Conduct and Practices Handbook Course
Copies of this publication are for the personal use of properly registered students whose names are entered on the course records of CSI Global Education Inc. (CSI)®. This publication may not be lent, borrowed or resold. Names of individual securities mentioned in this publication are for the purposes of comparison and illustration only and prices for those securities were approximate figures for the period when this publication was being prepared.

Every attempt has been made to update securities industry practices and regulations to reflect conditions at the time of publication. While information in this publication has been obtained from sources we believe to be reliable, such information cannot be guaranteed nor does it purport to treat each subject exhaustively and should not be interpreted as a recommendation for any specific product, service, use or course of action. CSI assumes no obligation to update the content in this publication.

A Note About References to Third Party Materials:
There may be references in this publication to third party materials. Those third party materials are not under the control of CSI and CSI is not responsible for the contents of any third party materials or for any changes or updates to such third party materials. CSI is providing these references to you only as a convenience and the inclusion of any reference does not imply endorsement of the third party materials.

Notices Regarding This Publication:
This publication is strictly intended for information and educational use. Although this publication is designed to provide accurate and authoritative information, it is to be used with the understanding that CSI is not engaged in the rendering of financial, accounting or other professional advice. If financial advice or other expert assistance is required, the services of a competent professional should be sought.

In no event shall CSI and/or its respective suppliers be liable for any special, indirect, or consequential damages or any damages whatsoever resulting from the loss of use, data or profits, whether in an action of contract negligence, or other tortious action, arising out of or in connection with information available in this publication.

© 2005 CSI Global Education Inc.
All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of CSI Global Education Inc.
### INTRODUCTORY COURSES
- Canadian Funds Course
- Canadian Insurance Course
- Canadian Securities Course
- Conduct and Practices Handbook Course
- CSI Prep Series
- Investment Advisor Training Program
- Investment Representative Training
- New Entrants Course

### COMPLIANCE & TRADING
- Branch Managers Course
- Canadian Commodity Supervisors Exam
- Chief Financial Officers Qualifying Exam
- Options Supervisors Course
- Partners, Directors & Senior Officers Course
- Trader Training Course

### FINANCIAL PLANNING & WEALTH MANAGEMENT
- Canadian Securities Course
- Professional Financial Planning Course
- Wealth Management Techniques

### INSURANCE
- Canadian Insurance Course

### PORTFOLIO MANAGEMENT
- Canadian Securities Course
- Investment Management Techniques
- Portfolio Management Techniques

### RISK MANAGEMENT & DERIVATIVES
- Derivatives Fundamentals Course
- Energy Markets Risk Management Course
- Financial Markets Risk Management Course
- Futures Licensing Course
- Options Licensing Course
- Options Strategies Course
- Technical Analysis Course

### CONTINUING EDUCATION
- Anti-Money Laundering
- Broker Liability
- CE Compliance Course including CPH for Industry Professionals
- Charts and Formations
- CPH for Industry Professionals
- Corporate Governance (compliance)
- Covered Call Writing
- Estate Planning
- Ethics Module and Case Study, Institutional Version
- Ethics Module and Case Study, Retail Version
- Exchange Traded Funds
- Fixed Income Investing
- Hedge Fund Essentials for Today’s Financial Professional
- How Mutual Funds and Hedge Funds Use Derivatives
- Income Trusts
- Industry Trends
- Investor Confidence
- Portfolio Theory, Asset Allocation and Performance Measurement
- Practice Management
- Pre-Retirement Planning
- Principal-Protected Notes
- Quantitative Analysis
- Retirement Planning
- Segregated Funds
- Single Stock Futures
- Socially Responsible Investing
- Trust Structures
- Understanding Margin: Benefits and Risks

### DESIGNATIONS
- Financial Management Advisor (FMA)
- Canadian Investment Manager (CIM)
- Derivatives Market Specialist (DMS)
- Fellow of CSI (FCSI)
# Table of Contents

## Introduction

Coverage of Material ................................................................................................................. 1

## SECTION I: THE REGULATORY ENVIRONMENT

### Chapter One – Canadian Securities Industry Registrant Code of Ethics and Standards of Conduct

- Introduction ......................................................................................................................... 3
- Know Your Client and Suitability ......................................................................................... 3
- Fiduciary Duty ....................................................................................................................... 5
  - I. Registrant Code of Ethics ............................................................................................... 5
  - II. Registrant Standards of Conduct .................................................................................. 6
    - Standard A – Duty of Care .............................................................................................. 8
    - Standard B – Trustworthiness, Honesty and Fairness ...................................................... 11
    - Standard C – Professionalism ......................................................................................... 14
    - Standard D – Conduct in Accordance with Securities Acts ........................................... 21
    - Standard E – Confidentiality ........................................................................................... 23
      - Personal Information Protection and Electronic Documents Act .................................. 24
  - III. Summary ..................................................................................................................... 26

### Chapter Two – Regulation of the Securities Industry

- Introduction .......................................................................................................................... 27
  - I. General Principles of Securities Regulation ................................................................. 28
  - Disclosure ............................................................................................................................ 29
  - Registration ......................................................................................................................... 30
  - Investigation and Prosecution .............................................................................................. 30
  - II. Key Players Involved in Securities Regulation ............................................................... 32
    - The Federal Government ................................................................................................. 32
      - Integrated Market Enforcement Teams (IMETs) .......................................................... 32
    - The Provinces .................................................................................................................. 32
  - III. Self Regulatory Organizations (SROs) ......................................................................... 36
    - The Canadian SROs ......................................................................................................... 38
    - The Investment Dealers Association (IDA) ...................................................................... 38
    - The Exchanges (Marketplaces) ......................................................................................... 40
    - Market Regulation Services Inc. (RS) ............................................................................. 43
    - The Mutual Fund Dealers Association (MFDA) ............................................................... 45
  - IV. Jurisdiction of the Provinces and SROs ......................................................................... 45
  - V. Dealing with Money Laundering and Terrorist Financing in the Securities Industry ................................................................................................................................. 46
  - VI. Investor Protection Funds ............................................................................................. 56
    - Canadian Investor Protection Fund (CIPF) .................................................................... 56
    - Mutual Fund Dealers Association’s Investor Protection Corporation (MFDA IPC) ............ 60
Chapter Three – Registration of Securities Industry Participants

I. Types of Registration
II. Categories of Registration
   Dealers
   Introducing/Carrying Broker Arrangements
   Advisors
III. Exemptions from Registration
   Advisors
   Banks and Other Financial Institutions
IV. Registration of an Individual as a Registered Representative
   Proficiency Requirements and Categories of Individual
   Registration
   Investment Advisor (IA)
   Investment Representative (IR)
   Mutual Fund Sales Representative (MFSR)
   Restrictions on Unregistered Staff
   Dual Licensing for Securities and Life Insurance
   The National Registration System (NRS)
   The National Registration Database (NRD)
   Procedures for Individual Registration
   Single and Multi-Jurisdiction Submission Types
   Renewal of Registration
   Notice of Changes
   Termination of Registration
   Registration After an Absence
   Filing Requirements for Proficiency Exemption

V. Summary

Section II: Dealing with Client Accounts

Chapter One – Account Opening Procedures

I. Opening Accounts
   The Cardinal Rule - Know Your Client
   Client Identification Requirements
   The New Account Application Form
   Client Information
   Account Opening Red Flags
Chapter Two  – Sales and Trading Conduct

Introduction .......................................................................................................... 135

I. Review of Basic Principles ........................................................................... 135
   Know Your Client ....................................................................................... 136
   Recommendations .................................................................................... 139

II. Rules of Conduct ...................................................................................... 141
   Sales Practices Prohibited by the Securities Acts ...................................... 141
      Calling at or Telephoning Residences ........................................... 141
      Sales Made from One Province to Another ...................................... 141
      Province or Country .......................................................................... 141
      Sale of Unqualified Securities ............................................................ 142
      Churning ............................................................................................. 142
      Illegal Representations to Effect a Trade ........................................... 142
   Improper Sales Practices .......................................................................... 144
   Manipulative Trading Practices as Defined by SRO Rules ......................... 144
   Discretionary Trading ............................................................................. 145
   Priority of Client Orders ......................................................................... 145

III. Principal vs Agency Transactions ................................................................. 146
   Principal Transactions ........................................................................... 146
      Client Priority Rules .......................................................................... 146
      Off-Floor Rule .................................................................................. 147
   Agency Transactions ................................................................................. 147

IV. Concerns about Client Trading ................................................................ 147
   Deliveries and Payments ......................................................................... 149

V. Account Activity and Money Laundering Red Flags .................................. 149

VI. Dealing with Confidential Information ...................................................... 150
Chapter Three – Placing Orders for Securities

Introduction ................................................................. 165

How Securities are Traded ........................................... 165
Trading Units ............................................................... 165
Minimum Quotation Spreads ........................................ 167

I. Placing an Order ....................................................... 168

II. Types of Orders ....................................................... 170
Orders Categorized by Duration ................................. 170
Orders Categorized by Price ........................................ 171
Orders Categorized by Special Instructions .................. 172
Other Types of Orders ................................................ 175

III. Settlement of Trades ............................................... 176
The Clearing System ................................................... 176
Advantage with Securities Sold ................................. 177
Accrued Interest to Seller .......................................... 177
Trading Ex-Dividends and Ex-Rights ......................... 177
Cash Trades ............................................................... 177
Exceptions ................................................................. 178
Rights on Stock ......................................................... 178
Reducing Outstanding Orders When Shares Go
Ex-Dividend, Ex-Rights etc ...................................... 178

Transfer of Securities ................................................ 178
Simple Transfer ........................................................ 179
Transfer Involving Legal Documentation .................... 179
Changes in Beneficial and Economic Ownership ....... 180

Failure to Deliver Listed Securities ......................... 180

IV. Errors ................................................................. 181

V. Summary .............................................................. 182
**Chapter Four – Cash and Margin Account Rules**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>183</td>
</tr>
<tr>
<td>I. Accounting for Client Transactions</td>
<td>183</td>
</tr>
<tr>
<td>II. Cash Accounts</td>
<td>185</td>
</tr>
<tr>
<td>Purchases of Securities</td>
<td>186</td>
</tr>
<tr>
<td>Sale of Securities</td>
<td>187</td>
</tr>
<tr>
<td>Special Cash Accounts</td>
<td>188</td>
</tr>
<tr>
<td>Detailed Rules for Cash Accounts</td>
<td>189</td>
</tr>
<tr>
<td>Dealing with Overdue Cash Accounts</td>
<td>190</td>
</tr>
<tr>
<td>Cash Accounts Overdue for Less Than Six Business Days</td>
<td>191</td>
</tr>
<tr>
<td>Cash Accounts Overdue for Six or More Business Days</td>
<td>193</td>
</tr>
<tr>
<td>Detailed Rules for DAP/COD Accounts</td>
<td>194</td>
</tr>
<tr>
<td>Overdue DAP/COD Accounts</td>
<td>194</td>
</tr>
<tr>
<td>Exceptions to the Cash Account Rule</td>
<td>195</td>
</tr>
<tr>
<td>III. Margin Accounts</td>
<td>197</td>
</tr>
<tr>
<td>Margin Agreements</td>
<td>198</td>
</tr>
<tr>
<td>Long Margin Accounts</td>
<td>199</td>
</tr>
<tr>
<td>An Introduction to Margin Rates</td>
<td>199</td>
</tr>
<tr>
<td>Securities Eligible For Reduced Margin</td>
<td>200</td>
</tr>
<tr>
<td>Operating a Long Margin Account</td>
<td>201</td>
</tr>
<tr>
<td>Loan Value</td>
<td>202</td>
</tr>
<tr>
<td>Margin Position</td>
<td>203</td>
</tr>
<tr>
<td>Equity Position</td>
<td>204</td>
</tr>
<tr>
<td>Long Margin Account - Case Study</td>
<td>204</td>
</tr>
<tr>
<td>More about Margin Rates</td>
<td>206</td>
</tr>
<tr>
<td>Margining Long Positions in Unlisted Equities</td>
<td>207</td>
</tr>
<tr>
<td>Sample Margin Account</td>
<td>208</td>
</tr>
<tr>
<td>Short Margin</td>
<td>210</td>
</tr>
<tr>
<td>Risk</td>
<td>210</td>
</tr>
<tr>
<td>Credit Balances</td>
<td>210</td>
</tr>
<tr>
<td>Margin Required</td>
<td>210</td>
</tr>
<tr>
<td>Combination of Short and Long Positions in a Margin Account</td>
<td>213</td>
</tr>
<tr>
<td>Special Margin Situations</td>
<td>213</td>
</tr>
<tr>
<td>Restrictions</td>
<td>213</td>
</tr>
<tr>
<td>Convertible Bonds/Debentures</td>
<td>213</td>
</tr>
<tr>
<td>Hedge Positions</td>
<td>214</td>
</tr>
<tr>
<td>Guarantees</td>
<td>214</td>
</tr>
<tr>
<td>Concentration</td>
<td>214</td>
</tr>
<tr>
<td>Unlisted Securities Sold Short</td>
<td>215</td>
</tr>
<tr>
<td>Options</td>
<td>215</td>
</tr>
<tr>
<td>IV. Free Credit Balances</td>
<td>215</td>
</tr>
<tr>
<td>V. Summary</td>
<td>216</td>
</tr>
</tbody>
</table>
# Chapter Five – Communications with Clients

Introduction .......................................................................................................... 217

I. General Regulations and Guidelines for Sales Literature ....................... 218

II. Mutual Fund Sales Communications ........................................................ 219
   General Requirements ................................................................................ 219
   Use of Performance Data .......................................................................... 221
   Warnings .................................................................................................. 222
   Standard Performance Data ..................................................................... 222
   Other Required Disclosure – Mutual Funds ............................................. 224

III. Electronic Communications ...................................................................... 225
   Issuer Disclosure and Delivery ................................................................. 225
   System for Electronic Document Analysis and Retrieval (SEDAR) ......... 226
   Company Websites .................................................................................. 226
   Internet Trading and Advising ................................................................. 227

IV. General Disclosure Requirements ............................................................ 228
   Disclosure When Acting as Principal ........................................................ 228
   Disclosure When Selling Securities Short ................................................. 229
   Disclosure of Conflicts of Interest ............................................................. 229
   Disclosure Relating to Products ................................................................. 230
   Leverage Disclosure ................................................................................ 231

V. Communicating Trading Information to Customers .................................. 231
   Confirmation of Trades ........................................................................... 231
   Account Statements ................................................................................ 232
   Margin Accounts .................................................................................... 235
   Other Information for Clients .................................................................. 238
   Safekeeping, Segregation and Street Name .............................................. 238
   Portfolio Reporting ................................................................................ 239
   Taxation .................................................................................................. 239

VI. Handling Client Complaints ...................................................................... 239
   Disputes with Clients ............................................................................ 239
   ComSet .................................................................................................. 241
   OSC Tipping Program ............................................................................ 242
   Arbitration ............................................................................................. 242
   Eligibility ............................................................................................... 243
   The Arbitration Process .......................................................................... 243
   The Financial Services OmbudsNetwork (the OmbudsNetwork) .......... 244
   Client Communication ........................................................................... 245

VII. Summary .................................................................................................. 246
### Section III: Special Transactions and Products

#### Chapter One – Bringing New Issues to Market

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Bringing Securities to the Market</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>Securities Distributions</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>When a Prospectus is Required</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>New Issues</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>Sale from a Control Position</td>
<td>249</td>
</tr>
<tr>
<td></td>
<td>Preliminary or Red Herring Prospectus</td>
<td>249</td>
</tr>
<tr>
<td></td>
<td>Permitted Activities During the Waiting Period</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>Final Prospectus</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>Details of the Offering</td>
<td>251</td>
</tr>
<tr>
<td></td>
<td>Information on the Business and Affairs of the Issuer</td>
<td>251</td>
</tr>
<tr>
<td></td>
<td>Factors Affecting an Investment Decision</td>
<td>252</td>
</tr>
<tr>
<td></td>
<td>Information on Promoters, Principal Security Holder and Interest of Management in Material Transactions</td>
<td>252</td>
</tr>
<tr>
<td></td>
<td>Financial Information</td>
<td>252</td>
</tr>
<tr>
<td></td>
<td>Representations, Declarations and Certificates</td>
<td>253</td>
</tr>
<tr>
<td></td>
<td>Market Out Clauses</td>
<td>254</td>
</tr>
<tr>
<td></td>
<td>Simplified or Short Form Prospectus and Shelf Prospectus</td>
<td>254</td>
</tr>
<tr>
<td></td>
<td>The Bought Deal</td>
<td>255</td>
</tr>
<tr>
<td></td>
<td>Use of U.S. Prospectuses</td>
<td>255</td>
</tr>
<tr>
<td></td>
<td>Securities Distributions through the Exchanges</td>
<td>256</td>
</tr>
<tr>
<td></td>
<td>Distributions through the TSX</td>
<td>256</td>
</tr>
<tr>
<td></td>
<td>Distributions through Bourse de Montréal</td>
<td>256</td>
</tr>
<tr>
<td></td>
<td>Distributions through the TSX Venture Exchange</td>
<td>256</td>
</tr>
<tr>
<td></td>
<td>Exempt Issues</td>
<td>257</td>
</tr>
<tr>
<td></td>
<td>Purchasers’ Statutory Rights</td>
<td>261</td>
</tr>
<tr>
<td></td>
<td>Right of Withdrawal</td>
<td>261</td>
</tr>
<tr>
<td></td>
<td>Right of Rescission</td>
<td>261</td>
</tr>
<tr>
<td></td>
<td>Right of Action for Damages</td>
<td>262</td>
</tr>
<tr>
<td></td>
<td>Restrictions on Trading</td>
<td>262</td>
</tr>
<tr>
<td></td>
<td>Hot Issues</td>
<td>263</td>
</tr>
<tr>
<td></td>
<td>Conflict of Interest Rules</td>
<td>263</td>
</tr>
<tr>
<td>II</td>
<td>Maintaining Publicly Trading Status</td>
<td>264</td>
</tr>
<tr>
<td></td>
<td>Financial Disclosure</td>
<td>264</td>
</tr>
<tr>
<td></td>
<td>Press Releases and Material Change Filings</td>
<td>266</td>
</tr>
<tr>
<td></td>
<td>National Policy 51-201</td>
<td>266</td>
</tr>
<tr>
<td></td>
<td>SEDAR</td>
<td>267</td>
</tr>
<tr>
<td></td>
<td>The System for Electronic Disclosure by Insiders (SEDI)</td>
<td>268</td>
</tr>
<tr>
<td></td>
<td>Proxies and Proxy Solicitation</td>
<td>268</td>
</tr>
<tr>
<td></td>
<td>Mandatory Proxy Solicitation</td>
<td>268</td>
</tr>
<tr>
<td></td>
<td>Shareholder Communication Procedures</td>
<td>268</td>
</tr>
<tr>
<td></td>
<td>Voting by Dealers</td>
<td>270</td>
</tr>
<tr>
<td>III</td>
<td>Summary</td>
<td>271</td>
</tr>
</tbody>
</table>
# Chapter Two – Takeover Bids, Insider Bids, and Issuer Bids

## Introduction .......................................................................................................... 273

### I. Formal Takeover Bids .............................................................................. 273

- What Is a Formal Takeover Bid? ........................................................ 273
  - Early Warning Rules ........................................................................... 274
  - Takeover Bid Rules ............................................................................ 275
    - **Takeover Bid Circular** ................................................................. 275
    - **Directors’ Circular** ...................................................................... 275
    - **Timing** .......................................................................................... 275
    - **Withdrawal Rights** ...................................................................... 276
  - **Fairness Rules** .................................................................................. 276
  - **Other Acquirers** .............................................................................. 276

### II. Insider Bids............................................................................................... 277

### III. Statutory Rights of Shareholders.............................................................. 277

- **Defenses To Unfriendly Takeover Bids** ........................................... 278

### IV. Exempted Takeover Bids ......................................................................... 278

- **Stock Exchange Takeover Bids** ....................................................... 279
  - **Normal Course Issuer Bid** ............................................................. 279
  - **Regulations on Substantial Takeover Bids Made on Stock Exchange** .................................................................................. 280
  - **Allotment Procedure and Competing Bids** ................................... 280
  - **Conduct of Members in Tendering Shares and Short Tendering** ..................................................................................... 280

### V. Issuer Bids................................................................................................ 281

### VI. Exchange Issuer Bids............................................................................... 282

### VII. Summary .................................................................................................. 282

## Case Studies........................................................................................................ 283

- **Case #1 - Gemini Mutual Funds** ....................................................... 285
- **Case #2 - Luke Picard** ................................................................. 288
- **Case #3 - The Cheng Accounts** ..................................................... 290

## Glossary ............................................................................................................ 295

## Appendix A – The CSA Numbering System for National Policies and National Instruments .................................................. 313

## Appendix B – TSX Electronic Communications Disclosure Guidelines .......................................................................................... 315
The Conduct and Practices Handbook (CPH) Course

Introduction

The following Handbook identifies many of the requirements of provincial securities legislation and of the Self-Regulatory Organizations (SROs) that affect registrants in their dealings with clients.

The Handbook results from careful consideration of the different elements that comprise the daily life of a registrant in the Canadian securities industry, and is organized into three major sections that reflect these areas:

Section I: The Regulatory Environment
  Chapter 1: Canadian Securities Industry Registrant Code of Ethics and Standards of Conduct
  Chapter 2: Regulation of the Securities Industry
  Chapter 3: Registration of Securities Industry Participants

Section II: Dealing with Client Accounts
  Chapter 1: Account Opening Procedures
  Chapter 2: Sales and Trading Conduct
  Chapter 3: Placing Orders for Securities
  Chapter 4: Cash and Margin Account Rules
  Chapter 5: Communications with Clients

Section III: Special Transactions and Products
  Chapter 1: Bringing Issues to Market
  Chapter 2: Takeover Bids, Issuer Bids and Issuer Bids

Ethics and compliance-related case studies, a glossary, and other supplementary resources have also been included for reference purposes.

Coverage of Material

This Handbook is intended as a guide to requirements (rules, regulations, policies, by-laws, etc.) of the Administrators and SROs. It should facilitate the study of these requirements but it is by no means exhaustive. The registrant should remember that the final authority is always provincial legislation and SRO rules and by-laws. It is the registrant’s duty to be fully familiar with the content of
all sections of this Handbook. In addition, registrants are responsible for knowing provincial legislation as it relates to their employment in provinces and/or territories where they are or will be licensed to sell securities. Some material included in this book should be known to students but will not be tested on the CPH exam. In such cases the material is highlighted and marked “For information only.” The registrant is still responsible for knowledge of this material apart from the actual CPH exam.

This material should be viewed as reflecting minimum standards or policy guidelines for compliance with industry rules. In practice, internal procedures of securities houses will reflect their individual management techniques and controls and, as a result, may be stricter than those presented here.

The Handbook does not specifically deal with futures and options matters. The registrant who is qualified to deal with the public in futures and options is subject to the various Securities Acts and Commodity Futures Acts, as applicable in these areas. Additional courses are required for licensing to deal in these products.

Major provisions of Canadian securities legislation of particular concern to investment professionals are summarized in the material that follows in this Handbook. Descriptions are based largely on the present Securities Act (Ontario), as this was the model used for most other provinces. Any significant differences in provincial legislation are noted. Where possible, the Handbook also provides highlights of proposed changes to requirements. Referencing of some of the relevant legislation has been included in the textbook.
Section I: The Regulatory Environment

Chapter 1

Canadian Securities Industry Registrant Code of Ethics and Standards of Conduct

Introduction

The securities industry is a business of trust and confidence. As a consequence, even in an environment that already has many complex rules and regulations, a Code of Ethics is warranted.

It should be understood that there is a difference between compliance and ethics. Compliance is, basically, following the rules, whether those rules are legal requirements or firm policies. Ethics involve not only complying with the letter of the law but also complying with the spirit of the law. Therefore, ethics go beyond prescribed behaviour, and address situations where rules are not clear or are contradictory. It is possible to take an action that is unethical, even though one is complying strictly with the rules.

Learning Objectives

After reading this section, you should understand:

- the importance of the Know Your Client rule and suitability in the registrant’s dealings with clients
- the importance of ethics in the securities industry
- the Code of Ethics and Standards of Conduct for the securities industry
- how to apply the Code and Standards to various situations

Know Your Client and Suitability

A way of integrating ethics into the rules is through ensuring suitability of investment recommendations. The focus of the registrant’s daily business hinges on this all-important matter. Suitability means ensuring that all recommendations
take into account the client’s unique situation and investment objectives. It also means that recommendations are based on a personal and financial knowledge of the client and knowledge of the investment products being recommended.

In April 2000, the Canadian Securities Administrators (CSA) ruled that discount brokers who do not provide investment advice may submit applications for an exemption from suitability requirements. Exemptions were to be granted under certain conditions, including:

- The dealer must operate as a separate legal entity or business unit that limits activities so that no advice or recommendations will be given regarding the purchase or sale of any security;
- The separate legal entity or business unit must, at a minimum, have separate letterhead, accounts, registered persons and account documentation;
- The dealer must not compensate individuals on the basis of transactional values; and
- The dealer must receive a client’s written acknowledgement that no advice or recommendations will be given and that no determination of suitability will be provided for any purchase or sale of a security through the legal entity or business unit.

In September 2001, the IDA implemented revisions to its know-your-client regulations that incorporate the April 2000 CSA ruling and expand it to give full service dealers the opportunity to accept non-recommended trades without a suitability obligation. The changes included revisions to IDA Regulation 1300 and the introduction of Policy 9.

Policy 9A applies to dealers or branches offering order-execution services only and contains the same provisions as the CSA ruling. The CSA exemptions, which were granted to dealers individually, generally required that members operating under a CSA exemption are required to obtain Policy 9A exemptions from suitability within a year of the implementation of the IDA rule.

When applying for relief under Policy 9A, dealers must submit new account forms, letterhead, account statements and confirmations that clearly differ in format from those used by any full service branch, and that clearly label the accounts as “order execution only” accounts or some variant thereof.

Policy 9B is applicable to full service dealers who want to be able to execute client orders that do not result from any advice or recommendation from the dealers and without incurring a suitability obligation. Those trades would be affected through the same accounts as trades that did result from advice or a recommendation.

In order to obtain relief under Policy 9B, a dealer must establish record keeping and supervisory systems acceptable to the IDA, capable of distinguishing between recommended and non-recommended trades. The dealer must also supervise the
marking of trades to ensure that there is no practice of marking recommended trades as non-recommended in order to avoid suitability obligations.

Policy 9B also requires disclosure to and agreement by clients whose non-recommended trades will not be subject to a suitability review.

A concerted effort must be made to know the client – to understand the financial and personal status and aspirations of the client. Thus, the Investment Advisor (IA) will make recommendations for the client to invest his or her funds in securities that reflect, to the best knowledge of the IA, these considerations. The IA, having provided sound advice, will therefore be above reproach for potentially unsuitable purchases and sales of securities for a client if the client does not heed the IA’s advice.

**Fiduciary Duty**

When disputes between dealers and clients are resolved through civil litigation, the courts will generally hold that the IA owes a fiduciary duty to the client if the IA provides investment advice and recommendations to the client, and the client relies on such advice. The existence of such a fiduciary duty imposes a higher standard of care upon the IA than would be the case if the IA merely executed the client’s orders without providing any advice. A fiduciary relationship requires the IA to act carefully, honestly, and in good faith in dealings with the client, and not to take advantage in any way of the trust the client has placed in the IA.

**I. Registrant Code of Ethics**

This Code of Ethics establishes norms that incorporate, but are not limited to, strict compliance with “the letter of the law” but also foster compliance with the “spirit of the law.” These norms are based upon ethical principles of trust, integrity, justice, fairness and honesty. The Code distills industry rules and regulations into five primary values.

A. Registrants must use proper care and exercise independent professional judgement.

B. Registrants must conduct themselves with trustworthiness and integrity, and act in an honest and fair manner in all dealings with the public, clients, employers and colleagues.

C. Registrants must, and should encourage others to, conduct business in a professional manner that will reflect positively on themselves, their firms and their profession. Registrants should also strive to maintain and improve their professional knowledge and that of others in the profession.

D. Registrants must act in accordance with the Securities Act(s) of the province or provinces in which registration is held and the requirements of all Self-
Regulatory Organizations (SROs) of which the firm is a member must be observed.

E. Registrants must hold client information in the strictest confidence.

II. Registrant Standards of Conduct

The Standards of Conduct on the following page amplify the Code of Ethics and set out certain specifics of required behaviour. These requirements are based in large part on the provincial Securities Acts and the SRO rules.
## Exhibit 1
**Canadian Securities Industry Standards of Conduct**
*(Summary)*

### Standard A: Duty of Care
- Know Your Client
- Due Diligence
- Unsolicited Orders

### Standard B: Trustworthiness, Honesty and Fairness
- Priority of Client Interests
- Protection of Client Assets
- Complete and Accurate Information
- Disclosure

### Standard C: Professionalism
- Client Business
  - Client Orders
  - Trades by Registered and Approved Individuals
  - Approved Securities
- Personal Business
  - Personal Financial Dealing with Clients
  - Personal Trading Activity
  - Other Personal Endeavours
- Continuous Education

### Standard D: Conduct in Accordance with Securities Acts
- Compliance with Securities Acts and SRO Rules
  - Inside Information

### Standard E: Confidentiality
- Client Information
- Use of Confidential Information
Standard A – Duty of Care

While a duty of care encompasses a wide number of obligations towards parties, the obligation to know the client is of paramount importance in order to ensure the priority of clients’ interests. Along with this obligation, the three other major components of duty of care are:

- **Know Your Client**: The Know Your Client (KYC) rule is paramount for the industry. All registrants, except those granted the exemption from the suitability requirement, must make a diligent and business-like effort to learn the essential financial and personal circumstances and the investment objectives of each client. Client account documentation should reflect all material information about the client’s current status, and should be updated to reflect any material changes to the client’s status in order to assure suitability of investment recommendations.

