protect investors from potential business failures, a growing venture may never get off the ground.

The industry has responded with variable listing standards. The CDNX, for example, has standards that are more likely to encourage companies that are brand new. The more senior exchange is the Toronto Stock Exchange. If you are looking for a stock on the *venture capital* exchanges, be very aware that the company may have no track record. That means it's going to be risky. If the stock is not listed anywhere, you have even less knowledge or reassurance. Look closely at the prospectus and be prudent!

Over and above setting listing standards, all exchanges in Canada require listed companies to disclose full information to shareholders and potential shareholders. This includes prospectus-type information for new issues as well as a requirement for *continuous disclosure*. If anything new happens that will affect the company's business, the company is obliged to release that information widely so all investors have access to it.

The industry believes that full, plain and true ongoing disclosure is good preventative medicine. It won't stop companies from going under, but it might stop you from sinking, too!

## I've heard lots of stories about insiders or large investors getting an edge in the markets. What is being done to prevent that?

The industry has made headway in ensuring equal treatment for all investors. For example, it was often said that investors who owned *non-voting* shares were disadvantaged, not just through restricted voting rights but also if the company was being taken over. Common shares with restricted voting rights still exist although they are discouraged and must meet stringent disclosure standards. In addition, most companies now provide a *coat-tail provision* which gives non-voting shareholders a chance to take part in any special deals that are offered for the shares in a takeover. In addition, big shareholders can't be enticed with special benefits to turn in their shares. All shareholders in the same class must be treated equally.

Insider trading is carefully regulated. Insiders are those who have special access to information about a company that is not generally known and which would affect the price of its securities. Anyone who is defined as an insider by the securities commissions has to report any trading in the security. It is illegal for advisors, investors, and anyone party to inside information to act on it.

The industry is always working to ensure that the individual investor gets fair treatment. We have made great progress since the early days when "buyer beware" was the watchword. But the job must be ongoing.

## How do I know that industry personnel are adequately educated and trained?

Before someone can provide investment advice on behalf of a firm, that individual must be registered with the securities

You can protect yourself by knowing the rules by which investment advisors have to work.

administrator. One qualification for registration is that the investment advisor must meet certain educational standards. Currently, all IAs must pass *The Canadian Securities Course® (CSC™)* offered by the Canadian Securities Institute®. The CSC is an intensive independent study course providing in-depth information on securities and their markets. IAs must also pass an exam on rules and regulations, and on ethics and conduct. Before they can start giving advice to clients, IAs must complete a three month training course. To further protect investors' interest, 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, also offered by the CSI.

## What happens if I think my investment advisor has done something wrong?

Your first step is to speak to the Branch Manager of your firm. He or she will try to resolve the problem or will channel it to one of the stock exchanges or the Investment Dealers Association.

These bodies will pursue the investigation further. If there is wrongdoing, the IA will be fined or forced to withdraw from the industry.

The regulators are not able to force a broker to pay you back, although a firm may choose to reimburse you if wrongdoing is proven. Normally disputes over restitution must be taken to a civil court. However, the industry is experimenting with an arbitration program for clients and advisors. This program should provide an alternative to expensive and lengthy court disputes when the claim is less than \$100,000. Arbitrators are independent of the securities industry.

## Are my investments as safe with a small firm as with a large or bank-owned dealer?

Yes. The securities industry is regulated to ensure that all firms have enough capital for the business that they do. All firms which are members of an SRO must meet capital and liquidity requirements on an ongoing basis. If a company suddenly can't meet the test, industry regulators are immediately alerted to the problem. The company must prove that it

can meet the capital and liquidity requirements and show what action has been taken to ensure that this takes place quickly. Even if the worst happens and the firm becomes insolvent, your cash and securities must be returned to you by the receiver or trustee. If there is a shortfall and your account was with a member of one of the Self-Regulatory Organizations, your account is protected by the Canadian Investor Protection Fund.

Because of this system, you are just as safe with a small broker as a large one.

## Can you tell me more about this investor protection fund?

The investor protection fund is called the *Canadian Investor Protection Fund (CIPF)*. It is sponsored by CDNX, the Montreal Exchange, the Toronto Stock Exchange and the IDA. The brokers and dealers which are members of these Self-Regulatory Organizations pay an assessment to provide funds. CIPF also has a line of credit with a chartered bank.

As soon as you become a client of a member, your accounts are covered. The maximum coverage is \$1,000,000 for losses related to securities and cash balances. Accounts such as cash, margin, short sale,

The key to being a safer investor is to be an informed investor.

options, futures and foreign currency are combined as one account for coverage purposes. Some accounts such as for RRSPs or RRFs are entitled to separate coverage of \$1,000,000. Customers have 180 days from the date of insolvency to file a claim.

## You've talked about how the system can protect me and my investments. How can I protect myself?

The key to being a safer investor is to be an informed investor. Read as much as you can about the products and securities that interest you. Visit an investor resource centre, library or bookstore and subscribe to a daily business newspaper. Attend a recognized course or seminar on investing like the Investor Learning Centre's Intelligent Investing non-promotional seminar series. Ask for annual reports about companies and make sure you get any other information the company sends out. Follow stock prices regularly and ask your IA for research reports.

Make sure you have an IA who takes the time to explain things to you. Understand how the investments you make relate to your objectives and don't be afraid to issue regular report cards. If your financial needs change, update your investment objectives promptly. Pay attention to simple risk management strategies like diversification and never put all your eggs in one basket!

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