- **Due Diligence**: Registrants must make all recommendations based on a careful analysis of both information about the client and information related to the particular transaction.

- **Unsolicited Orders**: Registrants who give advice to clients must provide appropriate cautionary advice with respect to unsolicited orders that appear unsuitable based on client information. The registrant must be aware of the objectives and strategies behind each order accepted on behalf of his or her clients, whether it is solicited or not. Registrants should take appropriate safeguarding measures when clients insist on proceeding with unsolicited, unsuitable orders.

**Example A:**

Jane Morgan is an IA. The New Account Application Form (NAAF) for one of her clients, Bruno Mannheimer, indicates that he has a moderate income, moderate net worth and conservative investment objectives. Mannheimer has recently come into a substantial inheritance. He calls Morgan, telling her about his inheritance.

Based on Mannheimer’s new net worth, Morgan recommends the purchase of several growth and speculative stocks, the total of which comes to over $200,000. When Morgan’s branch manager sees these orders the next day, she checks the client’s New Account Application Form. It shows a net worth of $100,000, annual income of $50,000 and objectives of 50% income and 50% safety. Immediately concerned, the branch manager calls Morgan into her office and requests an explanation of whether the client can pay for these securities and whether the securities are appropriate for the client.

**Comment**

The IA in this example was fortunate that her branch manager was alert. Either the orders were well beyond the client’s apparent ability to pay, or the client has experienced a major change in his financial situation. The client documentation did not show the financial resources to support acceptance of such an order.
It is not clear in this case whether Morgan discussed any change in objectives that might have accompanied the change in financial circumstances. Taking into account Mannheimer’s age, occupation, plans for retirement, and any change of attitude on the client’s part, Morgan should consider the continuing applicability of the objectives on the client’s NAAF.

In order to justify the suitability of the recent purchases in Mannheimer’s account, Morgan must update the client’s New Account Application Form. It is not always sufficient to “Know Your Client” – the registrant must also be able to prove that he or she does. Otherwise, if the securities did not perform well and the client complained, Morgan could be faced with the problem of justifying these orders. In fact, if the client claimed to be unsophisticated and conservative, and had the investment history to support these claims, a complaint by the client might result in sanctioning of the IA for giving unsuitable advice.

**Procedures for Compliance**

- Registrants must document any material changes to their clients’ situations.
- This includes changes to net worth, income, employment, investment objectives and marital status.
- The firm should ensure that any transactions that appear unsuitable based on a client’s NAAF are flagged and investigated.

**Example B:**

An IA, Stanley Kowalski, receives a phone call from one of his clients, Doris Green, who is interested in speculating on the proposed takeover of a national auto parts manufacturer. After a lengthy discussion, Green concludes that the speculation is worthwhile and instructs the IA to invest her excess margin in shares of the company. After checking the account’s margin balance, Kowalski buys 2,500 shares of the company’s Class B shares. Two weeks later, the takeover is finalized. At that time, the IA learns that the takeover has been directed at the company’s voting shares only. A quick review of a research source shows that the company’s class A shares carry one vote per share. However, Class B shares are non-voting. As a result, Green does not profit from the takeover, and in fact, actually takes a small loss on her trade.

**Comment**

The IA appears to have been negligent in not having taken enough care to learn the essential details surrounding the company in question and its proposed takeover. Through his negligence, Kowalski failed to act in the client’s best interests. It is likely that the IA could be held responsible for the client’s losses as well as missed profit opportunity.
Procedures for Compliance

- Registrants must have a thorough level of product knowledge and understanding.
- Many firms offer the facilities of a research department to assist registrants in locating up to date information on various companies and products.
- Firms often offer training for registrants in the areas of specialized products and trading strategies.
- A wide variety of financial and news publications are available to help registrants keep up on the latest developments in the investment industry.

Example C:

Kate Janeway, an IA, takes a call from a seventy-two year old retired client, Sam McMunny, whose NAAF states that his only income is from a pension, his net worth is $150,000 and his investment objective is 100% income. At the time of the call his account holds $130,000 in a combination of Canada Treasury Bills and long-term Government of Canada bonds. McMunny is calling to say that his son-in-law, who is a mining engineer, has given him a tip on a penny mining stock that is currently involved in explorations. The company is expected to announce drilling results in a few days. If the drilling results are favourable, the stock’s price could rise dramatically. McMunny instructs Janeway to liquidate all of his T-Bills (which make up about half of his portfolio) and use the proceeds to buy shares in the penny stock. Janeway promptly enters the orders as requested.

Comment

By accepting this order without question, the IA has violated the requirement for due care. It is her duty under Standard A to ascertain that this client is aware of the risk associated in buying speculative stock. He must also be made aware that this type of trade does not conform to the investment objectives that he specified when his account was opened. If his objectives have changed, the NAAF must be updated to reflect this. If the objectives of the client have not really changed, but the client continues to insist on the trade, the IA must clear it with her branch manager or compliance department. If the firm agrees to accept the order, it should be marked “unsolicited” and the circumstances of the trade should be documented in the client’s file.

Procedures for Compliance

- Clients must be warned when transactions seem unsuitable based on their NAAF.
- NAAFs should be updated if investment objectives have changed.
- Client orders entered against the advice of the IA should be marked “unsolicited” and the circumstances of the transaction documented.
• If IAs are unable to dissuade clients from making apparently unsuitable trades, they should clear such orders with the branch manager or compliance department before putting them through.
• Firms may refuse to accept unsuitable orders. Policies may be put in place or they may be dealt with on a case-by-case basis.

Standard B – Trustworthiness, Honesty and Fairness

Registrants must display absolute trustworthiness since the client’s interests must be the foremost consideration in all business dealings. This requires that registrants observe the following:

- **Priority of Client’s Interest:** The client’s interest must be the foremost consideration in all business dealings. In situations where the registrant may have an interest that competes with that of the client, the client’s interest must be given priority.
- **Respect for Client’s Assets:** The client’s assets are the property solely of the client and are to be used only for the client’s purposes. Registrants shall not utilize client funds or securities in any way.
- **Complete and Accurate Information Relayed to Client:** Registrants must take reasonable steps to ensure that all information given to the client regarding his or her existing portfolio is complete and accurate. While the onus is on the investment firm to provide each client with written confirmations of all purchases and sales, as well as monthly account statements, the individual registrant must accurately represent the details of each clients’ investments to the client. The registrant must be familiar with the client’s investment holdings and must not misrepresent the facts to the client in order to create a more favourable view of the portfolio.
- **Disclosure:** Registrants must disclose all real and potential conflicts of interest in order to ensure fair, objective dealings with clients.

Example A:

A fairly new IA, Kyle Toshiba, has a small group of clients. To increase his and his firm’s income, he favours an active trading approach with his clients. Toshiba’s branch manager notices that several of the IA’s accounts show very high levels of trading activity, many times without significant differences in the types of securities traded. Quite often, shares that had been sold from an account were bought back for the same account a few days later. In one case, a client whose investment knowledge was indicated as “fair” had 24 trades in his account over a two-month period, with no significant changes over that period in the type or performance of securities traded.
Comment

While registrants have an interest in executing transactions in order to earn commission revenue, they should do so only if the transactions are in the best interests of the clients. In this case, the number of trades in the IA’s client accounts does not seem to be in the clients’ best interests. Toshiba appears to be churning, or generating trades simply for the commission he will earn. Churning is a prohibited sales practice as it implies trading that is unnecessary and unsuitable for the client. Churning is trading which does not benefit the client and deprives the client of the money being paid in commission.

Procedures for Compliance

• Recommendations for trades should be made only when necessary and when it is to the benefit of the client.
• Branch managers must be aware of and question any trading that appears excessive.

Example B:

Jack Chopra, an IA, has a long-time client named Igor Sazonoff. One day, Chopra notices that Sazonoff’s account shows a small margin deficiency. Chopra knows that his branch manager will ask him to clear up this deficiency. Chopra also knows that Sazonoff is on vacation and will certainly be bringing the account up to date within the week. Another client of Chopra’s, Monica Mintz, has a large cash balance sitting idle in her account. Chopra moves some money from Mintz’s account into Sazonoff’s to cover the margin deficiency. Within the week, Sazonoff has returned from vacation and deposited enough money to bring his account up to date. Chopra then replaces the borrowed money into the Mintz account.

Comment

Chopra has used Mintz’s assets for the benefit of another client, Sazonoff. A client’s assets must be used solely for the benefit of that client. Mintz may have wished to convert her cash into securities while some of her cash was still in Sazonoff’s account. Her cash would have been at risk in Sazonoff’s account if Sazonoff had not repaid the balance owed.

However, no matter whether Mintz wished to access her money or not, an unauthorized transfer such as this is not permitted. Using client assets for the benefit of the registrant or another client is not permitted and reflects badly on the registrant, the firm and the industry. This violates the trust inherent in the registrant-client relationship and may constitute criminal behaviour.
Procedures for Compliance

• Firms should have policies in place to ensure that any movement of assets between client accounts is appropriately authorized and monitored.

Example C:

A retired client, Fredella Bingleby, holds a portfolio of preferred stocks, primarily for the dividend income they provide. Higher interest rates have caused the value of the portfolio to decrease, causing her some concern. She calls her IA, Philip de Groot, and asks if her money might be more safely invested in GICs at a local trust company. The IA explains that the higher interest rates are only a short-term problem, and that everything will be all right eventually. To help ease Bingleby’s concern, he volunteers to do a portfolio evaluation for her.

After de Groot has completed the evaluation, he realizes that the client’s total return on investment does not look favourable in light of current interest rates. So, not wanting to lose Bingleby’s business, de Groot re-calculates the portfolio’s yield using current market values rather than the purchase price of the various preferred shares. This method of calculation shows a higher income return on the shares and ignores the capital loss on the principal amount of the shares. Satisfied with the results, he sends the evaluation to the client, who is reassured by what she reads.

Several weeks later, Bingley’s tax accountant reviews the evaluation and realizes what has occurred. Angry at having been misled by the IA, the client complains to the branch manager and transfers her account to another firm.

Comment

By providing the client with inaccurate information regarding her portfolio holdings, the IA has deliberately misled the client. He has taken advantage of Bingleby’s lack of understanding of yield calculation to create the impression that the client’s portfolio was performing better than it really is. In so doing, the IA has attempted to deceive his client. The branch manager must also approve all such communication before it goes to clients.

Procedures for Compliance

• Rather than making an effort to disguise an apparent weakness in Bingleby’s portfolio, de Groot should appraise the portfolio constructively, perhaps suggesting some changes such as alternative securities which are suitable for the client and will increase her return.

• The member firm should have procedures in place to ensure that the branch manager or a director of the firm review any portfolio evaluations prepared by IAs in order to ensure that the enclosed information is accurate and complete.
Example D:

Jeff Doe, an IA, also sits on the board of directors of a small software company (Tekwax) owned by his cousin. Doe thinks that Tekwax is a promising investment, and has been recommending that clients purchase its stock on the over-the-counter market, telling them only that Tekwax is a promising new company in the technology sector. Doe does not think it necessary to inform his clients or employer that he is a director of Tekwax.

Comment

Doe must disclose his directorship to both his employer and his clients. His position with Tekwax may bias his investment recommendations to clients and cause him to overlook more suitable or advantageous investments.

Procedures for Compliance

- The IA must disclose his directorship to his employer and obtain written approval from the employer.
- The IA must tell his clients that he is a director of Tekwax when he makes any recommendations for the stock.

Standard C – Professionalism

It is generally accepted that professionals, by having specialized knowledge, need to protect their clients, who usually do not have the same degree of specialized knowledge, and must continually strive to put the interests of their clients ahead of their own. Registrants must also make a continuous effort to maintain a high standard of professional knowledge.

- **Client Business:** All methods of soliciting and conducting business must be such as to merit public respect and confidence.
  - **Client Orders:** Every client order must be entered only at the client’s direction unless the account has been properly constituted as a discretionary or managed account pursuant to the applicable regulatory requirements.
  - **Trades by Registered and Approved Individuals:** All trades and all acts in furtherance of trades, whether with existing or potential clients, must be effected only by individuals who are registered and approved in accordance with applicable legislation and the rules of the SROs.
  - **Approved Securities:** Only securities approved for distribution by the appropriate regulatory authority and partner, director or officer of the firm should be distributed, and all such transactions should be recorded in the normal way on the books and records of the firm.
Personal Business: All personal business affairs must be conducted in a professional and responsible manner, so as to reflect credit on the individual registrant, the securities firm, and the profession.

- Personal Financial Dealings with Clients: Registrants should avoid personal financial dealings with clients, including the lending of money to or the borrowing of money from them, paying clients’ losses out of personal funds, and sharing a financial interest in an account with a client. Any personal financial or business dealings with any clients must be conducted in such a way as to avoid any real or apparent conflict of interest and be disclosed to the firm, in order that the firm may monitor the situation.

- Personal Trading Activity: Personal trading activity should be kept to reasonable levels. If a registrant is trading his or her own account very actively on a daily basis, it is doubtful that the registrant will have enough time to properly service his or her clients. Excessive trading losses by a registrant will also present a negative image of the registrant as a responsible financial professional.

- Other Personal Endeavours: Each registrant must take care to ensure that any other publicly visible activity in which he or she participates (such as politics, social organizations or public speaking) is conducted responsibly and moderately so as not to present an unfavourable public image.

Continuous Education: It is the responsibility of each registrant to have an understanding of factors that influence the investment industry in order to maintain a level of competence in dealing with his or her clientele. A registrant must continually upgrade his or her levels of technical and general knowledge to ensure the accuracy and responsibility of his or her recommendations and advice.

Example A:

Mario Fellini, an IA, opens a margin account for a surgeon who wishes to speculate in growth stocks. Fellini suggests several trades to the client over a six-month period. Most of the trades are quite profitable. However, on a few occasions, the IA is unable to contact his client when he is tied up in surgery for several hours. As a result of these delays, some potential profits are reduced due to adverse market moves before Fellini is able to contact his client. Frustrated, but still pleased by the consistent success of the IA’s recommendations, the client tells the IA that if he is unable to reach him at any time in the future, the IA should go ahead and use his own initiative to take profits on existing positions, or to take on new positions as long as there is enough margin available in the account. Fellini agrees to do this on a “when necessary” basis.
Comment

Regardless of the client’s willingness to have the IA make certain decisions regarding the trading of his or her account, this arrangement contravenes the rules for two reasons:

• The registrant does not have the authority to accept a discretionary account on behalf of his or her firm. This can only be done by a partner or director of the firm (or his or her alternate) who has been designated to supervise account openings and activities (the “designated person”).
• The client must supply discretionary authority in writing. Verbal authority is not acceptable.

Unauthorized discretionary trading is one of the most common reasons for disciplinary action being taken against registrants. The nature of the business is such that, due to rapidly changing markets, it may be difficult for registrants to obtain specific orders from a client on short notice. Thus, the perception of a need to trade on a discretionary basis can become a serious temptation. However, penalties can be quite severe, and in most member firms unauthorized discretionary trading may be grounds for termination.

Procedures for Compliance

• The IA must have the client complete a discretionary agreement (assuming that the firm allows discretionary accounts), update the New Client Application Form to indicate that the account has become discretionary, and submit these documents to the firm’s designated person for approval.
• If the IA is not a person authorized to place discretionary orders, he or she would have to ensure that all discretionary orders for the account are approved by the appropriate person before they are entered.
• The onus is on each member firm to ensure that all representatives are familiar with the by-law regarding discretionary trading. In most member firms, unauthorized discretionary trading is grounds for termination. Since it is very difficult for supervisory personnel to detect unauthorized discretionary trading in the absence of a client complaint to that effect, it is necessary for the firm to initiate procedures to assist in this area. For example, all IAs who transfer in from other member firms should be asked if they maintain any discretionary accounts.
• The entire sales staff should be surveyed at least on an annual basis in order to verify what accounts are being traded on the basis of discretionary authority. Clients must reauthorize discretionary authority no less frequently than annually.
• The firm’s new account staff should be instructed to contact the compliance department whenever they see a new account that appears to be discretionary (e.g., an account over which an IA holds a Power of Attorney or a Trading Authorization).
Example B:

An established IA, Ramesh Issar, with a sizeable client base decides that strip bonds have become very attractive investments. He hopes to use Government of Canada strip bonds as a prospecting tool for new accounts, so he plans a month-long solicitation campaign. Because of the magnitude of the campaign and the fact that he will be spending a lot of time out of the office visiting prospects, he is worried that he will not have enough time to service his existing clientele. So, he instructs his unregistered sales assistant, who has taken the Canadian Securities Course and is now enrolled in the CPH, to take all of his incoming calls, and to place any orders that his clients may give. He also tells the sales assistant to convince his clients to take profits in their common stocks, as he expects prices to generally go lower for the next several months.

Comment

The IA (and the firm) is in violation of the rules. An unregistered individual must not be allowed to accept orders or solicit business from clients except in “exempt securities” (e.g. T-Bills, CSBs, etc.). Note that even if the assistant had completed the courses required for registration, the individual must be registered and acknowledged as such by the SRO. The firm could also be found guilty of failing to properly supervise the IA and the sales assistant.

Procedures for Compliance

• In a case such as this, the registrant must make arrangements with another IA in the firm to have the other IA handle existing clientele. In fact, some firms encourage their IAs to develop this type of buddy system to provide mutual back up when they are out of the office.
• Firms usually require their sales assistants to be registered to assist with order-taking duties.
• Each member firm should have policies in place to ensure that unlicensed employees are not taking orders from clients.

Example C:

An accomplished IA, Eric Jacobson, has a client, Antoinette Lagarde, who controls a number of small companies involved in various types of business. One of the more successful businesses is Toyco Inc., an import/export operation which has the exclusive right to distribute in Canada a line of interactive stuffed toys. Sales are growing quickly, and Lagarde needs additional capital to finance her inventory. Not wanting to borrow, she approaches a number of people, including Jacobson, to solicit interest in making an equity investment in the company. The IA is impressed by the profit potential of the business and agrees to invest $10,000 of his own money, for which he receives 10,000 common shares of Toyco Inc.
Jacobson mentions this investment to a number of other clients, five of whom express an interest in investing in Toyco as well. Jacobson relays this information to Lagarde, who says she would be willing to issue additional shares to the IA’s other clients on the same terms. The IA obtains cheques from the five clients, payable to Toyco Inc., and in return receives share certificates registered in the clients’ names, which he subsequently delivers to them. As Jacobson feels that this is a private arrangement between Toyco and the clients, he does not see any necessity to advise his branch manager of the transactions.

Comment

Although Jacobson may believe the transactions are a private arrangement, the clients may view him as acting as a representative of the firm in facilitating the investment. Dealings in securities outside of the normal business of the firm, sometimes referred to as selling away or outside deals may expose clients to unknown risks and expose registrants and firms to civil liability. Such activities done without the knowledge of the firm also prevents effective supervision of the handling of client accounts, which is a requirement placed upon firms by the SROs. Firms may be exposed to liability for the actions of their employees in effecting such trades, even though the firm is unaware of the activities.

Procedures for Compliance

- The firm must have knowledge of and give written consent to any business dealings outside of normal business.
- The IA should have taken Lagarde’s proposal to the appropriate official of the firm.
- The IA should have placed the securities with clients only if the firm agreed to participate in the distribution of the securities, perform the necessary due diligence with respect to the proposed distribution, and ensure compliance with securities legislation.
- Any trades must be recorded in a normal way with trade confirmations issued and monthly statements sent to the clients.

Example D:

An experienced IA, Edgar Brown, has a client, Michelle Green, with whom he has dealt for the past six years. Although Brown did not know Green prior to her becoming a client, since then they have socialized to some extent and might be considered friends. About a year ago, Brown needed $20,000 for renovations to his house. As the house was already heavily mortgaged and Brown knew he would have difficulty obtaining financing, he approached Green and asked if she would lend him the $20,000. Brown knew that Green could well afford to lend the funds as her account was worth over $100,000, much of which was liquid. The client agreed to lend the funds, and received from Brown a promissory note providing for payment within six months, with interest at the prime rate.
When the six months had passed, the client inquired about repayment. Brown replied that he would have difficulty paying the debt at this time, and asked for more time, to which the client reluctantly agreed. It has now been six months since the note came due and Brown has not yet been able to pay it. Green has grown increasingly upset with Brown’s stalling and has now complained directly to the firm’s management about the unpaid debt.

Comment

The purpose of this standard is to prevent the creation of conflicts of interest that may arise when the registrant enters into financial dealings with clients on a personal level, aside from normal business dealings conducted through the firm.

The IA in this example has entered into a transaction that creates a fundamental conflict of interest. He is now both a borrower from, and an advisor to, the client. In addition, Brown took advantage of his knowledge of Green’s financial circumstances, gained through his professional relationship with the client, thereby using their professional relationship for his personal benefit. By borrowing the funds from Green, Brown has also prevented the client from taking advantage of any superior investment opportunities that might have arisen.

The standard is not stated as an absolute prohibition, as it is recognized that there are some circumstances where such dealings may not be objectionable. There may be grey areas in compliance with the standard. For example, where there is a close, pre-existing relationship, or family relationship, between the registrant and the client, such dealings might not be objectionable, depending on the circumstances. However, any such dealing should not be entered into without the knowledge and approval of the firm, and the firm should ensure that the client’s interests are fully protected.

Procedures for Compliance

• Personal financial dealings with clients are to be avoided.
• Any proposed financial relationship with a client should be reviewed with an appropriate official of the firm, such as the head of compliance. The firm must give approval to the relationship and monitor the situation.
• Any such financial relationship must be conducted so as to avoid any real or apparent conflict of interest.
• In the event that a client is to be compensated for losses (for example, for trading errors or losses resulting from unsuitable recommendations), such compensation should only be paid through the proper channels of the firm, even if the loss is ultimately charged back to the registrant.
Example E:

Elaine van Nostrand, an IA, has used her increasing knowledge of investments to build up her own portfolio, as well as those of her clients. She is planning to buy a house next year, and is counting on profits from her portfolio to provide a large down payment. The stock market has been rather volatile lately, and van Nostrand finds that she has to keep monitoring her own holdings in order to prevent losses. On two consecutive days, van Nostrand spends at least one quarter of her time at the office buying and selling for her own account, both to protect her potential profit and because she sees many stock bargains.

Comment

Van Nostrand obviously is not serving her clients at the level they should expect. While trading for one’s own account is allowed, it should not be done to the point where clients’ accounts are in any way neglected or compromised. The reason that the IA in this example is spending a large amount of her time on her own account is given as the volatility of the stock market. If markets are volatile, clients’ accounts should be monitored even more closely than normally.

Procedures for Compliance

• Trading for a registrant’s personal account(s) should not be excessive, and should not affect the level of service given to clients.
• Firms should monitor trading in personal accounts by employees.
• Registrants should avoid taking excessive risk that may lead to large losses.

Example F:

An IA, Walter Garcia, participates in a political organization. This organization recently held a protest, which Garcia attended. An opposing group showed up and shouting matches ensued. The TV news that night featured Garcia, among others, speaking out against the opposing group. Both Garcia’s occupation and his firm were identified. The next day, several clients called Garcia’s firm, wondering if the firm supported Garcia’s organization.

Comment

This is an example of the type of situation that could present an unfavourable and unprofessional public image. This negative publicity reflects badly on the IA, the IA’s firm and on others in the industry, as it contributes to the public perception of the investment professional.
Procedures for Compliance

• Garcia should have ensured that his participation in organizations outside of the firm’s business did not result in negative publicity being reflected on the firm, or in any implication of the firm’s support of his personal activities.

• Firms should make their employees aware that they have an interest in any personal activities of the employee, as these activities may reflect badly on the firm and on the investment profession.

Standard D – Conduct in Accordance with Securities Acts

Registrants must ensure that their conduct is in accordance with the Securities Acts and the applicable SRO rules and regulations.

- Compliance with Securities Acts and SRO Rules: Registrants must ensure that their conduct is in accordance with the Securities Acts of the province or provinces in which registration is held. The requirements of all SROs of which a registrant’s firm is a member must be observed by the registrant. Note that if two rules apply, the registrant must adhere to the rule which is the most stringent. The registrant shall not knowingly participate in, nor assist in, any act in violation of any applicable law, rule or regulation of any government, governmental agency or regulatory organization governing his or her professional, financial or business activities, nor any act which would violate any provision of the industry Code of Ethics and Standards of Conduct.

- Inside Information: If a registrant acquires non-public, material information the information must neither be communicated (outside of the relationship) nor acted upon. Employees of a firm’s trading, corporate finance or research departments must be aware of the need to safeguard non-public, confidential, material information received in the normal course of business.

Example A:

Phyllis Erdo, an IA, is married to the treasurer of a publicly-traded pharmaceutical company, Feelgood Inc. Like many other employees of Feelgood Inc., Erdo’s husband holds a sizeable position in the company’s stock. Feelgood Inc. stock has recently enjoyed a 30 per cent increase in value due to rumours of an impending merger with a larger, U.S.-based company.

One day, Erdo receives a phone call from her husband, informing her that the merger has fallen through. The husband wants to unload a large portion of his Feelgood stock before news of the failed merger becomes public. Erdo enters her husband’s order to sell 10,000 shares. She then calls her sister, who is also a client. Erdo tells her sister that the merger has fallen through and suggests that her sister make a quick profit by short selling Feelgood shares. When news of the failed merger becomes public, the price of the shares should quickly drop back to its previous level. The sister agrees and sells 1,000 shares short.
Comment

The IA in this example has actually violated two rules regarding insider trading. First of all, she accepted a sell order from a client (her husband) who was obviously acting on inside information as a result of his special relationship with the issuer. A special relationship denotes a relationship in which confidential information is obtained about an issuer by virtue of employment or the employment of a close relative or cohabitant. This includes insiders of the issuer as well as those working in certain capacities for or with the issuer (see Section II, Chapter 1 for a more extensive definition of insiders and special relationships). Therefore, Erdo herself could be considered to have a special relationship with the issuer through her husband. Provincial securities legislation states that no person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.

The IA then passed along this information to her sister. This act of tipping is also contrary to provincial securities legislation. Regulation states that no person or company in a special relationship with a reporting issuer shall inform another person or company of a material fact or material change with respect to the reporting issuer before the material fact or material change has been generally disclosed.

Procedures for Compliance

• Erdo knew that her husband was an insider of Feelgood Inc.
• She should not have accepted the order.
• She should not have divulged the confidential information to (tipped) her sister.

Example B:

While using a fax machine in close proximity to her firm’s Corporate Finance Department, an IA, Margaret Peterson, notices an incoming fax message addressed to someone in Corporate Finance. The fax discusses the purchase of a large trust company by a competitor. Peterson’s firm is apparently assisting with the financing of this purchase. When she returns to her desk, Peterson proceeds to call several of her clients, suggesting that they purchase shares in the trust company. She tells the clients that they can expect to hear an announcement soon detailing the terms of the competitor’s purchase offer. Naturally, such an announcement could be expected to have a positive effect on the value of the trust company.

Comment

Although the registrant in this example is not directly involved in a special relationship with the trust company (although her firm appears to be), she has nonetheless come into possession of confidential, non-public information. By reading the fax message that was intended for her firm's corporate finance
department, Peterson has misappropriated this information. As well, by passing the information on to her clients and attempting to solicit trades based on the information, she has breached the Code of Ethics and Standards of Conduct.

**Procedures for Compliance**

- In this example, the registrant’s best course of action would have been to deliver the fax to the corporate finance department immediately.
- As well, the IA should have understood that she was in possession of confidential information, and that use of such information is not allowed. If she had any doubt as to her ability to use this information to solicit trades from her clients, the registrant should have discussed the matter with her firm’s corporate finance and compliance departments.
- The firm should assess its practices with regard to the protection of confidential information. Firms should implement effective “Chinese Walls” policies, by which persons within a firm who make investment decisions are physically separated from persons within the firm who are privy to undisclosed material information which may influence those decisions. For instance, there should be separate fax and photocopy machines for corporate finance departments and sales departments, in order to avoid the potential problem of leaving confidential documents in places where they may be intercepted.

**Standard E – Confidentiality**

All information concerning the client's transactions and his or her accounts must be considered confidential and must not be disclosed except with the client’s permission, for supervisory purposes or by order of the proper authority.

- **Client Information**: Registrants must maintain the confidentiality of identities and the personal and financial circumstances of their clients. Registrants must refrain from discussing this information with anyone outside their firm, and must also ensure that the firm’s client lists and other confidential records are not left out where they can be taken or observed by visitors to the office.

- **Use of Confidential Information**: Information regarding clients’ personal and financial circumstances and trading activity must be kept confidential and may not be used in any way to effect trades in personal and/or proprietary accounts or in the accounts of other clients. Not only must registrants refrain from trading in their own accounts based on knowledge of clients’ pending orders, but they must also refrain from using it as a basis for recommendations to other clients or passing this information along to any other parties.

Personal information is identifiable data about an individual and includes information contained in New Account Application Forms, account statements, trade confirmations and cheques and financial records in relation to the trading in securities. Clients from whom personal information is collected must be notified of
the purposes of the collection, use and disclosure of personal information, including its disclosure to SROs and its use and disclosure by SROs for regulatory purposes. It is important to note that Regulated Persons must decline to accept or administer an account in respect of which an individual does not consent to such intended collection, use or disclosure of their personal information.

Any organization, including any Regulated Person, may be subject to disciplinary proceedings by an applicable SRO if it:

- Fails to provide notification to individuals from whom it collects personal information sufficient to ensure that the Regulated Person can comply with its obligations to produce or make available for inspection documents and information to SROs for regulatory purposes, or
- Accepts or administers an account in respect of which the Regulated Person is unable to comply with its obligations to produce or make available for inspection documents and information to SROs for regulatory purposes, including circumstances in which the client of such Regulated Person does not consent to the disclosure of personal information to SROs and the use and disclosure of that information by SROs.

Effective November 2002, amendments to section 153 of the Ontario Securities Act dealing with the exchange of information between the OSC and those entities that provide services to the Commission became effective. The OSC now has greater flexibility in sharing information obtained in an investigation with other securities or financial regulatory authorities, stock exchanges and self-regulatory bodies.

**PERSONAL INFORMATION PROTECTION AND ELECTRONIC DOCUMENTS ACT**

Beginning January 1, 2004, the final stage of the Personal Information Protection and Electronic Documents Act (PIPEDA) came into force. The Act governs each firm’s information gathering processes and regulates what firms can do with the personal information that is collected, used and disclosed in the course of doing business. The final stage of the Act covers all businesses and organizations in Canada, both federally and provincially regulated, that collect, use or disclose personal information, except those in provinces where the government has enacted privacy legislation that is “substantially similar” to the PIPEDA. To date, British Columbia, Alberta and Quebec are the only provinces to do so, and firms should already be aware of this legislation and be complying with it. However, even where substantially similar provincial legislation exists, the PIPEDA will continue to apply to personal information transferred across provincial borders.

Fines for violations of the Act can range from up to $10,000 for a summary conviction or up to $100,000 for an indictable offence. It is also an offence under the Act to destroy personal information that a client has requested, or dismiss or harass an employee that has complained to the Privacy Commission, or obstruct a complaint investigation or audit.
The Nova Scotia Securities Commission issued Policy 11-601 to provide individuals with access to certain categories of records without having to submit a Freedom of Information and Protection of Privacy Act Application in that province. The policy allows for improved accessibility to certain records and to provide greater certainty of access for those requesting information.

**Example A:**

Phoebe Goldman, an IA, has a technical analyst as a client. Noting the successful track record of this analyst, Goldman calls several other clients and tells them of these successes. These clients agree to adopt the same trading strategies as the analyst.

**Comment**

Not only has the registrant violated the client’s confidentiality by passing along his trading strategies to other clients, Goldman has also done so simply by telling the other clients that she maintained an account for the analyst. This registrant may be vulnerable to regulatory penalties and possibly a civil lawsuit brought by the analyst.

**Procedures for Compliance**

- The confidentiality of each client must be protected.
- The firm must ensure that each of its representatives is aware of his or her responsibilities with regard to client confidentiality.

**Example B:**

Maria Oliveira, an IA at a large investment firm, has a client that is the pension fund of a local university. The pension fund has a sizeable holding in a national pharmaceutical company that has recently been developing a drug used in the treatment of allergies. Preliminary experimental results have been successful, so the stock has enjoyed a substantial rise in value in the past several months. However, potential patenting problems and pending legal action by a competitor have caused the stock’s price to decline from its recent highs. The director of the pension fund tells Oliveira that if the stock price falls below a technical support level of $30, the fund will take profits by liquidating its entire position in the stock.

Two days later, the IA notices that the stock has opened at $29.75. Aware of the impact that a large sell order could have on an already weakening market, Oliveira quickly sells short 1,000 shares in her own account. She then calls the director of the pension fund to report that the stock has opened below $30. As expected, the client instructs her to sell the entire position. By the end of the day, the stock has closed at $28.25, creating a nice profit in Oliveira’s short position.
Comment

By using her confidential knowledge of the client’s impending trade, Oliveira has taken advantage of her relationship with that client. Not only has she profited by trading on material, non-public information, she has also possibly cost her client a better fill price by not putting her client’s order ahead of her own. Thus, the registrant has not upheld her regulatory responsibility to that client.

The IA is also guilty of frontrunning (entering an order for her own account ahead of a similar client order). Had she called the client first and entered the client's order before her own, she would not be guilty of frontrunning, but she would still have been guilty of using confidential information for her own benefit. From the point of view of the member firm employing the IA, a simple review of the next day's commission run would almost certainly have brought attention to the trade and the obvious example of frontrunning, which would have left Oliveira susceptible to discipline by her firm.

Procedures for Compliance

• Confidential information may not be used either for the benefit of the IA or as the basis of recommendations to others.
• Firms should have policies in place regarding the use of confidential information.
• If registrants feel that their own trading activity may be such that it would cause an appearance of frontrunning, they must defer their own trades in the interest of protecting the integrity of the investment industry.

III. Summary

Ethical conduct is vital to ensuring the integrity and stability of the capital markets. Registrants should therefore be familiar with the Code of Ethics and Standards of Conduct and should be able to apply these standards to everyday situations. The Code and Standards incorporate the basic concepts of duty of care and suitability with the aim of protecting the interests of the investing public. The basic concepts of the Code and Standards underlie much of the regulatory material presented in this text.

The cardinal rule in making investment recommendations is that of Know Your Client. Investment recommendations must take into account all relevant factors regarding the client’s financial and personal situations, objectives and constraints. Registrants may be found to have a fiduciary duty to their clients if the client relies heavily upon their advice; this may have legal implications for the registrant and the firm.

Ethical conduct entails that registrants concern themselves not only with the actual rules as written, but also with the spirit and intent of the rules.
SECTION I: THE REGULATORY ENVIRONMENT

Chapter 2

Regulation of the Securities Industry

Introduction

The securities industry is a regulated industry. Various governmental and industry organizations impose rules and restrictions on participants in the securities marketplace to promote market integrity and to protect investors. For example:

• An issuer of securities may not sell new securities into the public marketplace without meeting certain requirements to provide information to potential purchasers as specified in the securities acts and regulations.

• Secondary trading in securities may not occur in public markets unless ongoing compliance with securities disclosure requirements takes place. This ensures that the public will continue to be adequately informed as to the nature of the securities and the associated risks so that an informed decision to purchase or sell the securities can be made.

• Distributors of securities (securities dealer firms and individuals) must also abide by rules governing their conduct. For example, securities regulation specifies the responsibilities which securities salespersons have to their clients when making recommendations for clients to buy and sell securities and when providing information to clients. Firms are required to supervise their employees’ conduct and to use care when handling assets of the clients.

These rules, among others, promote a fair and efficient securities marketplace.

The following chapter discusses the basic principles of securities regulation and the functioning of provincial securities legislation and the rules, regulations, by-laws, policies, guidelines etc. of the Self-Regulatory Organizations (SROs).
Learning Objectives

After reading this module, you should understand:

• the structure of Canadian securities industry regulation
• principles of securities regulation
• the role of the SROs and provincial regulators
• the role of the CIPF and limits of CIPF coverage
• penalties that can be applied by regulators for contravention of rules

I. General Principles of Securities Regulation

The mandates of each of the securities regulators are first and foremost to promote the integrity of financial markets and ensure investor protection. An example of these mandates is expressed in the B.C. Securities Commission Mission Statement:

“The mission of the British Columbia Securities Commission is to protect and promote the public interest by regulating trading in securities 1) to ensure the securities market is fair and efficient and warrants public confidence and 2) to foster a dynamic and competitive securities industry in British Columbia that provides investment opportunities and access to capital.”

and in the mandate of the Ontario Securities Commission:

“The Ontario Securities Commission’s mandate is to protect investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in their integrity.”

These statements and similar statements of other securities commissions and SROs have broad, extensive implications for the behaviour of participants in the securities industry. Securities legislation and SRO rules and regulations are crafted to incorporate these values.

Securities Acts have been passed by each province to regulate the primary and secondary distribution of securities and to protect buyers and sellers of securities. The term Act will be used to refer to the Securities Act of each province.

In most provinces, a securities commission administers the Acts. In provinces where there is not a separate commission, an administrator, registrar or other official handles securities administration. The term Administrator will be used here to describe the securities regulatory authority of a province, whether it be a commission, registrar, administrator or other official.
Generally, the Acts are based on three broad principles of regulation:

(i) **Disclosure** of facts necessary to make reasoned investment decisions;
(ii) **Registration** of securities dealers and advisors; and
(iii) **Enforcement** of securities laws and administrative policies.

**Disclosure**

The underlying principle of securities regulation in Canada is full, true and plain disclosure. Every person or corporation that sells, or offers to sell, to the public securities which have not previously been publicly distributed is required to file with the Administrator, and deliver to the purchaser, a prospectus containing full, true and plain disclosure of all material facts relating to the securities offered for sale. Until disclosure has been made to the satisfaction of the Administrator concerned, it is illegal to offer securities for public sale. Such disclosure is normally made in a prospectus issued by the company and its underwriter and accepted for filing by the Administrator of the province or provinces in which the offering will be made. In most provinces, a sale from a control position – where the holder of the securities exercises significant influence over the issuer of the securities – is subject to the same disclosure requirement.

As the security moves beyond the primary distribution, it may be further bought and sold by investors, often through the facilities of a stock exchange. This trading is called secondary trading and is done subject to the issuer meeting the requirements of the Securities Act(s) and the exchange(s) upon which the securities are traded. These rules require, among other things, periodic filing of financial statements and filing of information concerning material changes to the company. Examples of the emphasis on continued disclosure are seen in material to be covered later in this Handbook, such as:

- the regulatory requirements covering insider trading reports where persons connected to the company disclose their market activities;
- the information circular required in proxy solicitation;
- regular corporate financial reports, including management’s discussion and analysis;
- annual information forms;
- timely disclosure of material changes in the affairs of issuers; and
- other shareholder communication.

The purpose of this disclosure is to ensure efficient communication of material information from issuers to the public and investment professionals.
Registration

Every firm that underwrites or sells securities must be registered with the Administrator in the province in which the securities are sold. All partners, directors, officers and salespersons employed by securities firms must also be registered with the Administrator of the appropriate province.

The Administrators have the responsibility for registering persons and companies that are engaged in direct selling of securities to the public or engage in the business of advising others on the buying or selling of securities. This process allows the Administrators to impose proficiency requirements upon those that apply for or hold registration. The Administrators have the power to suspend or cancel registrations when they consider such action to be in the public interest.

Investigation and Prosecution

The Administrators are empowered to make investigations, to undertake prosecutions for violations against their respective Acts, to ensure that the laws are obeyed and to take administrative action - i.e., impose sanctions for breaches of the Acts - with respect to conduct that is contrary to the public interest. They also have authority to compel the attendance of witnesses at a hearing, take evidence under oath, seize documents for examination, freeze funds or securities on deposit with or under the control of any person and, in fact, have many of the powers of a court.

Although an Administrator, with the exception of the Manitoba Securities Commission, has no power to compel restitution of monies paid, nor to interfere in the internal disputes of shareholders of companies, registration can be suspended, cancelled or revoked, fines can be levied, trading in a security can be ordered to cease, and the right to trade securities in the province can be denied. Cancellation of registration can have serious consequences to a person in the industry who can lose the ability to earn a living. If securities of an issuer cease trading, the issuer will be less able to raise financing.

In certain provinces the Administrators have broader powers, such as preventing individuals from being directors or officers of public companies, giving public reprimands and levying fines. In all provinces, any person who considers himself aggrieved by a ruling of the Administrator may make an appeal to the courts. In addition, should the Administrators find that any provisions of their respective Acts have been violated, they may recommend that a charge be laid against the offending party. This may result in a guilty party suffering a fine or imprisonment or both.

With the passing of Bill 198 in December 2002, the maximum penalties for offences under the *Ontario Securities Act* have been increased from a fine of $1,000,000 and imprisonment for two years to a fine of $5,000,000 and
imprisonment for a term of not more than five years less a day. Also, Bill 198 gives the OSC the power to order the payment of an administrative penalty of up to $1,000,000 and to order the disgorgement of monies obtained as a result of non-compliance if a person or company fails to comply with Ontario securities law.

The amendments prohibit engaging in acts that a person or company knows, or reasonably ought to know, perpetrates a fraud or results in a misleading appearance of trading activity in, or an artificial price for, a security. The amendments also contain a general prohibition on making statements that a person or company ought to know are misleading or untrue and significantly affect, or would reasonably be expected to have a significant effect on, the market price or value of a security.

In February 2003, amendments to the *Manitoba Securities Act* gave the Manitoba Securities Commission the power to order repayment when investors lose money because of the improper or illegal conduct of others, including investment advisers. If an investor chooses to make a claim, the commission can now order repayment of up to $100,000 from an individual who is registered to sell securities as well as that individual's employer. Someone who is not registered but who is acting in the capacity of a trader or adviser on investment products can also be ordered to repay the investor. Following a hearing, if the commission finds that there has been improper or illegal conduct, a commission panel can order penalties, including reprimands, fines, suspensions or cancellation of registration to prevent further securities trading. The order may also include compensation for financial loss.

It is interesting to note that in the first quarter of 2003 the British Columbia Securities Commission began providing a feature on its website that provides investors with information about individuals who have faced disciplinary action since 1987. The *Disciplined Persons List* is an alphabetically organized list of individuals who have been sanctioned for trading bans or monetary penalties by the Commission for securities market misconduct. This initiative is similar to the *Public Disclosure Program* available on the NASD (National Association of Securities Dealers) website for investors in the United States.

Even the most determined public officials and the most exhaustive legislation cannot guarantee that persons who purchase or sell securities will not suffer financial loss. Securities with widely varying risk characteristics may be made available in the public markets. Although it is very difficult to completely restrict the activities of unscrupulous promoters without impeding the efforts of legitimate entrepreneurs, the laws are designed to prevent, as far as possible, blatant fraud and deceit as well as to protect the investor from his or her possible lack of investment sophistication. However, no legislation supplants the need for investors and their advisors to evaluate an investment both before initial purchase and periodically while the investment is held.
II. Key Players Involved in Securities Regulation

Regulation of the securities industry in Canada occurs to a greater or lesser degree at three levels: the federal, provincial and industry levels.

The Federal Government

No formal federal securities regulatory body exists in Canada, in contrast to the United States, where the Securities and Exchange Commission (SEC) has exerted considerable regulatory authority on a national level since the early 1930s. Canadian federal officials have suggested from time to time that some type of federal securities authority should be established, but at the time of writing, no Canadian federal securities regulatory body has yet been formed.

Nonetheless, certain securities activities are influenced by federal legislation. For example, the Canada Business Corporations Act (CBCA) regulates proxy solicitations and insider trading for federally incorporated companies. There is also an indirect federal government interest as banks are federally regulated and banks own many large securities dealers in Canada. However, any securities activity takes place in provincially regulated subsidiaries of the banks is subject to provincial securities regulation. Securities dealers are also subject to the federal Proceeds of Crime (Money Laundering) and Terrorism Financing Act, and the Personal Information Protection and Electronic Documents Act.

Integrated Market Enforcement Teams (IMETs)

Integrated Market Enforcement Teams (IMETs) were launched in November 2003 as an initiative of the Royal Canadian Mounted Police (RCMP) and the federal government with the goal of strengthening the law enforcement community’s ability to detect, investigate and deter capital markets fraud. To meet this obligation, the RCMP will focus its resources on the investigation and prosecution of the most serious market-related crimes by creating integrated enforcement teams composed of police, lawyers and other investigative experts through branches in Toronto, Vancouver, Montreal and Calgary. The teams are jointly managed by the RCMP and Justice Canada and work closely with securities regulators, such as the IDA, MFDA and RS, as well as other federal and provincial authorities.

The Provinces

Each province regulates securities activities within its borders. Since 1966, there have been efforts to make legislation in most of the provinces compatible. Ontario was the first to adopt a new Securities Act in 1979. Quebec’s new Securities Act came into force in 1983 and is generally compatible with Ontario’s Act. Alberta, British Columbia, Nova Scotia, Newfoundland and Labrador and Saskatchewan
have all adopted extensive amendments to their legislation in the area of takeover bids and insider trading in a uniform manner.

In Canada, there are three types of securities policies/instruments.

(i) **National Policies/Instruments** – apply in all Canadian jurisdictions. (Note that the primary difference between a National Instrument and a National Policy is that the National Instrument has the force of a binding rule, whereas the National Policy does not. The National Policy may be considered more akin to a guideline as it informs market participants of the manner in which the securities commission may exercise its statutory discretionary authority.)


(iii) **Provincial Policies** – reflect local differences in legislation, regulation and procedure, even within this latter group of policies there is substantial agreement between the jurisdictions in many areas.

As of February 1, 2004, the Autorité des marchés financiers (Financial Services Authority) (AMF) became the regulatory body that administers the regulatory framework surrounding the following areas of Québec's financial sector: the securities sector, the distribution of financial products and services sector, the financial institutions sector and the compensation sector.

The AMF is intended to be a single window for consumer information and complaint processing. Furthermore, it is intended to streamline the regulatory framework governing the financial sector and thus simplify the administrative procedures of individuals and businesses practicing in the sector. The AMF oversees or administers:

- the securities sector which covers the operations related to supervising the Québec securities market to ensure that it operates properly, to provide investor protection, and to regulate the information that companies make public. Prior to the establishment of the AMF, the former Quebec Securities Commission provided the regulatory framework for this sector.

- the distribution of financial products and services in all operations related to authorization of the right to practice in the eight following sector classes: insurance of persons, group insurance of persons, damage insurance, claims adjustment, financial planning, group savings brokerage (mutual funds), investment contract brokerage, and scholarship plan brokerage.

- financial institutions, other than banks, that conduct their activities in Québec. This refers primarily to regulation of insurance companies, financial service cooperatives, trust companies, and savings companies.

- the "financial services compensation fund", which compensates victims of fraud, fraudulent tactics, or embezzlement that occur during the distribution of financial products and services. This protects consumers of financial products and users of financial services when they do business with the authorized
persons and groups subject to certain provisions respecting the distribution of financial products and services in the eight sector classes listed above. This also includes protecting depositors, under certain conditions, to a limit of $60,000 per person per registered institution in the case of an insolvent financial institution.

Exhibit 2 lists the governing securities legislation and administrative organizations in each of the provinces.

Despite the fact that there is no federal regulatory body in Canada responsible for securities regulation, the securities regulators from 10 provinces and 3 territories have formed a joint panel, referred to as the Canadian Securities Administrators (CSA), to coordinate and harmonize regulation of the Canadian capital markets.

The CSA operates as an informal body through regular meetings of the commissions’ Chairs on issues of shared concerns or matters that are to be pursued jointly. By collaborating on rules, regulations and other initiatives on a national level, the CSA helps avoid duplication of efforts and streamlines the regulatory process for companies seeking to raise capital and others working in the securities industry. The CSA is also responsible for maintaining the public electronic databases SEDAR (the System for Electronic Document Analysis and Retrieval) and SEDI (the System for Electronic Disclosure by Insiders) on the Internet. SEDAR is a centralized database where public records of all publicly traded companies in Canada are pooled together, while SEDI is a database containing reports on securities holdings and trading for insiders of Canadian public companies.

In 1971 the CSA commenced issuing National Policy (NP) statements. It is now reformulating many of these policies as National Instruments (NIs), which are enforceable rules once the provinces have incorporated them into their legislation. Once the CSA has formulated a National Policy or Instrument, it is reviewed by the provinces and amended if necessary. Once approved by an Administrator, the NP/NI is then formally incorporated into its legislation.

As the 1980s ushered in an era of international securities markets, the need for cooperation among international securities regulators became obvious. In 1988, for example, the SEC and the Administrators in Ontario, Quebec and British Columbia entered into a formal Memorandum of Understanding (MOU) to cooperate in the enforcement of their respective securities regulations by providing each other with the fullest mutual assistance possible. A number of other MOUs have since been entered into between Administrators and the securities regulatory authorities of other jurisdictions, including Mexico, Australia, Italy, France, and Hong Kong. In March 2003, the Ontario Securities Commission along with the British Columbia, Quebec and Alberta Securities Commissions entered into a MOU with the China Securities Regulatory Commission to promote the integrity of the securities markets by establishing a framework for cooperation for the purpose of increasing mutual understanding and for the exchange of regulatory and technical information.
These MOUs are statements of intent that, while not legally binding, facilitate the exchange of information and foster regulatory cooperation in the global capital markets.

### Exhibit 2

*For information only:*

<table>
<thead>
<tr>
<th>Province</th>
<th>Governing Legislation</th>
<th>Administration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alberta</td>
<td>Securities Act, S.A. 1981, c.S-6.1, as amended</td>
<td>Commission, headed by a Chairman, possibly a Vice-Chairman, and other members. The Executive Director is responsible for the day-to-day administration.</td>
</tr>
<tr>
<td>British Columbia</td>
<td>Securities Act, R.S.B.C. 1996, c.418, as amended</td>
<td>Commission headed by a Chairman, a Vice-Chairman, and up to seven other members. The Executive Director heads day-to-day administration.</td>
</tr>
<tr>
<td>Manitoba</td>
<td>The Securities Act, R.S.M. 1988, c.S50 , as amended</td>
<td>Commission, headed by a Chairman, a Vice-Chairman and up to five other members. The Director heads day-to-day administration.</td>
</tr>
<tr>
<td>New Brunswick and Labrador</td>
<td>The Securities Act, R.S.N. 1990, c.S-13, as amended</td>
<td>Commission headed by a Chairperson. The Director of Securities heads day-to-day administration.</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>Securities Act, R.S.N.S. 1989, c.418, as amended</td>
<td>Commission, headed by a Chairman, a Vice-Chairman and up to four other members. The Director of Securities heads day-to-day administration.</td>
</tr>
<tr>
<td>Ontario</td>
<td>Securities Act, R.S.O. 1990, c.S-5, as amended</td>
<td>Commission headed by a Chair, up to two Vice-Chairs and up to eight other members. The Executive Director heads day-to-day administration.</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>Securities Act, R.S.P.E.I. 1988, c.S-3, as amended</td>
<td>The Director of Corporations. The Registrar heads day-to-day administration.</td>
</tr>
<tr>
<td>Quebec</td>
<td>Securities Act, R.S.Q. 1982, c.V-1.1, as amended</td>
<td>The Autorité des marchés financiers is headed by a Chief Executive Officer and seven Directors who head day-to-day administration.</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>The Securities Act, S.S. 1988, c.S-422, as amended</td>
<td>Commission headed by a Chairman and a Vice-Chairman and consisting of up to six members. The Director heads day-to-day administration.</td>
</tr>
<tr>
<td>Yukon Territory</td>
<td>Securities Act, R.S.Y.T. 1986, c. 158, as amended</td>
<td>The Act is administered by a Registrar, who performs similar functions to Commissions in other jurisdictions.</td>
</tr>
</tbody>
</table>
III. Self-Regulatory Organizations (SROs)

Self-Regulatory Organizations (SROs) are industry organizations that have the privilege of regulating their own members, whether as officially recognized “SROs” or under the “stock exchange” portions of their provincial Acts. SROs are responsible for enforcement of their members’ conformity with securities legislation and have the power to prescribe their own rules of conduct and financial requirements for their members. Since December 2000, the OSC has made it mandatory for all securities dealers and mutual fund dealers to become members of the Investment Dealers Association of Canada (IDA) or the Mutual Fund Dealers Association of Canada (MFDA).

Self-regulation is a privilege, not a right. SROs are delegated regulatory functions by the Administrators, and SRO by-laws policies and rules are designed to uphold the principles of securities legislation. The commissions monitor the conduct of the SROs and review the rules of the SROs in the province to ensure that the SRO rules do not conflict with securities legislation and are in the public’s best interest.

SRO regulation can be divided between member regulation and market regulation. The IDA and MFDA deal with member regulation while RS and the exchanges are the SROs that deal with market regulation.

The four main areas of member regulation are:

- **Financial Compliance:** Firms are required to maintain a minimum amount of capital if they want to conduct business in Canada. Financial compliance includes controlling the minimum capital and financial requirements of members and monitoring this through regular examinations.

- **Sales Compliance:** Sales compliance revolves around maintaining high industry standards of broker and member business conduct.

- **Registration:** Responsibility for overseeing professional standards and educational programs designed to maintain the competence of industry employees. All investment advisors employed by member firms are initially screened and have successfully completed the required educational courses.

- **Enforcement:** This department investigates complaints received against a member firm or a registered employee. The IDA has the authority to prosecute individuals and firms suspected of wrongdoing and to impose penalties in the form of reprimands, fines, suspensions, and expulsion from the industry.

Market regulation, on the other hand, focuses on three main areas – market surveillance, investigation & enforcement, and regulatory/market policy. Market regulation responsibilities in Canada are handled by the exchanges and RS and involves:

- **Market Surveillance:** Market surveillance involves the review of real time trading, historical trading and press releases, as well as brokers’ sales practices.
• **Investigation & Enforcement:** These activities usually begin after a complaint has been filed or when market surveillance finds that the rules have been broken. If an infraction has been committed, prosecution proceedings may begin.

• **Regulatory/Market Policy:** As the name implies, the SROs are also responsible for developing rules and policies that promote more efficient markets.

SRO rules must set a standard equal to or higher than those imposed by the provinces and they address:

• The issuing and trading of securities listed on exchanges, including:
  (i) the quality of disclosure required of companies who wish to list their securities on an exchange;
  (ii) the type of continuing disclosure required of companies which are traded on an exchange; and
  (iii) promoting of securities and investor relations.

• The affairs of member firms, include:
  (i) selecting those member firms which are permitted to use the trading facilities of an exchange and therefore act as intermediaries between the exchange trading function and the public;
  (ii) prescribing rules for the conduct of persons at the member firms who deal with the public; and
  (iii) establishing rules for financial conduct and the maintenance of adequate capital in member firms’ business. Among other things the financial rules of the SROs prescribe:
    • the frequency and format for financial reports which are submitted to the SROs;
    • the method of calculation of regulatory capital which is a measure of the financial capacity of the member;
    • the requirement to have an audit and some specific procedures to be carried out by member firm auditors;
    • proper books, records and procedures to be put in place to safeguard clients’ assets;
    • the necessity to have fully paid client securities held in trust for the client. These securities are to be segregated and not to be used by the member broker; and
    • the requirement to maintain sufficient insurance coverage against potential losses, and that insurable losses are identified and claimed on a timely basis.
The Canadian SROs

(i) The Investment Dealers Association of Canada
(ii) The Exchanges
(iii) Market Regulation Services Inc.
(iv) The Mutual Fund Dealers Association of Canada

The Investment Dealers Association (IDA)

The Investment Dealers Association of Canada (IDA) is the national self-regulatory organization of the Canadian securities industry. The IDA is an organization comprised of member firms governed by its Constitution, by-laws, regulations and policies. Effective December 1, 2000, all securities dealers and brokers must be members of the IDA (for details refer to the OSC Rule 31-507 SRO Membership—Securities Dealers and Brokers). As of July 2005, 201 firms were registered as members of the IDA and they employed 37,512 people.

The IDA is empowered by its by-laws to conduct examinations and investigations in response to complaints and other relevant information received, and to initiate disciplinary action against any individual registrant or member firm where appropriate. Typically, investigations are initiated either as the result of complaints because of questionable situations identified in the course of compliance examinations, or because of information received from a member in a Notice of Termination.

Once an investigation is opened, a staff investigator will gather documents, interview witnesses and perform any analysis required to determine whether there has been a violation of IDA rules. Members and individuals subject to investigation may be required to submit a report in writing with regard to the matter under investigation; produce for inspection and provide copies of books, records and accounts; and attend and give information respecting the matter under investigation.

IDA disciplinary proceedings are brought before the applicable IDA District Council in the particular case. There are ten District Councils in all, representing different provinces or regions of the country. The Councils are normally made up of officers, directors or branch managers of member firms. Disciplinary hearings are normally conducted before a panel of two industry members and one “public member.” A member of the public, who is legally trained, resident in the District and not associated with any member, chairs the disciplinary hearing. Each District Council may appoint a roster of qualified public members and may add to or delete from the roster as required.

The disciplinary powers of the District Councils are set out in the IDA By-laws, and include the power to impose any one or more of the following penalties where
a registrant or member is found to have violated IDA rules or to have engaged in unbecoming conduct:

- a reprimand.
- a fine of up to the greater of $1,000,000 per offence or three times (four times in Quebec) the gain accrued from the commission of the violation.
- suspension of registration approval or membership.
- prohibition against approval for any period of time.
- revocation of approval or termination or expulsion from membership.
- conditions of approval or continued approval.

In addition, costs of the investigation are usually assessed against any respondent found guilty of a violation. Commonly imposed conditions of approval or continued approval include the requirement to rewrite industry examinations and the requirement to disgorge commissions. It should be noted that registrants are still subject to IDA disciplinary actions for up to five years after leaving the industry, but the IDA on its own cannot force individuals who no longer work in the industry to pay fines. However, unlike in the other provincial securities Acts, the *Alberta Securities Act* permits approved self-regulatory organizations (such as the IDA) to file disciplinary decisions with the Alberta Court of Queen’s Bench to seek a civil execution order to ensure that fines, disgorgements and costs are collected.

Registrants who choose to act in ways that threaten the integrity of the capital markets must have the expectation that they will be held accountable through enforcement action by the regulators. Sanctions should be based on the circumstances of the particular misconduct with an aim at general deterrence, therefore, on January 29, 2003, the IDA released “Disciplinary Sanction Guidelines” that recommend penalties to an IDA disciplinary panel for various offences. The guidelines may also be taken into account when determining the appropriate sanction to be imposed as part of a Settlement Agreement or at the end of a disciplinary proceeding.

Since sanctions should be tailored to address the misconduct involved in a particular case, a penalty must be proportionate to the gravity of the misconduct and the relative degree of responsibility of a respondent. To properly assess the gravity of specific misconduct, a number of factors should be looked at, including:

- harm to clients, employer and/or the securities market;
- blameworthiness (distinctions should be drawn between conduct that was unintentional or negligent, and conduct that involves manipulative, fraudulent or deceptive conduct);
- the degree of participation (this is what is meant by “degree of responsibility”);
• the extent to which the respondent was enriched by the misconduct (whether it is appropriate to require that any profits, commissions, fees, or any other compensation earned be disgorged);
• prior disciplinary record;
• acceptance of responsibilities, acknowledgement of misconduct and remorse;
• credit for cooperation during the investigation;
• voluntary rehabilitative efforts (showing both recognition of the misconduct and a commitment to remedy it);
• reliance on the expertise of others;
• planning and organization (if there is evidence of planning and pre-meditation);
• vulnerability of the victim; and
• the significance of the economic loss to the client or firm.

In 2004, the IDA received approximately 1,200 complaints compared with 1,500 complaints received in 2003. The four most frequent complaints were unauthorized and discretionary trading (311), service issues (211), suitability issues (203) and misrepresentations (114).

The Exchanges (Marketplaces)

Presently, the exchange SROs in Canada are the Toronto Stock Exchange (TSX – formerly known as the TSE), the Montreal Exchange (ME), the TSX Venture Exchange (TSX V – formerly CDNX) and the Winnipeg Commodity Exchange (WCE). (Note: in Quebec, the Montreal Exchange is called Bourse de Montréal.)

Since the split of regulatory responsibilities into member and market regulation, the IDA has the power to govern and regulate the business conduct of its members and their employees and to impose tough penalties for breaching any of the SRO requirements. The IDA also conducts financial and sales compliance examinations of its member firms to ensure compliance. The TSX and TSX V have retained Market Regulation Services Inc. (RS) as their regulatory services provider. RS’s mandate is to monitor trading activities and initiate investigations of potential breaches of Universal Market Integrity Rules (UMIR) or exchange rules, as well as take disciplinary proceedings against those responsible for the infractions. Note that UMIR is a standard set of market integrity rules that generally apply to equity trading on all Canadian marketplaces in order to promote fair and orderly markets. The exchanges have retained some market regulation responsibilities, which pertain mostly to rules that are specific to their individual business niches.

Bourse de Montréal is unique among the SROs in that its by-laws grant it the power to order the restitution of funds to any person who has suffered a loss as a result of the misconduct of a person under its jurisdiction. Additionally, costs of the
investigation are typically assessed against respondents who have been found guilty of a violation.

The SRO system changed dramatically in November 1999 as the TSX, the Alberta Stock Exchange (ASE), the Vancouver Stock Exchange (VSE), the ME and the Canadian Dealing Network (CDN) reached a restructuring agreement, which basically resulted in the creation of three distinct, streamlined exchanges:

- The fully automated TSX took over all trading of senior Canadian equities including all senior equities that previously traded on the ME.
- The ASE and the VSE consolidated to form the Canadian Venture Exchange (CDNX), which trades all junior equities. CDN and the Winnipeg Stock Exchange (WSE) joined CDNX in October 2000 and November 2000, respectively.

Bourse de Montréal exclusively deals in all “non-agricultural” options and futures in Canada, including all options that previously traded on the TSX and all futures products that previously traded on the Toronto Futures Exchange (TFE). The WCE continues to deal in agricultural derivatives. Also under the agreement, Bourse maintained a market, as well as provided listing and regulatory services, to approximately 117 junior companies in Quebec. Beginning in October of 2001, the ME ceased to provide listings of these 117 companies and were invited to list on the TSX V.

Effective February 1, 1997, the TSX transferred its member regulation responsibilities to the IDA so it could concentrate on market regulation. In 1998, the WCE also transferred its member regulation responsibilities to the IDA, as did TSX V on January 1, 2000. In addition, as of January 1, 2005, the ME transferred all of its member regulation functions to the IDA. The TSX, WCE, TSX V Exchange, the ME and RS remain responsible for market regulation, which involves monitoring and regulating members’ trading activities on the exchanges.

On July 31, 2001 the TSX received approvals from the Alberta, British Columbia and Ontario securities commissions allowing it to acquire TSX V (then called CDNX). The benefits expected from the transaction ranged from cost efficiencies realized through combining certain services to a more streamlined approach to graduate listed companies from TSX V to the senior TSX market. The acquisition was intended to enhance the attractiveness of the TSX and TSX V as the exchanges for issuers seeking new listings. The two exchanges remained distinct with the senior market being operated by the TSX and the public venture market continuing to be operated by TSX Venture Exchange.

In April 2002, the Toronto Stock Exchange announced that, as a result of “rebranding”, its abbreviated form has changed from the TSE to TSX and that CDNX has been renamed the TSX Venture Exchange (TSX V). The CDNX logo was also replaced with the new “TSX” logo that is shared with the TSX. These changes were part of a re-branding initiative as the TSX and its subsidiaries prepare
to go public. Under the re-branding program, the TSX, TSX V and TSX Markets Inc. (the arm of the TSX that sells market information and trading services) are collectively known as the TSX group of companies.

On August 18, 2003, the NEX board became available for companies that had fallen below the TSX V’s ongoing listing standards. Before NEX was created, companies that fell below these standards were designated "inactive" and given 18 months to meet the standards or be delisted.

Only companies that were formerly listed on the Toronto Stock Exchange or TSX Venture Exchange and that failed to meet TSX V ongoing listing standards are eligible to list on NEX. This includes Capital Pool Companies that have failed to complete a Qualifying Transaction in accordance with TSX V’s requirements. Companies that have not been listed on TSX or TSX V and companies that have been delisted from TSX and/or TSX V are not eligible for listing on NEX.

A company listed on NEX may continue to have its securities listed for an indefinite period of time provided that it meets NEX listing requirements. In the event that a listed company does not comply with NEX Policies, fails to comply with applicable securities laws, completes a Reverse Takeover ("RTO"), conducts transactions or activities such that it meets applicable TSX V listing standards, or if NEX determines that it is in its best interest, NEX may delist the company.

NEX companies are subject to the same disclosure standards as all Canadian public companies and must maintain good standing with all relevant Canadian securities commissions. In addition, surveillance standards of NEX companies remain unchanged and they will continue to be overseen by RS.

In 2003, the Canadian Trading and Quotation System Inc. (CNQ) opened as a quotation and trade reporting system and in 2004 it gained recognition as an exchange by the Ontario Securities Commission. In July 2005, the British Columbia Securities Commission granted CNQ an exemption order allowing it to carry on business as a stock exchange in B.C. without having to apply and be recognized by the provincial regulator.

The intent of CNQ is to provide an alternative market to the TSX V for emerging companies. CNQ focuses on micro and small-cap issues (it will not accept shell company listings), has a flat fee structure and a unique disclosure model. Listed companies can directly post information for investors about its operations and public material transactions on CNQ’s website (www.cnq.ca) without having to wait for exchange permission.

CNQ is based on a combination of auction and dealer markets and liquidity is enhanced on a security by security basis via market makers. Dealers accessing this marketplace are required to be members of the IDA and must comply with CNQ’s trading and sales practice rules as well as RS’s Universal Market Integrity Rules.
RS also provides market surveillance and regulatory oversight as it does for the TSX and TSX V exchanges.

**Market Regulation Services Inc. (RS)**

The CSA’s on-going initiative to create a harmonized framework for the competitive operation of all Canadian marketplaces resulted in a creation of two National Instruments: NI 21-101 *Marketplace Operation* and NI 23-101 *Trading Rules*. These instruments require an independent “regulation services provider” to regulate trading in all Canadian marketplaces. Because of the conflicts of interest in having the TSX act as the regulation services provider with authority over its competitors, Market Regulation Services Inc. (RS), a new regulation services provider, was created.

RS is an independent, not for profit organization that is jointly owned by the TSX and the IDA and whose mandate is to monitor, administer and police trading on all Canadian markets. In February 2002, RS was recognized as an SRO in the provinces of Alberta, British Columbia, Ontario and Quebec, and on March 1, 2002, it officially started providing independent regulation services to Canadian marketplaces including traditional exchanges, quotation and trade reporting systems (QTRSSs), and alternative trading systems (ATSs). If retained, RS administers, monitors and enforces the Universal Market Integrity Rules (UMIR) that were approved as the standard set of trading rules on April 1, 2002. To ensure compliance with UMIR, RS is authorized to monitor real-time trading operations and market-related activities, to investigate alleged rule violations, and to administer any settlements and hearings that may arise in respect of such violations.

RS’s Investigations and Enforcement Division investigates:

- manipulative or deceptive trading;
- illegal insider trading, defined as unreported trading done by insiders of a listed company who trade while in possession of material and non-public information that could reasonably be expected to have a significant affect the market price or value of a security;
- the failure of a registrant to ensure that the best possible market price was obtained for a client;
- the failure of a registrant to give a client order priority over all other similar principal and non-client orders existing at the same time;
- a registrant trading ahead of a known client order (frontrunning) in an attempt to take advantage of the market impact such a pending trade might have;
- all technical rules violations such as restrictions on short sales and order marking;
- pre-marketing activities by an issuer and/or its representatives/underwriters before a distribution of stock;
background checks with respect to directors and officers of companies which have applied for listing.

Whenever a registrant, or another officer, director or employee of the registrant contravenes any UMIR or exchange requirement, RS may issue or impose one or more of the following penalties or remedies:

- a reprimand;
- a fine not to exceed the greater of:
  i. $1,000,000; and
  ii. an amount equal to triple the financial benefit that resulted from the contravention;
- the restriction or suspension of access to a marketplace for a period of time that RS finds warranted by the circumstances;
- the revocation of access to a marketplace; and
- any other remedy deemed as appropriate under the circumstances.

There are factors involved in every infraction that need to be assessed when determining a penalty. RS has set out a formal process governing penalties imposed upon persons who have violated UMIR and exchange requirements. The guidelines take into account the seriousness of the violation, whether or not the violation was intentional or inadvertent, and whether the violation was isolated or one of a series of similar violations which may indicate a lack of care or a lack of regard for the rules.

Effective March 11, 2005, the Alberta Securities Commission, British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and, in Quebec, the Autorité des marchés financiers (the “Recognizing Regulators”) approved amendments to the Universal Market Integrity Rules (“UMIR”) to:

- specifically provide that it is an offence to impede or obstruct a Market Regulator in an investigation, proceeding or the exercise of a power;
- provide that a person who is subject to the jurisdiction of UMIR (“Regulated Person”) shall respond to a request by a Market Regulator forthwith or not later than the date permitted by the Market Regulator as specified in its written request; and
- adopt a definition of “document” and clarify that records which must be provided by a Regulated Person during an investigation are not limited to “records” as contemplated by the audit trail and retention requirements.

As mentioned above, RS may be retained as a regulation services provider not only by the traditional exchanges, but also by ATSs and QTRSs. Alternative trading systems (ATSs) compete with recognized exchanges by providing trade matching and execution services. Although ATSs may register as either exchanges or
dealers, they cannot engage in certain exchange-typical activities, such as providing listing services to issuers. Quotation and trade reporting systems (QTRs) may also register as exchanges or dealers that operate facilities authorized to disseminate price quotations and report completed transactions to the applicable securities commissions, thus assuming the role formerly carried out by the Canadian Dealing Network (CDN) for over-the-counter (OTC) stocks.

The Mutual Fund Dealers Association (MFDA)

The mutual fund industry is currently managing over $400 billion in assets for Canadian investors who are now more invested in mutual funds than in savings accounts and GICs. As of August 2005, the Mutual Fund Dealers Association of Canada (MFDA) had 181 members, which employed approximately 70,000 registrants. Consequently, the provincial securities commissions had taken steps to ensure that an SRO is created for these people. As a result of these recommendations, the MFDA was created in November of 1997. On February 6, 2001, the Ontario Securities Commission recognized the MFDA as an SRO, as did the British Columbia Securities Commission on February 9, 2001, the Saskatchewan Securities Commission on February 13, 2001, and the Alberta Securities Commission on April 10, 2001.

The MFDA is the mutual fund industry’s SRO responsible for regulating all sales of mutual funds by its members in Canada. The MFDA does not regulate the mutual funds themselves, as this responsibility has remained with the securities commissions. Effective April 23, 2001, all mutual fund dealers must be members of the MFDA (for details refer to the OSC Rule 31-506 SRO Membership – Mutual Fund Dealers). In Québec, the mutual find industry is regulated by the Autorité des marchés financiers (AMF). An agreement has been signed between the AMF and the MFDA to avoid regulatory duplication for mutual fund firms operating both in Québec and elsewhere in Canada. The Chambre de la sécurité financière (CHAMBRE) is Québec’s self-regulatory organization of the mutual fund and insurance industry. The CHAMBRE is responsible for setting and monitoring continuing education requirements and for enforcing a code of ethics of the licensed representatives.

IV. Jurisdiction of the Provinces and SROs

The IDA, the exchanges and Market Regulation Services (the SROs) have extensive powers to investigate possible violations of their by-laws, regulations, rules and policies and to take disciplinary action in the event of alleged violations by member firms and their employees. As mentioned above, provincial securities commissions also have extensive enforcement powers. The SROs and/or the securities commissions may discipline IAs, depending on the circumstances.
Sanctions for less serious offences may include fines, strict supervision and rewriting qualifying exams. Serious offences may result in loss of registration and substantial fines.

V. Dealing with Money Laundering and Terrorist Financing in the Securities Industry

Money laundering is a process in which the proceeds of crime are converted into legitimate funds using complex transactions, usually through financial institutions. By obscuring the origin of the money, criminals can use the funds without raising any suspicion about its legitimacy. When a criminal activity generates substantial profits, the individual or the group involved must find a way to control the funds without attracting attention to the underlying activity or to the persons involved. This is done by disguising the sources, changing the form, or moving the funds to a place where they are less likely to attract attention.

The International Monetary Fund (IMF) has stated that the aggregate size of money laundering in the world could be somewhere between two and five percent of the world’s GDP. Based on 2002 statistics, this would equate to a range between US$980 billion and US$2.45 trillion. To put this into perspective, the lower figure is roughly equivalent to the total GDP of the combined economies of Canada and Sweden in the year 2002.

Securities dealers are in an ideal position to assist in curbing criminal and terrorist activities. Identifying clients and transactions that raise red flags or fail the “smell test” and reporting this information to the appropriate authorities can limit access to what has traditionally been a major piece in the money laundering puzzle.

The Three Stages of Money Laundering

There are three basic stages of money laundering – placement, layering and integration, which can also be thought of as the “wash cycle”, the “spin cycle” and the “dry cycle”.

Placement involves the physical disposal or deposit of cash proceeds derived from an illegal activity within the legitimate financial system. There are several methods of placing the proceeds of crime into the financial system, including:

- structured deposits, also called “smurfing”, involves breaking up large amounts of cash into smaller, less conspicuous sums that are subsequently deposited directly into bank accounts, always in amounts lower than cash deposit reporting levels;
- mingling criminal proceeds with deposits from legitimate cash businesses such as stores and restaurants;
• bribery of bank or other financial institution personnel to accept deposits without reporting them;
• smuggling of cash to countries lacking anti-money laundering requirements for deposit in their financial institutions; and
• purchasing a series of monetary instruments (e.g., certified cheques, money orders) that are then collected and deposited into accounts at another location.

The investment business is generally not cash-based, so it is at less risk from the initial placement of criminally derived funds than mainstream banking operations. Most payments to brokerage accounts are made by way of cheques or transfers from other financial institutions, so the first stage of money laundering has already been successfully achieved by the time the funds reach the firm. However, the bribery or persuasion of dealer personnel to accept cash deposits beyond firm limits is always possible.

Layering involves separating illicit proceeds from their source by creating complex layers of financial transactions designed to obscure an audit trail and the original source and thereby providing anonymity. This frequently involves moving funds across borders to make tracing the source more difficult for law enforcement. The securities industry is more at risk in this stage as funds can easily change form into entirely different assets and launderers can engage in a series of conversions and movements of the funds to distance them from their source. The origin of the funds may be concealed by executing numerous buy and sell transactions of various investment instruments or the launderer may simply wire the funds through a series of accounts at various banks across the globe. Securities transactions are very attractive because funds are easily converted into highly liquid assets and investment portfolios containing both lawful and illicit proceeds that can be quickly sold. Certificated securities can also be moved easily across borders.

Integration involves the provision of apparent legitimacy to criminally derived wealth. If the layering process has succeeded, integration schemes place the laundered proceeds back into the economy in such a way that they re-enter the financial system with the appearance of normal business funds. Frequent techniques include the use of corporate entities controlled by the launderers to make loans to themselves – the repayment of which is, of course, unnecessary – or to purchase high value items by such as businesses or real estate that can be used by the launderers without charge, either for personal use or to generate additional, seemingly legitimate income.

Money Laundering Mechanisms Involving the Securities Industry

When viewed on a global scale, the securities industry can be characterized by its diversity, the ease with which trading can take place and the ability to perform transactions in markets with little regard to national borders. Besides making securities markets attractive to ordinary investors, these same characteristics also
make the industry a potentially inviting mechanism for the laundering of funds from criminal sources.

Proceeds of crime laundered through the capital markets can be generated by illegal activities both from outside and from within the securities industry. For illegal funds generated outside of the industry, securities transactions are used for concealing the source of these funds and obscuring an audit trail. For illegal activities carried out within the securities markets (e.g., insider trading and securities fraud), securities transactions or manipulation generates illegal funds that must be laundered. In both cases, the industry offers launderers the potential for a double advantage by allowing illegal funds to be laundered and by making an additional profit from the related investments.

Illicit funds are often laundered through the purchase and sale of liquid securities. The audit trail of the proceeds of crime can be blurred through several buy and sell transactions involving numerous entities, accounts and types of securities. Securities can also be purchased in another name, such as that of a shell company (a business without substance or commercial purpose and incorporated to conceal the true beneficial ownership of business accounts and assets owned) located in tax or bank secrecy havens where local laws protect the anonymity of the owners and local professionals such as lawyers, accountants or “company formation agents” are in the business of setting up and operating such companies.

Some money launderers open accounts at two different brokerage firms and enter offsetting transactions with each broker. For example, at one firm the person would take long positions in Eurodollar futures contracts while being short the exact same contracts at another firm. The two transactions would basically offset each other, as the one side of the trade would report a capital gain while the other side reports a loss. The cost of doing this would primarily be the two commissions, but the proceeds of the profitable side have the appearance of legitimacy, while the losses on the other side are concealed.

Another money laundering method utilizing the securities industry involves establishing a publicly traded company to serve as a front for a money laundering operation. In this case, a criminal organization creates a company for an apparently legitimate commercial purpose and then commingles illegal funds with funds generated by the legal commercial activity. This usually requires the use of fraudulent accounting practices. There is also an advantage of using a publicly traded company for such a scheme because the owners could profit twice from the mechanism - by creating a successful means of laundering criminal funds and in selling shares in the business to unwitting investors. Another variation of this scheme would be to invest in a private company first, and then “go public” with a share purchase offer on the equities market. The earnings from the sale of shares creates the illusion that the funds are legitimate earnings on securities investments.

The entire arena of online brokerage accounts is raising some major concerns for law enforcement agencies. How can regulators stop money launderers who trade
securities through shell companies that may actually be nothing more than a brass plate on an office door in an offshore secrecy haven? These investment accounts also offer an unprecedented level of anonymity because there is no requirement for a “face-to-face” meeting between the beneficial owner of the account and the entity executing the transactions. Is it going to be possible to prevent the flow of the proceeds of crime from further infecting our financial markets through these unregulated accounts?

**Terrorism and Terrorist Financing**

The primary objective of terrorism is “to intimidate a population, or to compel a government or an international organization to do or abstain from doing any act”. In contrast, the motivating factor behind most other types of criminal activity is financial gain. While this difference certainly exists between these groups, terrorist organizations still require financial support to achieve their goals. A successful terrorist group, like a criminal organization, is one that is able to build and maintain an effective financial infrastructure through various sources of funding.

As of July 2005, over 1,600 individuals, entities and organizations have been designated as supporters of terrorism. This includes over 800 individuals ranging from organizational leaders such as Osama bin Laden and his key operatives as well as over 800 terrorist organizations, companies, charitable organizations, or entities who support and/or finance terrorism. Over 165 countries and jurisdictions have issued blocking orders against the assets of terrorists and US$112 million in terrorist assets have been frozen worldwide in over 500 accounts.

For terrorist funds that are derived from legitimate sources, such as charities, there are very few indicators that would make individual, or multiple, financial transactions stand out as being linked to terrorists. Terrorist financing is also more difficult to detect because the size and nature of the transactions needed to mount a terrorist attack do not always require large sums of money and the associated transactions are usually not complex. In fact, it is almost like trying to “find a needle in a haystack”.

**Anti-Money Laundering and Anti-Terrorist Financing Regulations**

The original *Proceeds of Crime (Money Laundering) Act*, passed in 1991, stipulated that financial institutions must retain a number of records including a signature card for each account holder, a deposit slip for every deposit made to an account and a record or copy of every cleared cheque. In addition, every cash deposit, or series of deposits over a 24-hour period that involved an amount of $10,000 or more for the same beneficial owner had to be documented via a *Declaration of Funds* form to be retained by the financial institution receiving the deposit.
As a result of this requirement, money launderers employ armies of “smurfs” to make deposits in lesser amounts. Splitting up large amounts of money into smaller amounts to conceal a trail and escape laws governing notification of transactions involving $10,000 or more in cash is also known as “structuring” deposits. The funds are then transferred by cheque or wire transfer to central collection accounts.

These regulations also made it mandatory to verify, within six months of opening a brokerage account, the identity of account holders via physical verification, cheque verification or a bank reference check. With limited exceptions, firms were required to verify the identity of all persons authorized to give instructions on an account, including giving instructions for accounts of corporations and other entities (i.e., accounts with third party authority). According to the Guide to Record Retention Requirements for IDA Members, these records are to be retained for seven years, which is in excess of the federal regulations requiring records to be retained for five years. Anyone contravening or failing to comply is guilty of an offence and liable for fines of up to $500,000 or imprisonment for a term not exceeding five years, or to both.

Firms will generally accept the following identification: passport, driver’s license, citizenship card, birth certificate (for applicants under the age of 21), a personal cheque drawn and cleared from a Canadian financial institution (requires banking information) and verification from a Canadian deposit-taking institution that the applicant has an account in his or her name (requires banking information). Photocopies or notarized copies are not acceptable, which generally means that the client and IA must meet face-to-face.

It should be noted that it is necessary to record the number of a financial entity account in the name of the person who is authorized to give instructions for the account where that person's identity is verified by confirming that a cheque drawn by that person on an account has been cleared, or by confirming that the person holds an account in that name with a financial entity. It is not necessary to record an account number where the person's identity is verified by reference to an acceptable identity document.

*The Proceeds of Crime (Money Laundering) and Terrorist Financing Act* requires securities dealers to maintain a signature card, account operating agreement or account application containing the number of an account at a financial entity (such as a bank account) in the name of anyone having authority over the account. However, this provision is intended to apply only when the person’s identity is verified by confirming that the person has an account in his or her name at a financial entity, either through clearing a cheque drawn on the account or by other means. When an account is opened in person and the accountholder’s identity is verified by an acceptable government-issued document, such as a passport or driver’s license, the dealer is not required under the Regulations to obtain financial entity account information.
Significant amendments to the *Proceeds of Crime (Money Laundering) Act* in 2001 added mandatory suspicious transaction reporting requirements on a wide range of financial institutions and other businesses that may be deemed vulnerable to money laundering activities. They also changed the requirements regarding cash deposits in excess of $10,000 from a record keeping to a reporting requirement.

The 2001 amendments also created the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) to collect, analyze, assess and disclose information to assist in the detection, prevention, and deterrence of money laundering and terrorist financing. It is authorized to provide key identifying information on suspicious transactions to law enforcement agencies if there are reasonable grounds to suspect that the information would be relevant to investigating or prosecuting a money laundering offence. This information could also be provided to the Canada Revenue Agency (CRA), the Canadian Security Intelligence Service (CSIS) and Immigration Canada if there was reason to suspect tax evasion or a threat to national security. The Centre also has the primary responsibility of monitoring the compliance of financial intermediaries with record keeping, Know Your Client and mandatory suspicious transaction reporting requirements.

Once it has been determined that there are reasonable grounds to suspect that a transaction is related to the commission of a money laundering offence, a suspicious transaction report must be sent to FINTRAC within 30 days. If done in good faith, member firms and their employees that are required to report suspicious transactions to FINTRAC are protected from criminal and civil legal proceedings for doing so. There is no monetary threshold for making a report on a suspicious transaction and an employee cannot be convicted of failing to report if a suspicious transaction is reported to his or her superior or supervisor.

In 2004, FINTRAC made 142 case disclosures to law enforcement or the Canadian Security Intelligence Service (CSIS) covering transactions with a total dollar value of just over $2 billion, close to triple the total in 2003. In addition, the total value of case disclosures of suspected terrorist activity financing and other threats to the security of Canada was approximately $180 million, a two and a half fold increase over 2003.

Of these 142 case disclosures:

- 110 were for suspected money laundering,
- 24 were for suspected terrorist activity financing and/or threats to the security of Canada, and
- 8 involved both suspected money laundering and terrorist activity financing and/or threats to the security of Canada.

IAs are not allowed to inform (or tip) anyone, including the client, about the contents of a suspicious transaction report or even that a report has been made.
because such notification could harm or impair a criminal investigation. Failure to comply with the reporting requirements can lead to criminal charges against a member firm and/or an individual employee. Depending on the facts surrounding a “tip”, an IA could be liable to a Criminal Code prosecution for a myriad of potential offences, including counselling an offence, accessory after the fact, breach of trust by a public officer, obstructing a peace officer, obstructing justice and public mischief.

“Wilful blindness” (a situation that arises when people are aware that a situation should be investigated but fail to follow through usually because they do not want to jeopardize a business deal or business relationship) that leads to the failure to report a suspicious transaction is punishable by a fine of up to $2 million and/or imprisonment for up to five years. Furthermore, the line between wilful blindness and knowing involvement in money laundering, which carries higher penalties (could be punishable by up to ten years in prison), may not be easy to define, putting anyone ignoring signs of money laundering or terrorist financing activity at higher risk.

If a transaction is not completed, there is no requirement for it to be reported. However, the indicators detected during an aborted transaction should be considered in subsequent dealings with the client if additional suspicious activity occurs. There is no requirement to close a client’s account when a suspicious transaction has been reported or is about to be reported - this is entirely up to the firm’s business practices.

On January 6, 2003, Cross-Border Currency and Monetary Instruments Reporting Regulations came into effect. These regulations require all persons and entities to report the importing and exporting of currency and monetary instruments of $10,000 or more, or the equivalent in a foreign currency to the CRA. There are however no restrictions on the amount of currency or monetary instruments that may be imported into or exported from Canada, simply that they must be reported. It includes any movement across the border, including by mail, courier or other conveyance, unless the currency or monetary instruments are being transported without leaving controlled areas.

IDA Member Regulation 188A clarifies the definition of monetary instruments to include those that are in bearer form only, or another form if title to them passes on at delivery. These include stocks, bonds, debentures and treasury bills, negotiable instruments such as bank drafts, cheques, promissory notes, traveler’s cheques and money orders. Instruments specified as belonging to a named individual or entity, such as cheques made out to a specific person or company and not endorsed and fully registered securities that have not been signed off are not required to be reported.

These regulations give customs officers with the Canada Border Services Agency (CBSA) the authority to seize unreported cash or monetary instruments above the threshold at border crossings. Written currency reports must be signed and given to a customs officer. The failure to report currency and monetary instruments may result in their seizure. While the owners of seized cash and monetary instruments
can recover them if it is found that the seized assets are not linked to money laundering or terrorist financing, they may be subject to the assessment of a penalty ranging from $250 to $5,000 depending on circumstances such as whether this is a first time event and whether there is any effort to conceal the assets. The Act also sets out a maximum fine of $500,000 and a maximum jail term of five years for failing to co-operate with CBSA when a submitting a report.

To combat terrorism and terrorist financing activities, Canada implemented the Anti-Terrorism Act, on December 24, 2001. The Act contains legislative measures aimed at identifying, deterring, prosecuting and punishing terrorist groups as well as providing new investigative tools for law enforcement agencies. Due to its comprehensive nature, the Anti-Terrorism Act also amended a number of other federal acts including the Criminal Code, the Official Secrets Act (which is now the Security of Information Act), the Canada Evidence Act, the Income Tax Act and the Charities Registration (Security Information) Act. It also amended several sections of the existing anti-money laundering legislation to include terrorist financing in its objectives.

To assist in the detection of terrorist activities, the Office of the Superintendent of Financial Institutions (OSFI) publishes a list of individuals and organizations that are suspected of engaging in terrorist activities. Regulations require that Canadian securities dealers determine on a continuing basis whether they are in possession of property owned or controlled by, or on behalf of, anyone on the list. The list of names is compiled according to the Regulations Establishing a List of Entities made under subsection 83.05(1) of the Criminal Code or the United Nations Suppression of Terrorism Regulations (UNSTR). The Canadian list is developed by the Department of Foreign Affairs and International Trade and modified by the Department of the Solicitor General. The OSFI list is published monthly and is accessible via its website.

Property of those whose names are published on this list must be frozen and transactions related to that property are prohibited. Canadian securities dealers must report monthly to their principal supervisory or regulatory body concerning the possession or control of any property described above. IDA members report to the IDA, federally regulated financial institutions to OSFI and non-IDA securities dealers such as mutual fund dealers to the provincial securities administrators.

Furthermore, these regulations require anyone in Canada, as well as Canadians outside Canada, to disclose to FINTRAC, the RCMP and CSIS the existence of any property in their possession or control that they believe is owned or controlled by, or on behalf of, anyone on this list. This includes information about any transaction or proposed transaction relating to that property.

Since November 8, 2001, securities dealers have had to report transactions if there are reasonable grounds to suspect that the transactions are related to the commission of a money laundering offence. Effective June 12, 2002, it is a requirement to report transactions to FINTRAC if there are reasonable grounds to suspect that the
transactions are related to the commission of a terrorist activity financing offence. There are also other offences associated with terrorist activities that are not specifically related to terrorist financing, such as participating in, or facilitating, terrorist activities, or instructing and harbouring terrorists. Under the new regulations, even a suspicion that a transaction is related to a terrorist activity financing offence triggers a requirement to report the suspicious transaction to FINTRAC.

In May 2005, FINTRAC and the IDA announced the signing of a memorandum of understanding (MOU) to exchange information related to money laundering and terrorist financing. The agreement is intended to minimize potential overlap between the organizations in carrying out compliance examinations within the investment sector, thereby reducing the administrative and regulatory impact for individual investment dealers in Canada. Under the agreement, FINTRAC will provide information to the IDA to facilitate its risk assessment of investment dealers subject to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. In turn the IDA will provide FINTRAC with information regarding Member firm’s adherence to and compliance with the Act.

In July 2004, OSFI and FINTRAC also signed an MOU under the authority of the *Public Safety Act* for exchanging information regarding money laundering and terrorist financing. This MOU will minimize potential overlap of work and reduce the impact of administrative requirements on federally regulated financial institutions.

In addition, in September 2005, the Financial Institutions Commission of British Columbia (FICOM) and FINTRAC entered into an MOU to exchange compliance information in their joint fight against money laundering and terrorist financing. FICOM, which is responsible for the administration of the *Financial Institutions Act*, the *Credit Union Incorporation Act* and the *Insurance Act*, will provide FINTRAC with the results of its assessments of compliance with anti-money laundering and anti-terrorist financing measures. In return FINTRAC will provide information to help facilitate FICOM’s risk assessment within its regulated sectors. The agreement will facilitate the exchange of compliance information and it will also minimize the potential overlap of work. This MOU was also signed under the authority of the *Public Safety Act, 2002*.

**Money Laundering Record Retention Guidelines**

In June 2005, FINTRAC released an updated version of their guidelines relating to “Record Keeping and Client Identification for Securities Dealers”. According to the guidelines, records must be kept for every account that a firm opens. Firms are required to keep a signature card, an account operating agreement or an account application that shows the signature of individuals authorized to give instructions
for an account, as well as an account number of any financial entity account that is in the individual’s name, or that the individual is authorized to give instructions for.

For an individual’s account, firms must retain new account applications, confirmations of purchase or sale, guarantees, trade authorizations, powers of attorney, joint account agreements and all correspondence about the operation of the account. Firms must also retain a copy of every statement sent to clients.

For corporate accounts, a copy of official corporate records identifying individuals authorized to sign on behalf of the corporation must be retained. If there are subsequent changes to this information, a board resolution stating the changes must be included in the records.

To open corporate accounts, firms are also required to identify all individuals who beneficially own more than 10% of that corporation, whether directly or indirectly. This involves obtaining the name, address, citizenship, occupation and employer of each beneficial owner and whether he or she is an insider or controlling shareholder of a publicly traded corporation or similar entity. Your firm must also verify the identity of those owners, but can use a wider variety of methods than verification under anti-money laundering legislation.

A list of the directors, certificate of corporate status, incorporation documents, etc., are required under anti-money laundering legislation. Corporate resolutions are required as evidence of who is authorized to trade in the account and the identity of these individuals must be verified by the firm and the IA.

Firms are not required to retain a large cash transaction record if the cash is received from a financial entity or a public body. In this context, a financial entity means a bank, credit union, caisse populaire, a trust and loan company or an agent of the Crown that accepts deposit liabilities. A public body refers to a provincial or federal department of a Crown agency, an incorporated municipal body or a hospital authority.

Records can be kept in a machine-readable or electronic form, as long as a paper copy can be readily produced. For records that are kept electronically, an electronic signature of the individual who must sign the record has to be retained. Also, records must be kept in such a way that they can be provided to FINTRAC within 30 days of a request to examine them.

Firms are not required to keep a copy of the reports made to FINTRAC, but it is recommended that they do so, as well as keeping acknowledgement messages that FINTRAC sends back about each suspicious transaction report processed.

Under FINTRAC’s guidelines, signature cards, account operating agreements, and account application forms have to be kept for five years from the day of closing of the account to which they relate. Records that confirm the existence of an entity (including a corporation) have to be kept for five years from the day the last
business transaction was conducted and all other records have to be kept for a period of at least five years following the date they were created. Failure to comply with these record keeping retention requirements can lead to up to five years imprisonment, a fine of $500,000, or both.

VI. Investor Protection Funds

Canadian Investor Protection Fund (CIPF)

The securities industry has long recognized the need to offer the investing public protection against loss due to the financial failure of any firm in the Self-Regulatory system. This is a vital element in the continuing confidence of the member firm-client relationship. Therefore, the Canadian Investor Protection Fund (CIPF) was established in 1969. From the moment an investor becomes a client of a CIPF member, the accounts of that client are covered by CIPF. The functions of the CIPF involve compensation for client losses and regulatory oversight. Presently the CIPF is sponsored by the IDA, TSX, TSX V and the ME (the SROs) and funded by quarterly assessments on member firms.

Compensation for Client Losses

The fund covers clients’ losses of securities and cash balances that result from the insolvency of a member firm of the IDA. CIPF does not cover clients’ losses that result from other causes such as changing market values of securities, unsuitable investments or the default of an issuer of securities. Accounts with non-CIPF members are not entitled to coverage except accounts of foreign affiliates of a CIPF member which are carried by the member in accordance with the requirements of the IDA.

Each claim is considered according to the policies adopted by the Board of Governors. Under the policies, certain persons are excluded as customers and are not, therefore, entitled to CIPF protection. Persons who deal with CIPF members through accounts used for business financing purposes such as securities lending and purchase/repurchase transactions, are not eligible for CIPF protection in respect of such accounts. The Governors may also determine that persons who do not deal at arm’s length with an insolvent member or with a person who is excluded as a customer are not customers entitled to protection.

CIPF is funded by the securities industry through: (i) quarterly assessments paid by members based on their gross revenues, (ii) risk premiums based on capital deficiencies, and (iii) an annual contribution by the SROs of the interest allocated to them in the prior year. The aggregate of all assessments in a calendar year cannot exceed 1% of the aggregate gross revenue of all IDA member firms for the previous
four quarters. Subject to this 1% limitation, CIPF can levy assessments on member firms through the IDA whenever required.

A limit has been placed by CIPF on the coverage provided for a customer’s general accounts equal to $1,000,000 for losses related to securities and cash balances. Separate accounts of customers are each entitled to the maximum coverage of $1,000,000 unless they are combined with other separate accounts.

General Accounts

Accounts of a client such as cash, margin, short sale, options, futures and foreign currency are combined and treated as one general account entitled to the maximum coverage. In addition, the proportionate interest of a customer in an account which is held on a joint or shared ownership basis is combined with the general account of the customer. For example, if spouses each have individual accounts in their own names and also have a joint account between them, their proportionate interest in the joint account would be combined with their respective individual accounts. The result is that such accounts of each spouse are entitled to CIPF coverage to the maximum limit of $1,000,000 for general accounts, and the joint account is not covered as a separate account. Within the $1,000,000 coverage, there was previously a limit on the amount of cash that was covered, but this limit has been removed so a client would now be covered up to $1,000,000 in cash if that is all that was in the account at an insolvent member firm.

Separate Accounts

Separate accounts (or groups of similar accounts) are treated as if they belonged to separate clients, and each account is entitled to the maximum coverage. Separate accounts include accounts for:

- Registered retirement plans such as registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), life income funds (LIFs), locked-in retirement accounts or plans (LIRAs or LIRSPs) and locked-in retirement income funds (LRIFs). All such retirement plans or funds established with respect to a customer (excluding spousal plans) through the same or a different trustee are combined and aggregated as a single separate account.
- Registered Education Savings Plans (RESPs).
- Joint Accounts (accounts which are owned on a joint or shared basis and for which each co-owner is authorized to act with respect to the entire account), except to the extent that the proportionate interest of a co-owner is required to be combined with a general account as described above. For example, if spouses have a joint account over which each spouse has full authority, but do not have individual accounts in their respective names, the proportionate interest of each
spouse in the joint account would be treated as if it were a separate account and each spouse would be eligible for coverage to the limit of $1,000,000.

- Testamentary trusts.
- Inter-vivos trusts and trusts imposed by law.
- Guardians, custodians, conservators, committees, etc.
- Personal holding corporations (if beneficial ownership of a majority of the equity capital of the corporation is held by persons other than the customer).
- Partnerships.
- Unincorporated associations or organizations.

Separate accounts are not combined unless a client holds them in the same capacity. The following two examples illustrate the application of this policy:

- If an individual had two personal holding corporations, they would be combined and treated as one separate account.
- If an individual had two accounts in trust, one for a daughter and the other for a son, they would be treated as separate accounts and not combined with each other or with the individual’s personal accounts, provided that they were genuine trusts and the beneficiaries were disclosed when the accounts were opened.

Claims are valued at the date of bankruptcy of the member, if applicable, or the date of the insolvency of the member as determined by CIPF. The client’s claim may be satisfied with the appropriate securities or with cash based on the value of the securities (in Canadian dollars) at the date referred to above and not the date of payment. CIPF or the trustee in bankruptcy/receiver will determine the client’s net equity in each of the client’s accounts. The net equity in an account is the total value of cash and securities owed to the customer by the insolvent member less the value of cash and securities owed by the customer to the insolvent member.

The customer’s claim for net equity is determined as follows:

\[
\text{Total value of cash and securities owed to customer} - \text{total value of cash and securities owed by customer to member} - \text{property returned to customer (including free credit balances, securities and other eligible property that has been returned to the customer following the date of bankruptcy in accordance with provisions of the Bankruptcy and Insolvency Act).}
\]

When a securities firm becomes bankrupt, securities owned by the firm and securities and cash held by the firm, other than customer name securities, collectively establish a customer pool fund. Cash and securities in the customer pool fund are allocated to customers in proportion to their net equity.
Under the Bankruptcy and Insolvency Act, “customer name securities” are securities that are registered in the name of the customer, or are in the process of being registered, on the date of the bankruptcy and are held by the securities firm for the account of a customer. These do not include securities registered in the name of the customer that are in negotiable form (e.g. Treasury Bills).

Clients have 180 days to file a claim. The period commences on (but excludes) the date of bankruptcy, if applicable, or the date of insolvency as determined and communicated by CIPF or the receiver. Claims by a client of an insolvent member must be made directly to the trustee in bankruptcy or the receiver, if any has been appointed, in accordance with the requirements for proving claims. For a claim to be considered by CIPF, it must first be recognized by the trustee/receiver as a legal obligation of the insolvent member.

In the unlikely event that the resources of CIPF are depleted, quarterly assessments within the prescribed limits will be made against the SROs and the proceeds will be distributed from time to time until all legal obligations of CIPF have been discharged.

**Regulatory Oversight**

As well as protecting investors through the actual fund, CIPF provides regulatory oversight by working with the financial examiners and senior regulatory officials of the SROs. Their role is to anticipate and to solve financial difficulties of members, and, to the extent possible, bring about an orderly wind-down or transfer of business if required. The CIPF conducts an annual review and evaluation of each SRO’s examination activities to ensure that there is compliance with CIPF Minimum Standards and it conducts financial examinations of member firms to ensure that they are in compliance with the CIPF Minimum Standards.

CIPF and its SROs, under the direct supervision of the Administrators, establish and continuously review national standards for capital adequacy and liquidity, financial reporting, accounting records, segregation of clients’ fully and partly paid securities, insurance and other matters relating to the financial condition of member firms. They also co-ordinate the surveillance and enforcement efforts of the examination staff and have close liaison with the panel of public accounting firms approved to audit and report annually on the financial condition of member firms.

**The SIPC-CIPF Memorandum of Understanding**

On April 13, 2005, the CIPF signed a Memorandum of Understanding (MOU) with the Securities Investor Protection Corporation (SIPC), the American equivalent of the CIPF, to work together more closely in the event of the insolvency of a brokerage firm doing business in both the U.S. and Canada.
The SIPC-CIPF MOU is the second such agreement for SIPC. In February 2004, SIPC executed a similar accord with the Financial Services Compensation Scheme, a SIPC-like entity that provides protection to investors in the United Kingdom.

**Mutual Fund Dealers Association’s Investor Protection Corporation (MFDA IPC)**

The MFDA Investor Protection Corporation (MFDA IPC) was established on July 1, 2005 to protect mutual fund investors from the insolvency of MFDA member firms, just as the CIPF protects investors from the insolvency of IDA member firms. The MFDA IPC contains financial assets of $30 million and is funded through member assessments and a line of credit. The firm assessments are calculated according to assets under administration. This protection fund provides coverage of $1,000,000 per eligible account for losses related to the insolvency of an MFDA member.

**VII. Protection for Depositors**

**Canada Deposit Insurance Corporation (CDIC)**

Created in 1967, the Canadian Deposit Insurance Corporation (CDIC) is a federal Crown corporation that provides insurance for deposits in Canadian banks, trust and loan companies.

Eligible deposits include savings accounts, chequing accounts and term deposits with a term of five years or less, in Canadian currency and payable in Canada. These deposits are insured by CDIC to a limit of $100,000 per person at each member institution. For example, if a depositor had two accounts at two different banks, each worth $100,000, they would be fully insured. If the depositor had two accounts at the same bank or at different branches of the same bank, they would be insured only to $100,000 for those accounts.

**Provincial Insurance Funds for Depositors**

The Quebec Deposit Insurance Corporation (QDIC) provides protection similar to that of the CDIC for depositors of financial institutions chartered in Quebec - for example, caisses populaires, trust and mortgage companies. The CDIC and the QDIC have agreed that both will guarantee eligible deposits at the same institution when these deposits are partially in Quebec and partially elsewhere in Canada.

Most other provinces also have credit union/caisse populaire insurance corporations, run by the provincial government and funded by member institutions.
VIII. Summary

The securities industry in Canada is regulated by the provincial securities commissions, SROs, and to a smaller extent, by federal legislation. The securities Acts of each province are based on the three basic principles of regulation; disclosure, registration and enforcement.

Each province regulates securities activities within its borders and attempts to create a formal national regulator have been unsuccessful so far. The provinces have managed, though, to harmonize their regulations through meetings of the Canadian Securities Administrators and through the reformulation and implementation of National Policies and Instruments.

From an industry point of view, regulation is conducted through self-regulatory organizations (SROs) that have been given the privilege of regulating their own members. SROs are responsible for enforcing conformity with securities legislation, as well as having the power to prescribe rules of conduct and financial requirements for their members.

As well as the securities industry being heavily regulated to protect investors, the Canadian Investor Protection Fund and the MFDA’s Investor Protection Corporation are set up to guard against losses due to the financial failure of any SRO member firm.
SECTION I: THE REGULATORY ENVIRONMENT

Chapter 3

Registration of Securities Industry Participants

Introduction

The provincial Acts require the registration of all individuals and firms who trade in securities as principal or agent or who engage in the business of advising others as to the buying or selling of securities. Individuals who are salespersons, partners or officers of securities firms must be registered as such. Moreover, the firm with which an individual is associated, whether as salesperson, officer or partner, must also hold its own separate registration.

Trade or trading in securities is defined generally to include dealing in, selling or disposing of any security for valuable consideration. In many jurisdictions it also includes participation as a trader on the floor of an exchange, the receipt by a registrant of an order to buy or sell a security and any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing. The Quebec Act does not define trade or trading, but requires registration in respect of trading activities through its definitions of dealer and advisor, which will be discussed later in this chapter.

Any person who even indirectly by act, advertisement, conduct or negotiation becomes involved in any attempt to deal in securities may be considered to be trading in securities (or, in Quebec, to be carrying on business as a dealer or advisor) illegally unless the person is registered. This provision is a warning to those who would act as finders or intermediaries in arranging the sale of securities, and to those who are doing investor-relations work.

Under all of the Acts the definition of security is very wide and generally includes:

- an interest in the capital, property or profits of a person or company;
- evidence of an option to purchase a security;
- an interest in a trust, estate or association;
- a profit-sharing agreement;
- an interest in an oil, gas or mining lease, claim or royalty;
• certain annuity contracts;
• an interest in a scholarship trust; and
• any investment contract.

The more common securities include shares, bonds, debentures, promissory notes, warrants, options, units of limited partnerships, units in mutual funds and other interests in tax sheltered vehicles, but may include other types of investments.

Learning Objectives

After reading this module, you should understand:

• the different registration categories for dealers and advisors
• proficiency requirements for different categories of registration
• the registration process under the National Registration System and the National Registration Database
• requirements for dealing with clients in the United States.

I. Types of Registration

Most Acts require the registration of dealers, advisors and underwriters. These terms are generally defined as follows:

☐ Dealer: A person or company who trades in securities in the capacity of a principal or agent.

☐ Advisor: A person or company engaging in the business of advising others with respect to the investing in or the buying or selling of securities.

☐ Underwriter: A person or company who, as principal, agrees to purchase securities with a view to distribution or, as agent, offers for sale or sells securities in connection with a distribution.

II. Categories of Registration

Dealers

Some of the relevant dealer categories are as follows:

(i) Investment Dealer: A person or company who engages in the business of trading in securities in the capacity of an agent or principal and is a member of the IDA.
(ii) **Securities Dealer:** A dealer who is registered for trading in securities in the capacity of an agent or principal.

(iii) **Mutual Fund Dealer:** A person or company registered exclusively for the purpose of trading in shares or units of mutual funds, as a required member of the MFDA.

Every investment dealer or securities dealer is deemed to have been granted registration as an underwriter in most provinces except British Columbia, where separate registration is required.

**Introducing/Carrying Broker Arrangements**

Service contract relationships between securities firms are an important factor in the securities business. They allow small firms to enter into the business and provide full service to their clients without bearing the large start-up and maintenance costs of operating a back office. They also allow established firms to lower the costs of operating their back office by selling excess capacity to other dealers, however, these smaller dealers are restricted in their activities, and these arrangements are subject to SRO approval and control.

Carrying brokers are securities firms that offer back office services and facilities to other member firms, which are known as introducing brokers. The services provided by a carrying broker include the execution, clearing and settlement of trades, the custody of funds and securities, the maintenance of books and records of customer transactions and the financing of customer positions. Under the regulations, the introducing broker maintains the relationship with the client while the carrying broker provides back-office services. The services provided by the carrying broker may include:

- execution, clearing, and settlement of trades (jitney services);
- custody of customer funds and securities;
- compliance;
- maintenance of books and records of client transactions;
- financing of client positions.

There are four types of introducing/carrying arrangements. The introducing broker takes on increasingly greater responsibilities, moving from Type 1 to Type 4 arrangements. While the client is considered a client of the carrying broker under all four types, the carrying broker has Know-Your-Client obligations only under Type 1 arrangement, in which the carrying broker has some or all of the sales compliance responsibilities. All four types of introducing brokers are still allowed to enter into additional arrangements for trading in futures contracts and options.

In the anti-money laundering context, the issues surrounding KYC and suspicious activity reporting become even more complex when viewed in terms of allocating...
responsibilities between introducing brokerage firms and the firms that clear securities transactions on their behalf. The Proceeds of Crime (Money Laundering) and Terrorist Financing Act and suspicious transaction reporting regulations contain no guidelines in this regard and provide no exemption for carrying brokers from compliance with all requirements with respect to carried accounts.

Given that the introducing broker has the primary relationship with the customer and is generally in the best position to know its client, suitability requirements fall on the introducing broker. However, the carrying firm may have the necessary systems for monitoring transactions, and may deal directly with the client in conducting transactions such as account deposits, withdrawals and wire transfers. Introducing and carrying firms need to ensure that there is a clear understanding between them as to where operational responsibility for all anti-money laundering procedures lies. They must ensure that sufficient information is available to those responsible for carrying out those procedures, specifically addressing record keeping responsibilities, the reporting of currency transactions and the filing of suspicious transaction reports.

Advisors

Only the provinces of Alberta, British Columbia, Newfoundland and Labrador, Nova Scotia, Ontario and Saskatchewan have different registration categories for advisors. These include:

(i) **Investment Counsel**: persons or companies who are in the business of advising others regarding investment in specific securities or who advise specific clients on a continuing basis, considering the particular objectives of each client.

(ii) **Portfolio Manager**: persons or companies who manage the investment portfolios of clients through discretionary authority granted by the clients.

(iii) **Securities Advisor**: those who are in the business of advising the public generally, either through direct advice or through publications, with regard to investing in specific securities where such advice is not purporting to be tailored to the needs of specific clients.

Brokers and investment dealers are exempted from registration as portfolio managers for the reason that they are subject to the rules of self-regulatory bodies which are substantially equivalent to those applicable to registered portfolio managers.

In Quebec an advisor may apply for either a restricted or unrestricted registration. If an advisor’s registration is restricted, the advisor cannot offer portfolio management services.

In Manitoba, the advisor categories are investment counsel and securities advisor.
III. Exemptions from Registration

As mentioned above, all of the Acts provide for exemptions from registration based on types of trades and securities or, in Quebec, in respect of categories of individuals and institutions.

Advisors

Most Acts exempt the following from the requirement to be registered as an advisor:

- Financial institutions such as banks, trust companies and insurance companies (see Banks and Other Financial Institutions, below).
- Members of the legal, accounting, engineering and teaching professions.
- Registered dealers or partners, officers or employees of registered dealers.
- Publishers of and writers for newspapers or financial magazines having a general paid circulation and which contain investment advice.

These exemptions apply provided that the performance of the service as an advisor is solely incidental to the person or company’s principal business or occupation. In the case of the writer or publisher, they must have no financial interest in, nor receive any commission or other consideration for, the giving of the advice.

*The Quebec Securities Act* also requires that members of the media do not trade in the securities of the company in respect of which advice is given in the seven days preceding the advice nor for 30 days thereafter. In Quebec, there is also an exemption for those who give advice only to *sophisticated purchasers* such as government-owned corporations, banks, loan and investment societies, trust companies, insurance companies, registered dealers and advisors and certain pension funds with assets over $100 million. Sophisticated purchasers are deemed to be sufficiently knowledgeable about investments that they are able to determine the suitability of an investment for themselves.

Banks and Other Financial Institutions

Canadian chartered banks and other federal financial institutions are for the most part outside the scheme of provincial securities regulation in Canada since banking is a matter of federal jurisdiction. However, when the banks or their affiliates are involved in securities-related activities, the securities legislation is relevant. In 1988, the federal and Ontario governments entered into an agreement that defines which securities-related activities may be carried out directly by federal financial institutions and which must be carried out through a subsidiary or affiliate. The federal Office of the Superintendent of Financial Institutions (OSFI) regulates federal financial institutions and the Ontario Administrator regulates subsidiaries or
affiliates of federal financial institutions which are engaged in securities-related activities in Ontario.

A federal financial institution may carry out the following securities-related activities of a federal financial institution directly:

(i) trading in government debt on both primary and secondary markets;
(ii) trading in negotiable promissory notes and commercial paper having a term to maturity of one year or less;
(iii) trading in debt securities of the financial institution or of an affiliate and guaranteed by the financial institution (e.g., GICs, bankers’ acceptances, variable insurance contracts);
(iv) secondary market trading in other debt securities;
(v) trading in syndicated or consortium loans (except when offered by prospectus);
(vi) trading in mutual funds in relation to corporate sponsored accounts for pension plans, deferred profit sharing plans, registered retirement savings plans and other similar capital accumulation plans;
(vii) trading with or for accounts duly managed by it as agent or trustee; and
(viii) taking as agent for a person or company an unsolicited order to purchase or sell equity securities for execution through a registered dealer.

IV. Registration of an Individual as a Registered Representative

The Acts require that individuals desiring to trade in securities or to advise on the purchase or sale of securities must first be approved and registered in the proper capacity. In many provinces, salespersons will not normally be granted registration unless they are employed full time as a salesperson with a registrant. In Alberta, British Columbia, Newfoundland and Labrador, Nova Scotia and Ontario, exceptions to this rule may be made in certain circumstances, for example, where the applicant:

• is a full or a part-time student in a business, commercial or financial course;
• is otherwise employed for less than six months of the year, holds a licence as an insurance agent or as an investment contract sales agent, and is employed by or under the sponsorship of a dealer who proposes to employ the applicant;
• is engaged in an activity which the Administrator considers will not in the circumstances interfere with a salesperson’s duties or give rise to conflicts of interest; or
qualifies for one of the other exemptions contained in the regulations or policy statements under the applicable Act.

Some of the provincial securities Acts (e.g., Ontario, Manitoba, Newfoundland and Labrador and Nova Scotia) do not permit individuals to advertise that they are registered as individuals to sell securities. Other provinces such as Alberta, British Columbia and Saskatchewan will allow it provided that it is true. British Columbia requires the category of registration also be disclosed and Saskatchewan requires that any conditions or restrictions on the registration are disclosed.

Traditionally, individuals selling securities to the public were required to be employees of IDA member firms. With the approval of IDA By-law 39 in May 2003, member firms and persons conducting securities related business on behalf of a member firm are also permitted to enter into principal/agent business relationship structures. This applies in all provinces provided that certain conditions are met to the satisfaction of the IDA. Principal/agent business relationship structures are commonplace in the mutual fund and insurance industries.

For the purposes of By-law 39, “securities related business” generally means any business or activity (whether or not carried on for gain) engaged in, directly or indirectly, which constitutes trading or advising in securities or exchange contracts (including commodity futures contracts and commodity futures options).

In September 2003, the IDA concluded that financial planning is a securities-related business in that the nature and extent of any investment recommendations to a client are inextricably tied to the overall plan. The IDA acknowledges that it is possible for a financial plan to generate no investment recommendations, but such plans are likely to prove to be the exception rather than the rule.

Member firms are therefore responsible for the supervision of financial planning activities of their agents and employees and related record keeping. This does not mean that all financial plans provided to clients require pre-approval by the member firm since firms may develop their own policies and procedures for the supervision of financial planning activities, subject to IDA review and approval.

Because most personal corporations are not registered with the relevant securities commissions, the relationship between a member and any person conducting securities related business on behalf of the member may not be that of an incorporated salesperson. Furthermore, the protection available to investors in an employer and employee relationship or principal and agent relationship is not available to investors when dealing with incorporated salespersons operating through their personal corporations. As such, these relationships have not been contemplated by the IDA at this time and are therefore prohibited.

In conjunction with By-law 39, Regulation Services Inc. has also defined an “employee” under the Uniform Market Integrity Rules to include a person who has entered into an agency relationship with a market participant in accordance with the
conditions established for such a relationship by any self-regulated entity of which the participant is a member.

Proficiency Requirements and Categories of Individual Registration

Base Requirements

The securities commissions and the IDA have prepared rules on the proficiency requirements for registrants. This includes updating proficiency requirements and the names of course materials, establishing time limits during which course and experience proficiencies remain valid for applicants, and determining periods of supervision, etc.

Continuing Education

Continuing education (CE) is fundamental in most knowledge-based industries and effective January 1, 2000 it became a requirement for ongoing licensing in the Canadian securities industry. With the growing complexity of the industry and its products, this requirement ensures that proficiency is maintained and that financial service professionals stay abreast of product developments, legal and compliance issues, emerging industry trends and other capital market developments.

The CE program for the securities industry applies only to individuals registered as trading (e.g., IAs, IRs, MFSRs) with an investment dealer and there is no requirement for non-trading registrants to participate in the program. The program operates in three-year cycles and participants are required to accumulate a certain number of continuing education credits during each cycle. All participants must take a compliance course and those registered to give advice to retail clients must also take a professional development course. Registrants who have been continuously registered for 15 years at the inception of a CE cycle will not be required to take professional development courses. Those who have been continuously registered for 10 years at the inception of a CE cycle will be required to take a professional development course only in the first cycle. For all others, full CE requirements continue through their careers.

The CE program requires the completion of one or more courses approved by the member firm to equal at least 12 hours for the compliance program and at least 30 hours for the professional development program. The required programs must be completed within each 3-year cycle.

Firms can design and deliver their own compliance and professional development courses or their employees can take CE courses from several sources including the CSI and other educational providers. Firms have total discretion to approve CE courses on the basis of guidelines prepared by the SROs. Firms will be responsible
for reporting each employee’s completion of CE requirements to the SRO responsible for approving them. If a registrant has not completed the required courses at the end of the three-year cycle, penalties will be invoked.

As of December 2005, CSI Global Education Inc. offered the following professional development courses to fulfill continuing education requirements:

- Anti-Money Laundering
- Branch Managers Course
- Broker Liability
- Canadian Commodity Supervisors Exam
- Canadian Insurance Course (Not available in Quebec)
- CE Compliance, including CPH for Industry Professionals
- Charts and Formations
- Chief Financial Officers Course
- Corporate Governance
- Covered Call Writing
- CPH for Industry Professionals
- Derivatives Fundamentals Course
- Effective Management Seminar
- Energy Markets – Risk Management Course
- Estate Planning
- Ethics Module and Case Study, Retail Version
- Ethics Module and Case Study, Institutional Version
- Ethics Seminar
- Ethics, You and the Corporation Seminar
- Exchange Traded Funds
- Financial Markets – Risk Management Course
- Fixed Income Investing
- Futures Licensing Course
- Hedge Fund Essentials for Today’s Financial Professional
- Hedge Funds Seminar
- How Mutual Funds & Hedge Funds Use Derivatives
- Income Trusts
- Incorporating Options into your Business Seminar
- Industry Trends (Commissions to Fees)
- Investor Confidence
- New Investment Management Techniques Course
- Options Licensing Course
• Options Strategies Course
• Options Supervisors Course
• Partners Directors and Senior Officers Course
• Portfolio Management Techniques
• Portfolio Theory, Asset Allocation and Performance Measurement
• Pre-Retirement Planning
• Principal-Protected Notes
• Professional Financial Planning Course
• Quantitative Analysis
• Retirement Planning
• Segregated Funds
• Single Stock Futures
• Socially Responsible Investing
• Technical Analysis Course
• Technical Analysis I Seminar
• Technical Analysis II Seminar
• Trader Training Course
• Trust Structures
• Understanding Margin: Benefits and Risks
• Wealth Management Techniques

A full list of accredited courses from all vendors is available at www.cecap.ca.

In early 2005, the IDA launched an online reporting system for members to track CE requirements. This system allows members to view the requirements for each registrant in the firm and to report the completion of each individual’s Compliance and Professional Development requirements.

The Acts and the IDA set requirements for initial and continuing registration of investment salespersons, who are referred to generally and under the legislation of most provinces as “Registered Representatives (RRs)”. Following are the most common registration categories for individuals.

**Investment Advisor (IA)**

Investment Advisors (IAs) are individuals registered to advise on the full range of equity and fixed income securities products, excluding options and futures. The term “IA” refers solely to employees of IDA member firms and is not an official registration category under the provincial legislation of most provinces. The official category in most provinces is “Registered Representative” (RR).
The core of the IA’s expertise is the breadth of his or her industry knowledge of individual securities, how the capital markets work, economic cycles and the performance of securities within these cycles, taxation issues, etc. It is this broad-based knowledge that allows them to advise on any number of investment products. IAs can be thought of as bridging the gap between order-takers and discretionary money managers.

Registration as a new IA requires:

θ **Formal training:** Candidate must successfully complete the CSC and the CPH, which are administered by the CSI.

θ **90-Day Period of No Client Contact:** During this period, candidates take their firm’s training course and, in some cases, are completing the CPH. Candidates are permitted to assist clients with inquiries about their accounts, give quotes and cold call from a script. However, they are not allowed to solicit orders or solicit trades in products that do not normally require registration (e.g., Treasury bills). Candidates are also not permitted to accept unsolicited orders, so, in effect, they must avoid all activity considered “in furtherance of a trade.” The only exception to this rule applies to candidates already registered as mutual fund sales representatives thus allowing these individuals to deal with their existing mutual fund client base in trading mutual funds only. However, they cannot solicit or take on any new clients during the 90-day period.

θ **Six-Month Period of Supervision:** Following approval as an IA, the registrant is placed under the close supervision of his or her supervisor. A six-month period of supervision is required, as outlined in IDA By-law 18.6, unless the registrant has worked for at least two years in a registered capacity with a securities firm which is a member of the IDA or a recognized foreign self-regulatory organization.

θ **30-Month Requirement:** IAs must complete the Professional Financial Planning Course (PFPC) or Part I of the Canadian Investment Management (CIM) program, which is now the Investment Management Techniques (IMT), course administered by the CSI, within 30 months of approval, or the approval is suspended. (Effective September 29, 2003, non-retail representatives in Ontario are no longer required to complete the PFPC or IMT under OSC Rule 31-502. This change is in line with the post licensing requirements of the IDA’s Policy 6, which imposes this requirement on retail staff only.)

θ **Continuing Education (CE):** Participation in the industry’s CE program is a condition of maintaining a licence.

Additional proficiency requirements are necessary for an IA to be registered to solicit orders for or to advise on trades with respect to options, futures contracts and futures contract options.

The attributes that make for a successful IA include:
• Extensive industry knowledge
• Strong communication skills
• Ethical decision making

**Investment Representative (IR)**

Investment Representatives (IRs) are individuals registered solely to take/submit client orders for execution – under no circumstances must these registrants provide clients with investment advice. As with the term “IA”, the term “IR” refers solely to employees of SRO member firms. RR (Restricted) is an SRO approval category and not listed in provincial legislation. Under the legislation of most provinces, IRs are categorized as “Salesperson”.

The proficiency requirements for IRs are similar to those for IAs, with the exception of the length of the training period, the 30-month and continuing education requirements. That is, IRs must complete the CSC, CPH, a 30-day (as opposed to 90-day) training program, they could be subject to a six-month period of supervision (as outlined in By-law 18.6), are subject to the compliance portion of the continuing education requirements but they are not required to fulfil the 30-month requirement. (Reduction of the training period for IRs from 90 days to 30 days was approved by the IDA on March 17, 2000 and OSC approval was granted on May 9, 2000.)

In December 2000, the IDA issued a bulletin outlining the guidelines for permissible activities for individuals taking the 30 and 90-day training programs. Because they are not registered yet, individuals in these training programs are not permitted to have contact with customers or prospective customers in obtaining, taking or soliciting orders for or advising on trades in securities. Furthermore, such persons must not receive commission splits as any part of their compensation. Activities that are considered to be permissible are:

• gathering info from existing or prospective clients on behalf of another registrant, including answering client account inquiries and giving quotes, provided that candidates do not open any client accounts until they are fully registered;
• contacting the public, including sending out introduction letters, inviting the public to firm seminars, and forwarding non-securities specific information, provided that they comply with the restrictions regarding impermissible activities;
• creating and researching lists of potential clients for future follow-up work.

Candidates who are registered to sell mutual funds can continue to deal with their existing mutual fund client base, but they can only purchase and sell mutual funds. During the 90-day training period, they also cannot solicit or take on any new clients or transact in any non-mutual fund securities with anyone. Basically, individuals in either the 30 or 90-day training program cannot engage in any activity “in furtherance of a trade”. In particular, they cannot:
• provide any recommendations, opinions or advice with respect to securities as defined in provincial Securities Acts, either in writing or verbally
• open client accounts;
• complete know-your-client information on a New Account Application Form or KYC form other than the biographical information at the beginning of a form completed on behalf of a registrant;
• distribute research reports under their own names to clients or prospective clients containing security-specific comments, recommendations or opinions. They can however, act on behalf of a registered person and distribute literature including research reports if it is pre-approved by the firm and/or the branch manager;
• solicit, accept or process any orders, including unsolicited orders.

There are two types of IRs:

- **Sales Assistants**: These are IRs employed at full-service investment dealers, working with and helping fully registered IAs manage their businesses. This largely involves administrative tasks such as organizing the IA’s client records, NAAFs and other client documentation. Sales assistants may speak with clients but are not permitted to give advice. Registered Sales Assistants may take unsolicited client orders to buy and sell securities. Often Sales Assistants work with more than one IA.

The attributes that make for successful Sales Assistants include:

- Strong organizational skills, in order to be able to multi-task effectively
- Strong communication skills, in order to interrelate with IA, client and other firm departments
- Good industry knowledge
- Strong familiarity of their firm’s back office operations, in order to process transactions/solve problems effectively (e.g., new client accounts, cage procedures, etc.)

- **IRs at Discount Brokers**: These IRs are registered to take/receive orders from clients and submit them for execution. They must recognize when an order is beyond their authority and pass it on to their supervisors.

**Mutual Fund Sales Representative (MFSR)**

MFSRs are registered solely for the purpose of advising on mutual funds and are generally employees of financial institutions or mutual fund dealers. Individuals who are employed by IDA member firms and restricted to mutual fund sales are called “Registered Representative (Mutual Funds)”. Under the legislation of most provinces, RRs (MF) are categorized as “Salesperson”. 
The proficiency requirements for MFSRs employed with non-SRO member firms are:

- **Formal Training Courses**: Each Approved Person who is a salesperson and who trades or deals in securities for the purposes of any applicable legislation in respect of a member shall have successfully completed any one of the following courses: (i) the Canadian Securities Course offered by the CSI; (ii) the Canadian Investment Funds Course offered by the Investment Funds Institute of Canada; (iii) the Investment Funds in Canada Course offered by the Institute of Canadian Bankers; (iv) the Principles of Mutual Funds Course formerly offered by the Trust Companies Institute; or (v) to the extent the Approved Person trades or deals in securities in the Province of Quebec only, the courses entitled Placements des particuliers (CEGEP) and Cours sur les fonds distincts et fonds communs de placement offered by the CSI.

- **Training Program and Six Month Period of Supervision**: Within 90 days of the commencement of trading or dealing in securities on behalf of a member, all new salespersons shall complete a training program and are then subject to a six month supervision period.

OSC Rule 31-502 permits dealers to have mutual fund only registrants (up to a limit) providing that they meet full IA proficiency requirements within nine months of being hired. A MFSR can continue to act as a full MFSR, including taking on new clients, until he or she begins the 90-day training period. Once a MFSR begins the training period, no new client prospecting is allowed, but the MFSR is permitted to service existing clientele.

MFSRs may transfer their status and apply for full registration with a member firm provided they meet certain industry-approved examination requirements. If the applicant has been registered as a MFSR only for more than three years prior to the transfer, IDA Policy 6 requires that both the Canadian Securities Course (CSC) and the Conduct and Practices Handbook Examination (CPH) be re-written. However, Part III of Policy 6 provides an exemption from the exam re-write requirement if the applicant has voluntarily met the continuing education requirements for a registered representative by taking CSI courses.

**Restrictions on Unregistered Staff**

Non-registered personnel employed by a member firm or a related financial services entity cannot (from Policy No. 1 – Relationships between Members and Financial Services Entities: Sharing of Office Premises):

- open client accounts;
- distribute or receive order forms for securities transactions;
- assist clients in completing order forms for securities transactions;
• provide recommendations or advice on securities;
• complete know-your-client information on a New Account Application Form other than the biographical information; and
• solicit securities transactions.

However, these individuals are permitted to:

• advertise the services and products offered by the firm;
• deliver or receive securities to or from clients;
• contact clients to arrange appointments or give notice regarding deficiencies in completed forms;
• provide information on the status of a client’s account and provide account balances, quotes and other market information;
• contact the public, including inviting the public to firm seminars and forwarding non-securities specific information;
• receive completed New Account Application Forms to forward to the member for approval; and
• distribute account opening applications, but in branches where there is no registered salesperson, only the manager, assistant manager or credit officer can assist in completing the form, and before any trades are conducted, a registered person must review the account documentation to ensure compliance with Know your client rule and suitability obligations.

**Dual Licensing for Securities and Life Insurance**

All Canadian jurisdictions allow salespersons to be dually licensed as an IA and as a life insurance representative. Candidates must meet the requirements of both the Securities and Insurance Acts in their registration jurisdiction(s). The Securities Acts generally require that:

• insurance and securities businesses be carried on separately and insurance agents be identified as such;
• the dual-licensee’s securities employer give written approval to the employee’s insurance license application;
• any changes in status or disciplinary actions under the Insurance Act are promptly reported to the Securities Administrator. Any disciplinary violations under the *Insurance Act* may adversely affect registration under a Securities Act;
• clients be made aware that they are dealing with two separate business entities for securities and insurance.

In March 2000, the Canadian Insurance Self-Regulatory Organization (CISRO) put forward recommendations on Life Insurance Agent education in Canada (outside of
Quebec). Their recommendations were adopted and implemented by most provinces.

The goal of this new licensing regime is to standardize licensing education requirements across Canada (outside of Quebec) thus reducing regulatory complexity while ensuring consumers are well protected.

The key highlights of this licensing regime are as follows:

• Implementation of a mandatory pre-licensing training program. Life agent candidates will have to complete a pre-licensing Life License Qualification Program (LLQP) offered by an approved course provider in order to be eligible to attempt the licensing examination.

• A move towards a single step licensing process. Previously, in most jurisdictions, licensing of life agents consisted of two levels: Level 1 and Level 2. Under the new regime a single licensing examination will be phased in by 2005 thereby replacing Levels 1 and 2.

• An enhanced licensing examination. The LLQP represents a “raising of the bar” in terms of covering higher levels of learning and application of knowledge, as compared with the current proficiency standards.

For more detailed information regarding life insurance agent licensing refer to the complete legislative provisions applicable in your province.

National Registration System (NRS)

In April 2005, the Canadian Securities Administrators (CSA) launched the National Registration System (NRS), which harmonized and streamlined the registration process across all jurisdictions.

The NRS allows an individual or firm to apply for registration in multiple jurisdictions and deal with only one regulator – the principal regulator. The principal regulator for an individual filer is the securities regulatory authority or regulator of the jurisdiction in which the individual filer’s working office is located.

The NRS improves the registration process by applying principles of mutual reliance to reduce unnecessary duplication in the analysis and review of registration applications of investment dealers, mutual fund dealers, unrestricted advisers (investment counsel/portfolio managers) and their sponsored individuals.

Under NRS, an applicant will be required to meet the “fit and proper” requirements of only the principal regulator. Non-principal jurisdictions will generally rely on the principal regulator’s decision to grant registration and will normally grant registration within five business days after the principal regulator. NRS enhances efficiencies by requiring fewer application reviews, streamlining regulatory decision-making and providing applicants with a single point of contact with
regulators. NRS also simplifies the registration process for firms and individuals, and permits a quicker process for those applicants who want to be registered in multiple jurisdictions.

The requirements and procedures under NRS are set out in National Instrument 31-101 National Registration System, and National Policy 31-201 National Registration System.

The National Registration Database (NRD)

The following discussion will focus on the registration requirements for individuals only and will not deal with any requirements or procedures related to the registration of firms.

As of March 31, 2003, all regulatory filings regarding registered individuals must be completed through the National Registration Database (NRD). The NRD is a web-based system that permits dealers and advisers to file registration forms electronically, reduces the regulatory burden for industry participants and harmonizes securities regulations across jurisdictions. It was an initiative of the IDA and all of the Canadian Securities Administrators.

Because the MFDA has currently not been delegated the authority to grant registration on behalf of any commission, registration for MFDA individuals is still handled by the applicable commissions.

The significance of this harmonized effort means that instead of requiring registrants who want to be licensed in more than one province or territory to file separate registration forms in each jurisdiction, the NRD is designed to enable a single electronic submission (Form 33-109F4) to satisfy all jurisdictions in Canada. The NRD also eliminates the burden of providing proof of registration in other jurisdictions because the regulators can use the NRD to verify registration status in other jurisdictions.

Under the NRD, firms must designate one or more individuals as “Authorized Firm Representatives” (AFRs). These individuals are responsible for managing the firms’ access to the NRD, with the firms themselves determining who will become an AFR with the authority to certify all of their NRD submissions.

Although signatures are not required for NRD submissions, it is an offence for an individual to submit inaccurate information, whether directly or through an agent (i.e., an AFR). Notarization is also not required for NRD submissions because the applicant certifies the accuracy of the information in the application that is submitted electronically by an AFR.

Regulators have significantly reduced the requirements to submit supporting documentation with registration forms, even though they retain the discretion to
request additional documentation. This is a result of the regulators rethinking the registration process and eliminating documents that they no longer consider necessary to be submitted. In some cases, the NRD system itself eliminates the need for certain documentation. Under record-keeping obligations, firms are now required to retain certain documentation that they previously submitted (e.g., proof of proficiency). Firms will also continue to determine which other records and documentation they will keep on hand for due diligence purposes because regulators can require firms to produce registrants’ records or supporting documentation for compliance or inspection purposes. However, in certain circumstances (e.g., if an individual has disclosed a prior bankruptcy or criminal conviction) supporting documentation is still required to be submitted when registering individuals.

One of the major advantages of the NRD is that it will not accept incomplete applications. The user will receive an automatic message on the screen if he/she tries to submit incomplete applications or filings using NRD, and will be required to complete the missing information. This feature eliminates some of the delays resulting from correspondence between regulators and firms provided there are no contentious issues or criminal or civil disclosures. Another advantage of the NRD is that registrations in all jurisdictions renew on December 31 of each year and not on different dates as was the case under the old paper-based system.

All notices of changes to information regarding firms and individuals, other than notices of changes to an individual’s proficiency and personal information previously submitted on Form 33-109F4, must be submitted, filed or delivered within five business days of the occurrence of the change. Notices of changes to an individual’s proficiency and personal information must be submitted within one year of the occurrence of the change.

Besides providing firms with full access to all registration information about individuals associated with their firm, the NRD can automatically generate four different reports for users. The first report is a “Reconciliation Report by Submission” that lists all submissions made by a firm over a period of time, the amount of fees paid in respect of each submission, and the status of that payment. The second report is a “Reconciliation Report by Electronic Pre-Authorized Debit” and lists all electronic pre-authorized debits taken from a firm’s designated account over a period of time. The third report is an “Individual Registrant Report” that lists basic information for all individuals associated with a firm. Finally, the fourth report that can be generated is an “AFR Report” listing basic information for all AFRs that have been authorized by a firm.

From a regulatory point of view, the NRD creates a single official record for each registrant and provides easy access to registrant information across the country. The NRD also eliminates the time regulators spend on handling incomplete and missing information on registration application forms, thereby allowing them to
spend more time on value-added procedures that enhance the effective functioning of Canada’s capital markets.

**Procedures for Individual Registration**

There are three categories of individual submission types that can be made by an AFR using the NRD. They are:

- Initial submissions
- Amendment submissions
- Notice submissions

An initial submission involves the completion of Form 33-109F4 on behalf of registered individuals and non-registered individuals when applying for registration through the NRD for the first time. This submission is also used when transferring a registration, getting registered with an additional firm or in an additional jurisdiction and when reactivating a registration.

Form 33-109F4 asks questions about the salesperson and any companies with which the salesperson has been associated in certain senior capacities (partner, director, officer) or as a major shareholder. For example, the applicant is asked to reveal:

- any action against the salesperson regarding any government registration to deal in securities or with the public in any other capacity requiring registration;
- any disciplinary action regarding an approval by any securities commission or other similar professional body;
- any past criminal convictions or current charges or indictments;
- any bankruptcies or proposals to creditors; and
- any civil judgment or garnishment.

The second category of individual submission types that can be made using the NRD are amendments. Amendments are used to deal with deficiencies addressed by the regulators. This submission would also be used when changing or surrendering individual categories of registration. If the individual is surrendering all categories in all jurisdictions in which he or she is registered, a Notice of Termination should be used instead of an amendment.

An amendment would also be used when a registrant is applying for an exemption from a proficiency requirement. If this submission is approved, the proficiency section of the individual’s permanent record is automatically updated.

The third category of individual submission types that can be made using the NRD are notices. These would be used in situations such as:

- Notice of Termination (Form 33-109F1)
• Individual Name Change (Item 1 of Form 33-109F4)
• Residential Address Change (Item 2 of Form 33-109F4)
• Personal Information Change (Item 3 of Form 33-109F4)
• Citizenship Information Change (Item 4 of Form 33-109F4)
• Proficiency Information Change (Item 8 of Form 33-109F4)
• Current Employment Change (Item 10 of Form 33-109F4)
• Criminal Disclosure Change (Item 14 of Form 33-109F4)
• Civil Disclosure Change (Item 15 of Form 33-109F4)
• Financial Disclosure Change (Item 16 of Form 33-109F4)

**Single and Multi-Jurisdiction Submission Types**

Certain aspects of the submissions described above are single jurisdiction submission types, which means they are only appropriately made in one province or territory. Other submissions are multi-jurisdiction submission types, which means they may or will be made in more than one province or territory. When you complete a submission and send it to the NRD, the system sends the submission to the appropriate jurisdictions.

The single jurisdiction submission types include “Change Address and Agent for Service”, “Apply for Exemption”, and “Change or Surrender of Individual Categories”. All other individual submission types are multi-jurisdictional submission types.

**Renewal of Registration**

The amount of the annual NRD user fee is as follows:

• $75 (plus GST) for each registered and non-registered individual in one jurisdiction; and
• $50 (plus GST) for each registered and non-registered individual in each additional jurisdiction (up to a maximum of 5 jurisdictions or $250 plus GST).

Annual NRD user fees are due on December 31 as a payment for the following year.

**Notice of Changes**

IDA Policy 8, which came into force on October 15, 2002, established minimum reporting and record keeping requirements relating to information that registrants must report to their firm and information that member firms are required to report
to the SROs. As of January 1, 2003, failure to comply with Policy 8 requirements will result in a referral to the IDA’s Enforcement Department for investigation.

Policy 8 requires registrants to notify their firm within two business days of material changes and then the firm has five business days to report this to the IDA’s Registration Department via the NRD. Policy 8 also requires firms to report to the IDA written client complaints and whenever they or their IAs are named a defendant of any proceeding (including civil) or disciplinary action. If an IA is found guilty or at fault, this would be reported to NRD and it would be put on the IA’s permanent record. Duplication of reporting exists for civil proceedings and criminal activities through both ComSet and NRD, while all other reportable disclosures (e.g., bankruptcies and garnishments) are required to be reported only through NRD.

Policy 8 includes a comprehensive list of items that registrants must report to their firm. Some of these include, whenever:

- there is any change to information contained in Form 33-109F4;
- the registrant has reason to believe he or she is in violation of any law or legislation pertaining to securities or exchange contracts, any by-laws, regulations, rules, rulings or policies of any SRO, professional licensing or registration body in any jurisdiction, inside or outside of Canada;
- the registrant is the subject of any customer complaint in writing, except service complaints;
- the registrant is aware of a customer complaint, in writing or any other form, relating to any other registrant that involves allegations of theft, fraud, misappropriation of funds or securities, forgery, money laundering, market manipulation, insider trading, misrepresentation or unauthorized trading.

Once notified of any of the above matters, the firm has the responsibility to report this information, within five business days of being notified by the registrant, to the appropriate SRO.

**Termination of Registration**

If a registrant’s employment is terminated, the employer is required to report it and the reason for termination by submitting a Notice of Termination (Form 33-109F1) within five days of the termination or a late filing fee will be imposed. The filing of this form is extremely important, as it is sometimes through the Notice of Termination (Form 33-109F1) that the regulators become aware of regulatory infractions.
Registration After an Absence

Products, regulations and procedures change often in the securities industry. The knowledge of applicants who have been out of the industry for a substantial period of time may well be outdated. Therefore, the SROs require that anyone applying for registration after an absence of three years from the industry as a registrant must rewrite and pass the Canadian Securities Course exam. Anyone applying for registration after an absence of two years from the industry as a registrant must rewrite and pass the Conduct and Practices Handbook (CPH) Course exam. Appropriate exams must be written and passed if the applicant has been absent for three years and applies for registration as an IA, IR, branch manager, or other category of registration.

Individuals may extend the validity periods of their CSC and CPH courses by successfully completing CE courses offered by the CSI. In order to extend the validity period for one of these courses, there are two conditions that must be met. Firstly, the course must be successfully completed within the three years prior to the start of the current CE cycle; and secondly, both the compliance and product knowledge portions of the CE program must be completed. Note that this extension applies to individuals who had left the industry within three years prior to the start of the current CE cycle and to those who were never registered but had passed the course three years prior to the current CE cycle. For Ontario residents, an exemption from OSC rule 31-502 is also required, which carries a $1,500 fee.

Filing Requirements for Proficiency Exemption

A proficiency exemption may be requested under IDA By-law 40.6 by applicants seeking a license or those already licensed who wish to change their category of registration, but who do not meet the proficiency requirement. If the firm sponsoring the applicant has not filed the application for approval through the NRD, the firm may attach a $250 cheque to the IDA with a letter signed by a Partner, Director or Officer stating how the applicant’s academic achievements and/or relevant employment experience meet the proficiency requirement of IDA Policy 6. For those applicants already licensed and therefore have an NRD file, the proficiency exemption must be filed through NRD stating the same explanation as the letter above, and the same fee will be electronically debited from the sponsoring firm’s bank account.
Jurisdictional Registration Considerations

Dealing with Clients in Other Canadian Jurisdictions

Registrants may transact in securities business only in the provinces in which they are registered. The filing of even an unsolicited order from a client living in another province may constitute trading in that other province. This could bring about action by the securities administrator in the province in which the salesperson is not registered and could result in the administrator of the salesperson’s own province cancelling the registrant’s license or failing to renew it.

Most of the provinces will allow non-residents to become registered. However, both New Brunswick and Nova Scotia will not allow non-residents to be registered in those provinces.

On October 29, 2003, the MFDA released a member regulation notice (MR-0022) regarding out of province registration. While conducting their compliance examinations, the MFDA discovered a number of situations where mutual fund registrants were dealing with clients located in jurisdictions in which they were not properly registered. MFDA by-laws and provincial/territorial securities legislation require registration in all jurisdictions where clients are located, regardless of where the client was located when the account was opened and whether or not there is trading in the account. The MFDA now requires that within six months of the release of MR-0022, all of its members and registrants are required to ensure that all approved persons are properly registered or all existing client accounts are transferred to an appropriately registered person. In addition, within the same timeframe, member firms are required to have procedures and internal controls in place to prevent the opening of accounts in jurisdictions where the proper registration has not been obtained and to identify and take appropriate action when clients move to jurisdictions where proper firm or registrant registration is not in place.

Dealing with U.S. Residents

Member firms may hold accounts for residents of Canada and the United States provided that the firm and the individual broker are properly registered. The basic rule is that the IA must be registered in the state in which the U.S. client resides. Registration is generally done through an affiliate of the member firm that is registered in the U.S. (not through the Canadian IDA member firm). In addition, the Canadian IA would have to pass the Series 7 (or Series 37 or 38) exam and the Series 63 exam administered by the National Association of Securities Dealers (NASD) unless an exemption has been granted.

As a result, firms have implemented procedures and methods of doing business to ensure compliance with registration requirements in all jurisdictions where their
clients are located. Recent developments in the area of cross-border trading has resulted in reaching an agreement with the U.S. Securities and Exchange Commission (SEC) and most of the state regulators for registered plan accounts and persons temporarily present in the U.S.

Both federal and state laws govern dealing with clients in the United States. With the exception of Canadian self-directed tax advantaged retirement plans, persons temporarily present in the U.S., and other exemptions generally for dealing with institutions and registered dealers, Canadian salespersons are prohibited under the Securities Exchange Act of 1934 from dealing with clients in the U.S. unless they are registered with a dealer registered in the U.S. Without registration or an exemption, a salesperson dealing with a client present in the U.S. may be subject to charges under the Securities Exchange Act of 1934, as would the firm employing him or her. In addition, the firm may have difficulty enforcing any contractual rights in litigation with customers in the U.S. if it is not registered or exempt from registration in the U.S.

Rule 15a-6(a)(4)(iii) under The Securities Exchange Act of 1934 exempts a foreign dealer from registration when dealing with a person temporarily present in the U.S. with whom the dealer had a bona fide pre-existing relationship prior to the person entering the U.S. Temporary residence generally means residence for less than 183 days in a year.

On June 7, 2000, the SEC granted an exemption from broker-dealer registration for firms and salespersons dealing with U.S. residents who have Canadian self-directed tax advantaged retirement plans such as RRSPs and RRIFs. The exemption is subject to the following conditions:

- The account must be managed by the client, i.e. the client must select or control the securities in the account.
- The firms and salespersons may not advertise such accounts in the U.S. Member firms may, however, grant access to clients holding such accounts for trading and to obtain information about their accounts through a website. They may also provide general information about such accounts on their websites.
- Member firms must disclose to clients holding such accounts, when a new account is opened and at least annually thereafter, that such accounts are not regulated under the securities laws of the U.S. and that the member is not subject to the broker-dealer regulations of the U.S.
- The member or salesperson must have a bona fide pre-existing relationship with the client before he or she entered the U.S. Members and salespersons are not permitted to solicit such accounts from U.S. residents; however, a Canadian salesperson can, when changing firms, solicit the transfer of the account of a client with whom he or she has an existing relationship. Furthermore, U.S. residents having Canadian self-directed tax advantaged retirement plans are permitted to transfer their accounts between Canadian members if they choose to do so on an unsolicited basis.
• The member and salesperson must comply with the anti-fraud provisions of U.S. securities laws.

Effective June 23, 2000, the SEC adopted Rule 237 and Rule 7d-2, which permit U.S. residents who have Canadian self-directed tax advantaged retirement plans to trade the securities of foreign issuers, including Canadian issuers and mutual funds, in those accounts even though those securities are not registered to trade in the United States. This exemption is only limited to foreign issuers (unregistered U.S. issues may not be sold to such accounts in reliance on Rule 237) and is subject to two conditions:

• All written offering materials for such securities, including advertisements and newsletters, delivered to a U.S. resident having a Canadian self-directed tax advantaged retirement plan must prominently disclose that the securities are not registered with the SEC and are being offered or sold in the U.S. under an exemption from registration.

• Members or salespersons relying on the rule must not disclaim the applicability of Canadian law or jurisdiction in any proceeding involving eligible securities.

Canadian mutual funds cannot generally be offered to Canadians temporarily resident in the United States outside of Canadian self-directed tax advantaged retirement plans since such offers are part of a continuing public offering. Other Canadian securities can be offered to Canadians who are temporarily present in the United States in ordinary secondary market transactions, which generally may begin 40 days after the public offering of such securities in Canada.

It is very important that Canadian registrants remember that all U.S. states have their own securities laws requiring registration of broker-dealers and individuals dealing with state residents. Without state registration or an exemption from state registration, dealings with individuals temporarily present in a state are not permitted despite the federal exemptions available to such persons and Canadian self-directed tax advantaged retirement plans. Without registration or an exemption under the applicable state securities laws, a salesperson dealing with a client present in the U.S. may be subject to charges under the applicable state securities law, as would the firm employing him or her. In addition, the customer may have a defence in a civil action in a state court for an unpaid account and may have a claim for any losses in the account.

Several years ago the North American Securities Administrators Association (NASAA), which includes all of the state regulators, recommended to its members changes in their legislation which would grant Canadian firms and their salespersons regulatory relief when dealing with persons temporarily present in the U.S. and holders of Canadian self-directed tax advantaged plans. State regulators have taken different approaches to implementing the recommendation and many have not yet implemented it. Some have granted blanket exemptions; some require
limited registration; some require that the firm and its Canadian salespersons make filings to obtain conditional exemptions.

Generally the states have been grouped under three models:

(i) Model No. 1 - Self-Executing Exemption
(ii) Model No. 2 - Exemption by Notice Filing Procedure
(iii) Model No. 3 - Special Registration Procedure.

The first type of model is referred to as the “Self-Executing Exemption”. Under this exemption, the Canadian broker-dealer, its salesmen and the securities they sell to Canadians temporarily present in the state and Canadian self-directed tax advantaged retirement plans are exempt as a matter of course, provided that the Canadian broker-dealer meets all of the following requirements:

• Be a Canadian resident.
• Have no office or other physical presence in this state.
• Only effect or attempt to effect transactions in securities:
  • with or for a person from Canada who is temporarily present in the state, with whom the Canadian broker-dealer had a bona fide business-client relationship before the person entered this state; or
  • with or for a person from Canada who is present in this state, whose transactions are in a self-directed tax-advantaged retirement plan in Canada of which the person is the holder or contributor.
• Be a member in good standing of an SRO or stock exchange in Canada.
• Maintain its provincial or territorial registrations and its membership in a self-regulatory organization or stock exchange in good standing.
• Not be in violation of the anti-fraud laws of the state.

The second type of model is referred to as “Exemption by Notice Filing Procedure”. This model provides exemptions for the Canadian broker-dealer, its salesmen and the securities they sell to Canadians temporarily present in the state and Canadian self-directed tax advantaged retirement plans, provided that:

• The Canadian broker-dealer meets all of the requirements for the “Self-Executing Exemption Model” (Model No. 1).
• The Canadian broker-dealer discloses to its customers in the state that it is not subject to the full regulatory requirements of the state’s Blue Sky laws.
• The Canadian broker-dealer makes a notice filing to claim the exemption.
• No filing fees are required to be paid.

The third type of model is referred to as the “Special Registration Procedure Model”. Florida, for example, uses this model, which provides a special registration procedure for the Canadian broker-dealer, its salesmen and the
securities they sell to Canadians temporarily present in the state and Canadian self-directed tax advantaged retirement plans, provided that:

- The Canadian broker-dealer meets all of the requirements for the self-executing exemption (Model No. 1).
- The Canadian broker-dealer:
  - files a registration application.
  - renews the registration annually.
  - corrects inaccurate information in the application on an ongoing basis.
  - provides the state with its books and records upon request.
  - provides the state with notice of any criminal, civil and administrative actions.
  - discloses to its customers in the state that it is not subject to the full regulatory requirements of the state Blue Sky laws.
- Each salesman intending to transact business with Canadians temporarily present in the state and/or Canadian self-directed tax advantaged retirement plans in Florida:
  - files a registration application.
  - renews the registration annually.
  - provides Florida with notice of criminal, civil and administrative actions against the salesman.
  - has an expensive fee structure - $200 per year for the Canadian broker-dealer and $40 per year for each salesman.

The following chart lists the states that have adopted regulatory relief for Canadian broker-dealers when dealing with holders of Canadian self-directed tax advantaged retirement plans and in most cases with Canadian clients who are temporarily present in the respective states. The states have been grouped under the three models described above or as “no action yet”.

<table>
<thead>
<tr>
<th>Model No. 1</th>
<th>Model No. 2</th>
<th>Model No. 3</th>
<th>No Action Yet</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Alabama</td>
<td>Alaska</td>
<td>U.S. Virgin Islands</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Arizona</td>
<td>District of Columbia</td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>Arkansas</td>
<td>Florida</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>Colorado</td>
<td>Iowa</td>
<td></td>
</tr>
<tr>
<td>Kansas</td>
<td>Delaware</td>
<td>New Hampshire</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>Hawaii</td>
<td>North Carolina</td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td>Idaho</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(last updated January 12, 2005)
Special States

**Louisiana** - On January 30, 2002, the Louisiana Commissioner of Securities adopted a Statement of Policy intended to provide regulatory relief for Canadian broker-dealers, their salesmen and the securities sold when sold to Snowbirds and RRSPs. Compliance with the Statement of Policy appears to provide protection for Canadian broker-dealers from enforcement actions by the Louisiana Securities Commission; however, it is unclear what effect the Statement of Policy may have regarding a customer’s statutory right to bring a civil action against an unregistered broker-dealer for any losses in his account.

**Nebraska** - On July 17, 2002, the Nebraska Department of Banking and Finance issued a no-action letter intended to provide regulatory relief for Canadian broker-dealers, their salesmen and the securities sold when sold to RRSP’s. Compliance with the no-action letter provides protection for Canadian broker-dealers from enforcement actions by the Nebraska Department of Banking and Finance if they effect transactions with RRSP holders in Nebraska. However, the no-action letter expressly states that it “does not affect the right of any individual to pursue a private action in connection with the activity of any broker-dealer covered by this no-action position.” Thus, customers will have the right to bring a civil action against an unregistered broker-dealer relying on the no-action letter for any losses in their account. Furthermore, the no-action letter only provides regulatory relief for transactions with RRSPs; it does not provide any relief for transactions with Snowbirds, which are still not permitted.

**New York** - In 1995 New York issued a letter (New York Investor Protection and Securities Bureau No-Action Letter dated March 15, 1995) stating that it would take no action against the Canadian broker-dealer requesting the no-action letter for failure to register in New York as a broker-dealer with respect to RRSP accounts of...
two former Canadian residents residing in New York provided that (1) the Canadian broker-dealer remains a member of the IDA, (2) the dealings in which the unregistered Canadian broker-dealer engages are limited to the RRSP accounts of the two Canadian residents residing in New York, and (3) the Canadian broker-dealer advises the New York residents in writing that it is not registered to transact securities business in the U.S. Staff at the New York Bureau of Securities have taken the position that Canadian broker-dealers are expected to individually request their own no-action relief instead of relying on the 1995 no-action letter as a statement of New York’s policy on RRSPs.

**U.S. Virgin Islands** - Effective February 12, 2005, the U.S. Virgin Islands will have a comprehensive Blue Sky law in place for the first time. This new Blue Sky law authorizes the adoption of rules to provide for (1) an exemption from registration for Canadian broker-dealers and their salesmen when dealing with Canadian snowbirds and RRSPs and (2) an exemption from registration for the securities sold in such transactions. However, the necessary implementing rules have not yet been proposed or adopted.

**Virginia** - Virginia Rules 21VAC 5-20-85 and 21VAC 5-20-155 provide a special registration procedure for Canadian broker-dealers and their salesmen when dealing with Canadian snowbirds and RRSPs. In addition, Rule 21VAC 5-40-160 provides a parallel securities registration exemption for the securities sold. However, Canadian dealers and their salesmen who register in Virginia will be subject to the requirements of 21VAC 5-20-280, which imposes certain U.S. compliance and conduct requirements that Canadian dealers may not be willing or able to meet. Accordingly, the Virginia registration procedure may be of limited usefulness.

**Blanket Exemption for TSX Listed Securities**

On April 17, 2002, the NASAA approved a blanket “model exemption” for the secondary trading of all Toronto Stock Exchange (TSX) listed securities by U.S. investors. This exemption facilitates the distribution in the U.S. of TSX securities that are not listed on a U.S. exchange. Most U.S. state securities commissions prohibit trading in stocks which are not listed on a U.S. exchange unless they have been individually registered or are exempted from registration on a state-by-state basis. The blanket model, which must be adopted by each state individually, allows individual state commissions to quickly and simply exempt TSX listed companies from these requirements. This removes any registration burden on Canadian issuers when a secondary market develops in the U.S., but it does not allow distributions into the U.S. (i.e. primary distributions via a prospectus or otherwise) which would still have to go through U.S. registration.
V. Summary

Generally, an individual or company whose business involves trading, underwriting or advising with respect to securities is required to register annually with one or more of the provincial securities regulators. The registration process is designed to protect the investing public by striving to ensure that only qualified and reputable individuals and firms are licensed.

Registration is one of the three principles upon which regulation of the securities industry is based. Therefore, it is important to have a basic understanding of the requirements and procedures for registration and the National Registration Database. Registrants should be familiar with the applicable requirements for their registration category as well as the procedures for special situations such as transfer or termination of registration.

A registration in good standing is a registrant’s most important asset, as his or her ability to earn a living depends upon it.
SECTION II: DEALING WITH CLIENT ACCOUNTS

Chapter 1

Account Opening Procedures

Introduction

The opening of a new account is an important first step in the IA-client relationship. It gives the IA and the client an opportunity to review all aspects of the client’s situation that will have an effect on the suitability of investment recommendations. This is the best time for both to ask questions and get to know each other. Sometimes an existing client will open an additional account and this opportunity should be used to review the client’s situation and amend the client’s account documentation if necessary.

Learning Objectives

After reading this module, you should understand:

• procedures for opening accounts
• the importance of the New Account Application Form (NAAF)
• what constitutes proper completion of the NAAF
• procedures for maintaining client records.

I. Opening Accounts

The Cardinal Rule - Know Your Client

The Know Your Client ("KYC") rule relates to Standard A, Duty of Care, and it is the cornerstone of all dealings with clients. The KYC rule requires that every member use due diligence:

• to learn the essential facts relative to every client and to every order or account accepted;
• to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
• to ensure that recommendations made for any account are appropriate for the client and in keeping with their investment objectives.

At the beginning of Section I, we discussed the importance of suitability in making investment recommendations to clients. Suitability can only be assured if an effort is made to “know the client” to the best of the registrant’s ability (excluding the registrants granted exemption from the suitability requirement).

The five most important factors in assessing a client’s situation are:

(i) **Age**: this may give an indication of the client’s time horizon and income needs;

(ii) **Income and net worth**: these show the client’s financial resources and income needs;

(iii) **Investment knowledge**: this assists in determining the amount and type of information that the registrant must provide to the client when making recommendations. Over time, the client’s knowledge of the various investments may increase. Failing to correctly update the client’s KYC form to reflect the change may lead to problems as the ongoing investments may not be properly aligned with the documentation of record.

(iv) **Investment objectives**: different combinations of safety, income and growth; and

(v) **Risk tolerance**: high, moderate or low

As mentioned in the discussion on Money Laundering in Section I, investment advisors and all employees who have direct contact with clients as well as those who monitor and supervise daily activities play an important role in the combating and detection of money laundering and terrorist financing activities. Recall that any employee who does not diligently fulfill his or her reporting responsibilities under *The Proceeds of Crime (Money Laundering) and Terrorist Financing Act* can potentially face a prison term of up to five years, a fine of up to $2,000,000, or both.

**Client Identification Requirements**

A firm’s anti-money laundering and anti-terrorist financing procedures should incorporate, to the extent appropriate, existing KYC obligations as described in current regulations. IDA Regulations 1300.1 and 1300.2 and Policy 2 require that for each account opened, a firm must obtain and maintain certain customer information. Similarly, a firm’s procedures should emphasize that firms are required to request the essential facts relating to each customer and each account. It should be
noted that suspicious transaction reporting might require more information about the customer than was traditionally gathered to meet the IDA’s suitability requirements.

Account opening procedures should provide the necessary information to make a reasonable risk-based assessment of clients, their source of income and amount of expected activity in an account. This knowledge will help determine what extra customer information and documentation is needed for certain clients and what additional monitoring and due diligence may be required for particular accounts (e.g., offshore accounts).

Following the client identification and verification requirements by rote is not sufficient. Those involved must exercise professional judgment, seeking help where necessary, in both opening accounts and subsequent dealings with clients. Simply having followed the letter of the regulations may not be enough if there are red flags suggesting that clients or transactions are involved in money laundering.

Many firms establish anti-money laundering procedures on the basis of the risks that particular types of clients may be involved in money laundering. For example, they may exercise extra due diligence on clients from bank secrecy jurisdictions or countries with high levels of corruption; they may require extra information and documentation about corporations and trusts, particularly private offshore entities or they may look more closely at dealings with cash businesses.

When dealing with domestic entities, there should be enough information on record to properly determine the identity of the business entity and the authority given to the individual who will act on the entity’s behalf. The IDA requires that firms determine the identities of the beneficial owners who own more than 10% of any private entity. At the same time, firms need to carefully assess the risks of doing business with any entity that refuses to provide this information. Under IDA Regulation 1300.1(b), firms cannot deal with an entity that refuses to provide beneficial ownership information. It must get the information when opening an account and if it can’t verify the identity of the beneficial owners within six months, it has to put the account on liquidating trades only and close the account.

Dealing with non-resident individual accounts requires additional identity verification requirements than those set out for resident individual accounts. Obtaining a current passport number or other valid government identification will fulfill these additional requirements. Bank verification or verification of identity through the cashing of a personal cheque works only with Canadian deposit-taking institutions. If the non-resident individual does not have a Canadian bank account, the only verification method available is the review of personal identification papers, such as a passport. This method requires a review of the original document in the presence of the person. If the individual is not in Canada, the firm may need to hire an agent in the client’s home country to conduct the verification. It is not sufficient to simply obtain a copy of the document, even if the copy is notarized, nor can a firm accept verification from an agent of the client, like a lawyer or accountant.
To be compliant with developing international standards on client due diligence, including the revised Financial Action Task Force on Money Laundering’s (FATF) 40 Recommendations, IDA regulations require firms to learn and remain informed of the essential facts relative to the beneficial owners of corporations and similar entities and beneficiaries and settlers of trusts. This means that firms must take reasonable steps to keep current regarding client information that is material to the operation of an account and the Know Your Client rule.

IDA Regulation 1300.1 requires IDA member firms, when opening an account for a private corporation, trust or similar entity, to identify and then verify any person who is the beneficial owner, directly or indirectly, of more than 10% of a corporation or similar entity or trusts. (The focus of this requirement is on ownership interest, not on voting control.) The information regarding the identity of individuals whose beneficial ownership or interest exceeds the 10% threshold must be obtained prior to opening an account and there are exemptions from this requirement for various types of clients, including publicly traded issuers and financial institutions. The verification of the identity of other beneficial owners for new accounts must be completed as soon as practicable, and in all cases no later than six months after the account has been opened. In the case of existing accounts where the identities of beneficial owners are not known, the information must be obtained within one year, but there is no requirement to verify the identity of beneficial owners of such accounts unless there is reason to suspect that the information is unreliable or incomplete.

The standard for verification is more flexible under IDA regulations than for individual accountholders under the money laundering regulations as firms can rely on information provided by authorized representatives of the client or proposed client provided that this information is verified by independent means. Firms may use a variety of verification methods provided that they “enable the Member to form a reasonable belief that it knows the true identity of the individual”.

The basic principle is that verification methods must be reliable and independent of the client. Unexpired, government-issued identification documents are acceptable, but as with verification under money laundering regulations, the originals should be viewed in the presence of the person by an employee or agent of the firm and faxed or photocopied personal identification documents are not acceptable.

Bank or cheque cashing verification methods can also be used, but without the restriction to Canadian banks. Where it is used, the bank or similar financial institution must be subject to a satisfactory regulatory regime (i.e., be an FATF compliant jurisdiction). Member firms are also permitted to use other independent verification means such as credit bureau checks and public databases.

In some circumstances, the verification of the identity of trust beneficiaries may pose difficulties, for example where the settler does not want the beneficiaries or other parties to know who the beneficiaries are or the extent of their interest, or where the beneficiaries are minor children. In cases in which the risk of improper
use of the trust is low and no other means of verification are available, firms may accept assurances from the settlor or trustee as to the identity of the beneficiaries, but they should carefully document their reasons for doing so.

The regulations also respond to concerns raised by the 2003 Illegal Insider Trading Task Force Report regarding the use of corporate accounts with unknown ownership for illegal insider trading.

Also when dealing with offshore clients, a firm should have procedures in place that allows it to identify accounts maintained for senior foreign government officials, their immediate family members and their close associates (often referred to as politically exposed persons, or ‘PEPs’). This protects the firm from unknowingly dealing with the proceeds of embezzlement or foreign corruption. Furthermore, when opening accounts for a personal holding company or personal investment corporation, the IA must take steps to determine whether the account is being set up by, or for the benefit of, a senior foreign public official or politically exposed person.

Shell banks are banks that do not have a physical presence anywhere, other than those that are affiliates of regulated financial institutions. Both the IDA and OSFI have encouraged Canadian financial institutions under their jurisdiction not to enter into relationships with shell banks.

Member firms are also required to have anti-money laundering and anti-terrorist financing procedures in place to cover their institutional business and clients. These accounts are characterized as being opened and operated for financially sophisticated customers who frequently purchase and sell securities in significant volume. Institutional clients themselves are usually widely known, regulated and/or publicly held.

Due to the nature of institutional business practices, member firms may actually have little or no direct contact with the underlying beneficiaries of their institutional clients, thus they deal solely through intermediaries. Two typical examples of intermediaries in this type of relationship are investment funds and hedge funds. In other cases, however, institutional accounts are established solely for trade execution purposes, which infer that there is a very limited relationship between the institutional client and the firm itself. Presently there are no general exemptions from the KYC requirements of the Proceedings of Crime Act regulations or the IDA By-laws, Regulations and Policies for a firm’s institutional business even though it is quite different from the traditional retail business.

There should also be firm policies in place to handle accounts opened via the Internet or other such technologies. Identity verification requirements set out in the Proceedings of Crime Act and regulations apply regardless of the method in which the account is opened. Therefore, unless the bank or cheque verification method is possible, original copies of personal identification documents used to open the account must still be reviewed by an employee or agent of the firm to verify the
identity of the account holder. Photocopies, facsimiles or other reproductions are not acceptable for verification purposes.

IAs must also be on the lookout for identity theft. In August 2004, the IDA issued a fraud warning to member firms as a result of one member firm reporting that an account was opened using stolen and modified identification and a cheque drawn on a bona fide Canadian bank. The cheque was deposited in the client’s account at the firm followed by a request to have the firm issue a cheque to the individual. The fraud was exposed and the cheque was never issued.

Table 1 has been set up to guide IAs and other staff involved in account opening procedures through the specific requirements and details that must be adhered to when opening the following types of accounts: resident individual, corporate, domestic securities dealers and foreign securities dealers.
### Table 1

**Know Your Client and Account Opening Requirements**

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resident Individual</td>
<td>Information to be obtained</td>
<td>There is no listing of mandatory information in the <em>Proceeds of Crime (Money Laundering) and Terrorist Financing Act</em>. However, a firm must make reasonable transaction reports, i.e. as much of the listed information as is relevant must have been obtained in order to meet the suspicious transaction reporting requirements: full name, address and country of residence, personal telephone number, citizenship and, if non Canadian, immigration status, social insurance number, date of birth, occupation, business telephone number, employee, employer, employer’s full business address, employer’s business telephone number.</td>
</tr>
</tbody>
</table>
| Signature document | Signature card, account operating agreement or account application:  
  • Bearing the signature of the person authorized to give instructions for the account setting out the number of a financial entity account, if any, that is in the name of that person or in respect of which that person is authorized to give instructions. (Not required if the individual does not have, or have authority over, an account at a financial entity.) Members should determine whether it is reasonable to expect that the person would not have such an account, for example if the client is not a resident of Canada. |
| Exception to signature document required | An account in respect of which instructions are authorized to be given by a financial entity or Canadian securities dealer. |
| Other documents or information | None. |
| Identity verification | Within six months of account opening:  
  • In person: by referral to an original birth certificate, driver’s licence, provincial health insurance card (unless in Ontario, Manitoba or Prince Edward Island where health cards cannot be used for this purpose), passport of similar record.  
  • Where person is not physically present: by confirming that a cheque drawn by the person on an account of a financial entity has cleared, by confirming that the person holds an account in his or her name at a financial entity. |
Table 1 (continued)
Know Your Client and Account Opening Requirements

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
</table>
| Exceptions to identity verification | • An account opened solely for the deposit and sale of shares from a corporate demutualization, employee stock purchase plan or privatization of a crown corporation.  
• A registered plan account (RRSP, locked in retirement plan, group RRSP).  
• An account opened for the sale of mutual funds where there are reasonable grounds to believe that the person’s identity has been verified by another securities dealer in respect of the sale of the mutual funds for which the account has been opened or a transaction that is part of a series of transactions that include that sale.  
• An account opened for an individual who already has an account. | |
| Third party information | Individuals or non-corporate entity third party: name, address and principal business or occupation of the third party.  
Corporate third party: name, address and principal business; incorporation number and place of its issue. | |
| Large cash transaction reports required | Yes. | |
| Corporation (other than a financial entity, securities dealer or public body for which see below) | Information to be obtained | Name, address, structure and purpose of the principal business. |
| | Signature document | Signature card, account operating agreement or account application:  
• Bearing the signature of persons authorized to give instructions for the account.  
• Setting out the number of financial entity accounts, if any, that is in the names of those persons or in respect of which those persons are authorized to give instructions. (Not required if an individual does not have, or have authority over, an account at a financial entity.) Members should determine whether it is reasonable to expect that the person would not have such an account, for example, if the client is not a resident of Canada. | |
| | Exception to signature document requirements | An account in respect of which instructions are authorized to be given by a financial entity or Canadian securities dealer. |
## Table 1 (continued)
### Know Your Client and Account Opening Requirements

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other documents or information</td>
<td>Copy of the part of official corporate records that contains any provision relating to the power to bind the corporation in respect of the account. Within six months, names of the directors from a certificate of corporate status, a record required to be filed annually under provincial securities legislation or any other record ascertaining the existence of the corporation.</td>
<td></td>
</tr>
</tbody>
</table>
| Identity verification | Within six months of account opening, verification of the existence of the corporation from a paper or publicly available electronic source:  
- A certificate of corporate status.  
- A record required to be filed annually under provincial securities legalization.  
- Any other record that ascertains the existence of the corporation.  
- Within six months of account opening, verification of all individuals authorized to give instructions for the account to a maximum of 3.  
- In person: by referral to a birth certificate, driver’s licence, provincial health insurance card, passport or similar record.  
- Where person is not physically present: confirming that a cheque drawn by the person on an account of a financial entity has cleared; by confirming that the person holds an account in his or her name at a financial entity. |
### Table 1 (continued)
#### Know Your Client and Account Opening Requirements

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
</table>
| Exceptions to identity verification | Identification of persons authorized to give instructions are not required for the following. However, verification of the existence of the corporation is required.  
• An account opened solely for the deposit and sale of shares from a corporate demutalization, employee stock purchase plan or privatization of a crown corporation.  
• An account opened for the sale of mutual funds where there are reasonable grounds to believe that the corporation’s identity has been verified by another securities dealer in respect of the sale of the mutual funds for which the account has been or a transaction that is part of a series of transactions that includes that sale.  
• An account opened for a corporation that already has an account.  
• An account for a foreign affiliate of a financial entity. | |
| Third party information | Individual or non-corporate entity third party: name, address and principal business or occupation of the third party.  
Corporate third party: name, address and principal business; incorporation number and place of its issue. | |
| Large cash transaction reports required | Yes. |
Table 1 (continued)

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Dealer (Canadian): Provincially registered dealers including portfolio managers and investment counsellors</td>
<td>Information to be obtained</td>
<td>Name, address, nature of principal business.</td>
</tr>
<tr>
<td></td>
<td>Signature document</td>
<td>No requirement.</td>
</tr>
<tr>
<td></td>
<td>Other documents or checks</td>
<td>If a corporation, a copy of the part of the official corporate records that contains any provision relating to the power to bind the corporation in respect of the account.</td>
</tr>
</tbody>
</table>
| | Identity verification | If a corporation, within six months of account opening, verification of the existence of the corporation from a paper or publicly available electronic source:  
  - A certificate of corporate status.  
  - A record required to be filed annually under provincial securities legislation.  
  - Any other record that ascertains the existence of the corporation.  
If another entity, within six months of account opening, verification of the existence of the entity from a paper or publicly available electronic source:  
  - Partnership agreement or Articles of association.  
  - Any other similar record that ascertains the existence of the entity. |
| | Large cash transaction reports required | Yes. |
| Foreign securities dealer in an FATF compliant jurisdiction. Securities dealer doing business only outside of Canada and located in an FATF member country or a country compliant with the FATF customer identification recommendations | Information to be obtained | Name, address, nature of principal business. |
| | Signature document | Signature card, account operating agreement or account application:  
  - Bearing the signature of the person authorized to give instructions for the account.  
  - Setting out the number of a financial entity account, if any, that is in the name of that person or in respect of which that person is authorized to give instructions. (Not required if the individual does not have, or have authority over, an account at a financial entity.) Members should determine whether it is reasonable to expect that the person would not have such an account, for example, if the client is not a resident of Canada. |
| | Other documents or checks | If a corporation, a copy of the part of official corporate records that contains any provision relating to the power to bind the corporation in respect of the account. |
# Table 1 (continued)

## Know Your Client and Account Opening Requirements

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Identity verification</td>
<td>Within six months of account opening, verification of all individuals authorized to give instructions for the account to a maximum of three. In person: by referral to a birth certificate, driver’s licence, provincial health insurance card, passport or similar record. Where person is not physically present: confirming that a cheque drawn by the person on an account of a financial entity has cleared; confirming that the person holds an account in his or her name at a financial entity. If a corporation, within six months of account opening, verification of the existence of the corporation from a paper or publicly available electronic source: • A certificate of corporate status or a record required to be filed annually under provincial securities legislation. • Any other record that ascertains the existence of the corporation. If another entity, within six months of account opening, verification of the existence of the entity from a paper or publicly available electronic source either a Partnership agreement or Articles of association. Any other similar record that ascertains the existence of the entity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Exceptions to identity verification</th>
<th>Identification of persons authorized to given instructions for account of a foreign affiliate of a financial entity.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large cash transaction reports required</td>
<td>Yes.</td>
</tr>
<tr>
<td>Foreign dealer in FATF non-compliant jurisdiction: Securities dealer doing business only outside of Canada located in a country that is not an FATF Member and has not implemented the FATF customer identification recommendations</td>
<td>Information to be obtained</td>
</tr>
<tr>
<td></td>
<td>Name, address, nature of principal business.</td>
</tr>
</tbody>
</table>
### Table 1 (continued)
**Know Your Client and Account Opening Requirements**

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
</table>
| Signature document | Signature card, account operating agreement or account application:  
  - Bearing the signature of the person authorized to give instructions for the account.  
  - Setting out the number of a financial entity account, if any, that is in the name of that person or in respect of which that person is authorized to give instructions.  
  (Not required if the individual does not have, or have authority over, an account at a financial entity.)  
Members should determine whether it is reasonable to expect that the person would not have such an account, for example, if the client is not a resident of Canada. |
| Other documents or checks | If a corporation, a copy of the part of official corporate records that contains any provision relating to the power to bind the corporation in respect of the account. |
| Identity verification | Within six months of account opening, verification of all individuals authorized to give instructions for the account to a maximum of three.  
In person: by referral to a birth certificate, driver’s licence, provincial health insurance card, passport or similar record.  
Where person is not physically present: confirming that a cheque drawn by the person on an account of a financial entity has cleared; confirming that the person holds an account in his or her name at a financial entity.  
If a corporation, within six months of account opening, verification of the existence of the corporation from a paper or publicly available electronic source:  
  - A certificate of corporate status.  
  - A record required to be filed annually under provincial securities legislation.  
  - Any other record that ascertains the existence of the corporation.  
If another entity, within six months of account opening, verification of the existence of the entity from a paper or publicly available electronic source:  
  - Partnership agreement or Articles of association.  
Any other similar record that ascertains the existence of the entity. |
Table 1 (continued)
Know Your Client and Account Opening Requirements

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Type of Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptions to identity verification</td>
<td>Identification of persons authorized to give instructions for account of a foreign affiliate of a financial entity.</td>
<td></td>
</tr>
<tr>
<td>Third party information</td>
<td>Individual third party name: name, address and principal business or occupation of the third party.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Third party entity: name, address and principal business; plus incorporation number and place of its issue if the third party is a corporation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>This information must be obtained where the foreign dealer is acting as an agent for its customer, on a transaction by transaction basis. It is not required if the Canadian dealer has, at the time of account opening, obtained the information about and verified the identity of all of the foreign dealer’s clients.</td>
<td></td>
</tr>
<tr>
<td>Large cash transaction reports required</td>
<td>Yes.</td>
<td></td>
</tr>
</tbody>
</table>
The New Account Application Form

Prior to a new account being opened, this form must be completed. Amongst other items, the New Account Application Form ("NAAF") records:

- the identity of the client, including the client’s full name, address, citizenship and social insurance number;
- the client’s personal information such as marital status, numbers of dependents and employment;
- personal financial information including income, net worth and liquidity;
- the client’s investment objectives, risk tolerance and level of knowledge about investing; and
- information about the client’s relationship with any publicly trading companies.

This form is fully completed, checked and signed by the IA and approved by the branch manager and the firm’s designated person. The NAAF has three main purposes:

(i) to determine the client’s investment objectives and risk tolerance;
(ii) to judge the creditworthiness of the client; and
(iii) to identify any industry regulations which will apply to this client or this account.

Exhibit 4 shows a sample NAAF developed by the IDA. The information on this form is a minimum requirement for a new account, and individual member firms may require additional information. A copy of the information on a NAAF must be made available to all persons within the firm who are responsible for the supervision of that account. These would include the IA and the branch manager as well as staff in the firm’s head office, such as a sales manager or compliance officer.
### Exhibit 4 - New Account Application Form

(To be completed by Registered Representative)

<table>
<thead>
<tr>
<th>Account Supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
</tr>
</tbody>
</table>

#### (1) Name
- Mr.
- Mrs.
- Miss

<table>
<thead>
<tr>
<th>Home Address</th>
<th>(Street)</th>
<th>(City)</th>
<th>(Province)</th>
<th>(Postal Code)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Phones:</th>
<th>Home Business</th>
<th>Other</th>
<th>Fax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date of Birth</th>
<th>Client’s Social Insurance Number</th>
<th>Client’s Citizenship</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (2) Type of Account Requested:

<table>
<thead>
<tr>
<th>Is RR. registered in the Province or Country in which the client resides?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes: Cash</td>
</tr>
<tr>
<td>No:</td>
</tr>
</tbody>
</table>

#### (3) Clients Information

<table>
<thead>
<tr>
<th>Name:</th>
<th>Employer:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Address:</th>
<th>Type of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No. of Dependents</th>
<th>Client’s Occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Special Instructions:</th>
<th>Hold in Account</th>
<th>Register And Deliver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duplicate Confirmation</td>
<td>And/Or Statement</td>
<td>DAP</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Postal Code</th>
<th>Postal Code</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (4) Family Information

<table>
<thead>
<tr>
<th>Spouse’ Name</th>
<th>Occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No. of Dependants</th>
<th>Type of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (5) How long have you know client?

<table>
<thead>
<tr>
<th>Advertising Lead</th>
<th>Phone In</th>
<th>Have you met the client face to face?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Referral by:</th>
<th>(name) if customer, give account no.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (6) Insider Information

| Will any other persons or persons: (a) Have trading authorization in this account? |
|----------------------------------------|----------------------------------|
| Yes | No |
|     |    |

<table>
<thead>
<tr>
<th>Guarantee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

1. Will any other persons or persons:
   - (a) Have trading authorization in this account?
   - (b) Guarantee this account?
   - (c) Have a financial interest in such accounts?
     - Yes | No |
     - Yes | No |
     - Yes | No |

2. Do any of the signatories have any other accounts or control the trading in such accounts?
   - Yes | No |

3. Does client has accounts with other Brokerage firms? (Type of Business)
   - Yes | No |

4. Is this account (a) discretionary or (b) managed
   - (a) | (b) |

5. Is client a senior officer or director of a company whose shares are traded on an exchange or in the OTC market?
   - Yes | No |

6. Does the client, as an individual or as part of a group, hold or control such a company? (Insider Information)
   - Yes | No |

#### (7) General Documents

<table>
<thead>
<tr>
<th>Client’s Agreement</th>
<th>Margin Agreement</th>
<th>Cash Agreement</th>
<th>Guarantee</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attached</td>
<td>Obtaining</td>
<td>Attached</td>
<td>Obtaining</td>
<td>Attached</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (8) INVESTMENT KNOWLEDGE

<table>
<thead>
<tr>
<th>Investment Knowledge</th>
<th>EST. NET LIQUID ASSETS</th>
<th>(Cash and securities less loans)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Outstanding against securities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A PLUS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INVESTMENT KNOWLEDGE</th>
<th>EST. NET FIXED ASSETS</th>
<th>(Fixed assets less liabilities)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>OUTSOURCED</td>
</tr>
</tbody>
</table>

#### (9) Bank Reference

<table>
<thead>
<tr>
<th>Name:</th>
<th>Bank credit check-acceptable?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Branch</th>
<th>Or Credit Bureau check-acceptable?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Refer to Accounts</th>
<th>Above credit checks considered unnecessary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Explain in (11)</td>
</tr>
</tbody>
</table>

#### (10) Deposit and/or Security Received

<table>
<thead>
<tr>
<th>Initial</th>
<th>Buy</th>
<th>Sold</th>
<th>Solicited</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (11) RR Signature

<table>
<thead>
<tr>
<th>Date</th>
<th>Designated Officer, Director Or Branch Manager’s Approval</th>
<th>Date of Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

© CSI Global Education Inc. (2005)
In addition to completing an NAAF for all new clients, registrants should update existing clients’ NAAFs periodically. The form should be updated whenever there is a major change in a client’s circumstances such as:

- change of account name (i.e. from “Marie Roy” to “Marie and Robert Roy”)
- address change which would take client out of RR’s jurisdiction
- new marital or employment status
- another person who takes a financial interest in or who gains control over the account
- new trading authorization
- a major change in financial circumstances
- new investment objectives or risk factors
- any amendment to items in the regulatory section (i.e., insider status)

Any major change in circumstances could affect the client’s investment objectives, creditworthiness or risk tolerance.

We will now move through the NAAF from top to bottom and discuss the significance of each type of information required. The general categories of information required are:

- client information
- account information
- registrant information

**Client Information**

**(i) Client Name**

It is important to open an account in the correct legal name of the client and not in abbreviated form. For example, ”David Edward Smith” should not be abbreviated to ‘Dave Smith’. A full and correct legal name provides an additional level of defense against possible deception, forged documents, etc. Particular care must be taken where the client is an entity and not a person. For example, if a company's legal name is ‘Acme Widgets Incorporated’ it should not be abbreviated to ‘Acme Widgets Inc.’, ‘AcmeWidgets Corp.’, or ‘Acme Widgets.’ In the latter case, for example, the fact that Acme Widgets is a limited liability company is no longer apparent. An incorrect or incomplete name may have serious legal repercussions if an account’s ownership is in question.
(ii) Confidential, Nominee or Numbered Accounts

The SROs allow member firms to maintain accounts for clients identified only by number, nominee name or other symbol. This is permissible in order for clients to maintain confidentiality. The member firm must keep, at its principal office in Canada, sufficient identification in writing to establish the beneficial owner of the account or the party or parties financially responsible for the account. This information must be available at all times upon the request of the SROs.

(iii) Home Address

Both a residence address and a business address should be obtained. At least one of these must be a permanent address as opposed to a post office box or other such temporary address. The firm and the IA must have a reliable place to contact the client. If it is not possible to obtain a permanent address, the IA should proceed with caution. In some cases there may be a valid reason for lack of a permanent address; however, this may also be an indication that the prospective client is trying to circumvent industry rules and/or avoid making payment. In any questionable case, the IA should bring the matter to the attention of the sales supervisor, compliance department, or whoever is responsible for enforcing firm policy in this regard.

Under no circumstances may the IA’s residence, post office box, or other address be used for client mail. This prohibition includes “c/o the IA” at the office. It is a serious conflict of interest for an IA to in any way act as an intermediary in the mailing of trade confirmations, monthly statements, or other communication from the firm to a client.

(iv) Contact Number(s)

In addition to home and business numbers, many people have cell phones, pagers, cottage phones, fax machines, etc. It is a good idea to gather as much information as possible so that the client can be readily contacted if circumstances require immediate communication. If the client is a new acquaintance, residence and business numbers should be verified.

(v) Social Insurance Number

Virtually all Canadian residents have a Social Insurance Number (SIN). If a client claims not to have one or refuses to disclose it, the IA’s sales supervisor or the firm’s new accounts department should be consulted. A SIN is required for tax reporting.
(vi) **Date of Birth**

Date of birth, rather than age, is required. This is essential for registered accounts such as RRSPs and RRIFs in order to avoid possibly serious consequences regarding deregistration. In these cases, the calendar year of the client’s birth must be recorded.

Particular care should be taken to avoid opening accounts in the name of minors, since contracts made by minors may be repudiated within a reasonable time after reaching the age of majority. Minors also cannot exercise their right to vote if they own voting shares, do not have the capacity to designate beneficiaries with respect to RRSP accounts, and cannot make RRSP contributions if they have not earned income in the previous year. If asked to open an account for a minor by an established client, the IA should check with the firm’s new accounts department or compliance department to determine what special documentation is required, such as a personal guarantee from a parent or legal guardian. These persons can also advise as to the age of majority in different jurisdictions. **Exhibit 5** shows the ages at which persons may enter into legally binding contracts in all Canadian jurisdictions.

The Quebec *Civil Code* contains a special status of “emancipated minor” for persons under 18 who, by marriage or court order, are emancipated to perform certain acts, including securities trading, as if they had attained the age of majority. Emancipated minors may have their contractual obligations reduced if a court determines them to be excessive, i.e. not strictly necessary as a prudent course of investment action.

<table>
<thead>
<tr>
<th>Exhibit 5</th>
<th>Age of Majority in Canadian Jurisdictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia</td>
<td>19</td>
</tr>
<tr>
<td>Alberta</td>
<td>18</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>18</td>
</tr>
<tr>
<td>Manitoba</td>
<td>18</td>
</tr>
<tr>
<td>Ontario</td>
<td>18</td>
</tr>
<tr>
<td>Quebec</td>
<td>18</td>
</tr>
</tbody>
</table>

(vii) **Citizenship**

Only Canadian citizens resident in Canada can purchase certain percentages or numbers of shares of companies that are considered culturally or economically
important to Canada (including those in broadcasting and communications, as well as banks and other financial institutions). These companies are known as constrained share companies. It is therefore important to know a client’s citizenship in case orders are placed for shares of such companies. In many instances, these companies will require purchasers to complete an Ownership Declaration, thereby providing a formal statement as to domicile and citizenship.

Dealing with non-resident individual accounts requires additional identity verification requirements than those set out for resident individual accounts. Obtaining a current passport number or other valid government identification will fulfill these additional requirements. Also, if a firm permits the opening of confidential accounts, for celebrities, undercover police officers, politicians, etc., appropriate documentation must be received and kept on file identifying the underlying owners.

A client’s citizenship information is also important for tax reporting purposes.

(viii) Mail Confirmations

A client may ask that trade confirmations be mailed to a different address than the one given as a home address. It is very important that clients receive confirmations (see next chapter); therefore, the IA must ensure that the client’s home address is real and valid and that the mailing address is not false or a mail drop. Requests for change of address should be received in writing from the client or independently verified.

(ix) Employment

Employment information is required for two reasons:

(i) to help establish the client’s creditworthiness; and
(ii) to establish whether any regulatory requirements for reporting (i.e., insider status) apply to this account.

If the client is self-employed, financial information in particular should be clarified to assist in checking credit.

(x) Marital Status

A client’s marital status has both financial and legal impact on the account. Therefore, it is necessary to obtain certain information about the client’s spouse, if the client is married or equivalent to married (the definition of “equivalent to married” may vary depending on applicable legislation). Information must be gathered for three reasons:
(i) to help judge the credit-worthiness of the client;
(ii) to ensure that investment objectives and risk factors can be determined relative to the overall circumstances of the parties;
(iii) to determine whether the spouse is subject to any regulatory requirements by virtue of their employment, insider status, etc.

When the information gathered about the spouse indicates that he or she may fall into the insider category, appropriate regulations must be followed. If the client argues that he or she possesses sole interest and control over the account, it is up to both spouses to satisfy the member firm that regardless of their marital association, the person opening the account is totally disassociated from the other with respect to authority over the account and financial interest. In order to formalize the opinion that the accounts are separate, it is good business practice to obtain a written statement, signed by both parties, stating that the spouse has no authority or proprietary interest in the account and, should these circumstances change, the client will undertake to advise the member firm.

Where one account is guaranteed by another, for example, a husband or wife guaranteeing the other’s account or the account of another family member, the registrant should make a diligent effort to confirm the guarantor (the person guaranteeing the account) understands the obligation being assumed. The guarantor should understand what impact the type of trading activity in the account will have on his or her potential liability. A speculative margin account will be of greater risk to the guarantor (and the account owner) than an account made up primarily of preferred stocks and government bonds. Where it is felt that the guarantor does not understand his or her obligations, the registrant should consult with the supervisor to determine the proper course of action.

(xi) Financial Information

Financial information is fundamental in judging a client’s creditworthiness if credit is to be extended, and is also a major factor when establishing suitability of investment recommendations.

*Total net worth* is the sum of all assets less all liabilities. Part of these assets will be liquid (easily convertible into cash). These are the assets that are likely to be available for investment. The registrant should have an understanding as to what major items make up the difference between the total and liquid assets (i.e., a house, a business, other real estate). An asset such as a client-owned business may have demands for cash from time to time.

While only one combined figure is asked for in *annual income*, registrants would be wise to inquire as to whether it is composed of employment income, investment income, or income from other sources.
Investment Knowledge

A discussion with the client will disclose the client’s knowledge of investment matters and the amount of guidance that would be beneficial to him or her. This may have implications of fiduciary duty for the IA if it is found that the client has little investment knowledge (see Section I, Chapter 1).

Investment Objectives and Risk Tolerance

The IA’s initial discussion with the client must include a review of the client’s investment objectives to determine what plans the client has for his or her money? The percentages of funds allocated to safety, income and growth can then be determined.

The client’s risk tolerance should also be assessed to ascertain the degree of risk the client is willing to assume. Obviously, the time horizon of the investments must be taken into account. The following types of questions can also be asked to judge how risk-tolerant a client really is:

- What range of value are you willing to accept for your portfolio in \(x\) years? (i.e., high of $20,000, low of $4,000; high of $12,000, low of $9,000)
- How would/do you react to a decline in market value? Would/do you sell right away, wait a few weeks, wait a year, or hold on for the long term?

Account Opening Red Flags

The process of knowing one’s client does not end once the initial account opening information has been obtained. Even after the account is established, in the normal course of the relationship, firms should continue to build upon the information initially provided by the customer and update their records accordingly.

One of the most effective tools that a member firm can put in place to assist employees in performing their duties relating to anti-money laundering and anti-terrorist financing provisions is the implementation of an effective “red flag” program. A red flag is a warning that should raise suspicions that there is a reasonable chance a transaction is related to a money laundering offence or terrorist financing activity. Red flags are used as warning signals and indicators of possible improper activities that after being reported can provide an appropriate basis for further actions.

Red flags that IAs may encounter during the account opening process include:

- clients who are reluctant to provide adequate information or supporting documentation;
• clients who submit documentation that appears to be altered or counterfeit or if all of the documents have recent issue dates;
• clients who submit documents that are photocopies, facsimile images or other electronic reproductions, even when certified as true copies by an attorney acting on behalf of the client;
• clients who attempt to open accounts in other people’s names;
• clients who supply information that seems vague or even potentially untrue;
• clients who provide an address that is out of the local service area;
• clients who provide a P.O. Box, General Delivery, or other type of mail drop address, instead of a street address when this is not the norm for that area;
• clients who provide a phone number, but the client cannot be reached there;
• clients who make inquiries that suggest a desire to avoid reporting;
• clients who do not complete or supply required documentation.
• inquisitiveness about a firm’s compliance and anti-money laundering procedures; and
• attempting to use aliases or open accounts in different names.

Whenever dealing with offshore accounts, IAs must beware of any offshore customer who is unwilling or unable to clearly and accurately provide detailed ownership information. A local resident opening an account for an offshore entity should also give rise to suspicions and enquiries as to the business and ownership of the entity and the nature of the relationship between the individual and the entity.

The process of knowing one’s client is not concluded once the initial account opening information has been obtained. Even after the account is established, in the normal course of the relationship, firms should continue to build upon the information initially provided by the customer and update their records accordingly. Increases in the size or nature of transactions in an account that are not consistent with the known facts about a client should result in enquiries, both to meet securities regulatory requirements and to meet the customer due diligence requirements of anti-money laundering regulations.

**Account Information**

Account information consists of:

(i) account type;
(ii) beneficial ownership;
(iii) currency;
(iv) payment/delivery procedures; and
(v) special instructions.
(i) Account Types

It is very important to determine exactly what type of account(s) is(are) appropriate for the client. Not only are there a number of considerations as to suitability of investments for the account type, many accounts are mutually exclusive or limit the account to certain types of activity (i.e., RRSPs and margin accounts, see below). Outlined below are the broad categories and a brief commentary on each.

Cash Accounts

These accounts require the client to deposit payment in full for each purchase transaction. For sales, the securities must be in the account or must be delivered to the account by settlement date of the sale transaction. Cash accounts must be operated in accordance with the industry Cash Account Rules, which are discussed in Section II, Chapter 3. The firm does not provide financing to clients that operate cash accounts.

Margin Accounts

These accounts require only partial payment for purchases, with the firm loaning the client the unpaid portion of the market value of the securities at prevailing interest rates. The client is required to make an initial deposit of a specified portion of the value of securities purchased. The client margin is the portion of the cost of the security that the client is required to deposit and it varies based on the type of security and its price, and is determined according to a standard formula.

Since margin accounts involve a loan by the dealer to the client, a financing agreement (known as a margin agreement) between the client and the firm must be completed before the account is approved. See Section II, Chapter 3 for more information on margin accounts.

Margin accounts are also used for short sales of securities. With the firm’s permission, clients may sell securities that they do not own. The firm borrows the securities and delivers the securities to the purchaser. The client must leave the proceeds of the sales in the margin account, plus make an additional margin deposit in case the value of the securities rises. The client will purchase the securities when the client chooses or when the firm can no longer borrow the securities, whichever comes first.

Delivery Against Payment (DAP)

Also known as Cash on Delivery (COD), these accounts involve the purchase of securities and payment on settlement date. An intermediary, usually a financial institution, often acts as agent to complete these transactions for the client. The firm delivers the securities to the purchaser or the purchaser’s settlement agent,
who pays for the securities in full. The client or its agent then has possession of the securities and the securities will not show in the client’s account at the brokerage firm.

DAP accounts are the norm for institutional accounts. The proposed settlement arrangements must meet the firm’s criteria in order for the account to be approved. These accounts are also subject to the *Cash Account Rule*. The client must pay in full before the securities are delivered by the member firm.

**Receipt Against Payment (RAP)**

These accounts, like DAP accounts, are also known as COD accounts. They operate as described above for DAP accounts, except that securities are sold by the client. The securities firm receives the securities from the client (or its agent) and pays the client (or its agent) in full.

[Note: DAP and RAP transactions are often combined in one account, which is usually known as a COD account.]

**Registered Accounts**

These accounts are registered in an individual’s name with the Customs and Revenue Agency as tax-deferral plans. This category includes Registered Retirement Savings Plans (RRSPs), Registered Education Savings Plans (RESPs), Registered Retirement Income Funds (RRIFs) and various locked-in accounts.

Regulations governing registered accounts are constantly changing and detailed coverage is beyond the scope of this manual. However, registrants must be aware of the fact that there are very specific limitations on the types of investments allowed in these accounts. In addition, there are tax consequences relating to the flow of monies and securities in and out of these accounts.

**Pro Accounts**

It is a generally accepted industry practice that all employees of a member firm or a related company and any of their family members living under the same roof are considered to be non-clients or “pros.”

**Simple Discretionary Accounts**

A simple discretionary account is one where the discretionary authority has not been solicited. With discretionary accounts, the client gives discretionary authority to a member firm to select securities and execute orders on his or her behalf on a temporary basis. The client must clearly indicate his or her reasons for requesting
the discretion, such as in the case of illness or absence from the country. As well, registrants cannot exercise discretionary authority over a client account unless the account is maintained with the registrant’s employer. Discretionary authority is only valid for a maximum term of twelve months, unless the member firm has satisfied the IDA that a longer term is appropriate and that the client is aware of the longer term. Discretionary accounts are only renewable in writing.

This type of account must be specifically authorized, approved and accepted in writing as a discretionary account by a designated director, partner, officer, branch manager, futures contract principal or futures contract options principal (depending on the type of products that will be dealt with in the specific account). Both the client and the member firm must sign a discretionary account agreement, which includes any restrictions to the trading authorization. The member firm must also have the proper documentation and supervisory procedures in place to handle such accounts. As well, internal policies and procedures, under which discretionary accounts are to be handled, must be developed by the member and distributed to all approved persons.

All discretionary orders must be marked as such at the time of entry and no person, other than a partner, director, officer or registered representative (other than a registered representative (mutual funds) or (non-retail)) who has been approved as such by the IDA shall effect trades for a customer in a discretionary account. Also, if the securities of a member or its affiliates are publicly traded, no discretionary account may hold those securities and registrants approved to deal with these types of accounts must have at least two years experience in any product that is to be traded on a discretionary basis. For purposes of this discussion, a discretionary order is any order in which the client has not clearly articulated any one of the following: the security, the quantity, the price or the length of time for which the order is good for (or when the order is entered).

Discretionary account reviews must be conducted at least monthly and must include all discretionary accounts handled by registrants, branch managers, partners, directors or officers. To ensure that these accounts are properly supervised, member firms must clearly identify in their books and records which accounts are discretionary. In addition, persons conducting such reviews must have adequate “Know Your Client” information readily available for each discretionary account. All discretionary orders for client accounts affected by producing branch managers, partners, directors and officers must be reviewed no later than the next day by head office.

Both the client and member firm may withdraw from the discretionary agreement provided that such request is submitted in writing. If the client is terminating the agreement, he or she may do so at any time by notice in writing, which shall be effective on receipt by the member except with respect to transactions entered into prior to such receipt. A discretionary agreement can only be terminated by the member by notice in writing, which notice shall be effective not less than 30 days
from the date of mailing the notice to the customer by pre-paid ordinary mail at the customer's last address appearing in the records of the member firm.

**Managed Accounts**

A managed account is “any account solicited by a Member or any partner, director, officer or registered representative of a Member, in which the investment decisions are made on a continuing basis by the Member or by a third party hired by the Member”. This is actually discretionary authority given on an ongoing basis, and is a permanent, rather than temporary arrangement. Member firms must be approved by the IDA to handle managed accounts and ensure that they are compliant with all the requirements detailed in the IDA’s by-laws, regulations, rulings and policies.

No member firm or any person acting on its behalf is permitted to exercise discretionary authority over these accounts unless the individual responsible for the account is a partner, director, officer employee or agent of a member and has been approved by the IDA as a portfolio manager or assistant portfolio manager. The IDA will permit sub-advisors to manage these accounts provided that there is a written sub-advisor agreement with the member in place and the individual or firm is registered to provide discretionary portfolio management services in the jurisdiction in which it resides and conflict of interest provisions at least equivalent to IDA regulations are in place.

In order for the member firm to approve a managed account, a client must sign a managed account agreement, and the member firm’s designated partner, director or officer or a branch manager must accept it. The managed account agreement must also clearly indicate the client’s investment objectives for this account and the client must be provided with a copy of the member’s procedures to ensure the fair allocation of investment opportunities among managed accounts. Unlike discretionary accounts, managed accounts may be solicited.

Without the written consent of the client, member firms dealing with managed accounts are restricted from:

- investing in an issuer in which the registrant is an officer or director, unless such office or directorship has been disclosed to the client;
- investing in a security which is being bought or sold from the registrant’s account to a managed account;
- investing in new or secondary issues of securities underwritten by the member;
- making a loan to a registrant or his or her associate.

Each managed account must be reviewed on a quarterly basis by a designated person to ensure that the investment objectives of the client are diligently pursued and that the managed account is being conducted in accordance with the applicable
regulations. Reviews may be conducted on an aggregate basis where decisions are made centrally and applied across a number of accounts.

As with discretionary accounts, both the client and member firm may terminate managed account agreements as long as the request is submitted in writing. Clients may terminate the agreement at any time, but if the member firm is terminating the agreement, the client must be given at least 30 days notice.

Managed accounts of partners, directors, officers and employees or agents of a member firm are exempted from the client priority rule where the account is centrally managed with other client accounts and it participates equally with client accounts when investment decisions are implemented.

**Investment Clubs Accounts**

When setting up an Investment Club, a specific document called an Investment Club Agreement must accompany the standard NAAF. This agreement must contain the names, addresses and signatures of all of the individual members of the Investment Club. In addition, one or more of the members of the club has to be authorized to give trading and administrative instructions to the firm on behalf of the Investment Club.

If the registrant handling the account is also a member of the Investment Club the account becomes a “pro” account. Furthermore, the registrant cannot be the person responsible for authorizing trades for the account unless it is set up as a discretionary or managed account and is made subject to the supervision requirements for those types of accounts.

It is very important that firms implement controls over these accounts, such as sending duplicate confirmations and monthly statements to an independent member of the club.

**Futures Accounts**

A futures account is a margin account approved for trading in futures contracts. Disclosure of the risks of futures trading must be made to clients. For a registrant to open such an account, he or she must have obtained regulatory approval to deal in futures and the account must be approved by a Registered Futures Principal (RFP) or a futures-licensed branch manager.

**(ii) Beneficial Ownership**

The issue of who beneficially owns an account (especially offshore accounts) has raised regulatory concerns for quite awhile, but since the terrorist attacks on September 11, 2001 this issue has become an even bigger concern. Bringing this to
the spotlight are international organizations such as the Financial Action Task Force (FATF) and the Organization for Economic Cooperation and Development (OECD) that go to great lengths to identify jurisdictions that lack adequate financial supervision systems and are deemed to be “non co-operating”. Despite the surge in money laundering activities and the war against terrorism, current provincial and federal securities laws do not prohibit the use of brokerage accounts where the beneficial owners are unknown.

Obtaining ownership information on offshore accounts can often be difficult, as such accounts might be “veiled” by an offshore jurisdiction’s secrecy laws, as well as a lack of multi-jurisdictional legal assistance agreements. In such cases, regulators have begun to apply the Know Your Client Rule in its narrowest sense to obtain relevant beneficial ownership information on offshore brokerage accounts.

In October 2001, the CSA and IDA conducted an industry-wide survey that revealed the staggering number of offshore accounts, approximately 13,000, which are currently managed by IDA member firms. Regulators have determined that about 3,000 of these accounts originate from jurisdictions that are branded as “non-cooperating” by the international organizations combating money laundering.

As a first step, the IDA decided to concentrate on these accounts the most. The survey also revealed that 700 of the 3,000 accounts originating from the non-cooperating jurisdictions are accounts whose beneficial ownership documentation is either incomplete or non-existent. As a result, the IDA’s initial focus will be to obtain accurate and detailed beneficial ownership information on those 700 accounts, as well as to look for the usual signs of money laundering activities.

In an attempt to streamline the regulations pertaining to beneficial ownership and at the same time to assist in international efforts to combat money laundering, the IDA has amended Regulation 1300 that deal with KYC requirements for corporate accounts (see “Client Identification Requirements Related To Money Laundering Regulations”). The objective of the amendments is to clarify the circumstances under which the beneficial owners of corporate accounts must be identified and to determine exactly what documentation is required and what procedures should be followed when opening such accounts.

(iii) Currency

Clients may choose to purchase or sell securities denominated in foreign currencies. Typically, clients request that Canadian dollar transactions remain in Canadian dollars, and U.S. dollar transactions remain in U.S. dollars. However, the evolution to a global market has made available many investments in other currencies. Registrants should check with their firms (usually the operations or credit department) to determine in which currencies accounts may be operated.
Registrants must ensure that the client is aware that in addition to the usual investment risk, an investment denominated in a foreign currency also carries a currency risk. Adverse currency fluctuations may not only reduce an investment return but may even result in a loss.

(iv) Payment & Delivery

Methods for payment and delivery of securities traded are fairly standard. When a security is purchased, payment can be taken directly from the client’s account if there is sufficient cash or margin available. Otherwise, the client may deposit sufficient cash to his or her account to pay for the security. These payments must be made within the specified settlement period (see information on settlement dates in Section II, Chapter 4). Likewise, securities that have been sold must be delivered to the purchaser’s account within a certain time period.

Other than in connection with a bona fide Delivery Against Payment (DAP) account, any request for payment or receipt of funds to a third party is a warning flag and management should be consulted. This may indicate that a party other than the client has an interest in the account. Many firms have specific policies in regard to third party cheques.

(v) Special Instructions

This area of the NAAF is intended primarily to accommodate instructions such as duplicate confirmations or pay dividends monthly.

Registrant Information

This section is so named because the information concerns the registrant who is opening the account. Certain information is needed to ensure that the registrant is qualified to open the account.

(i) Licensing

From time to time, registrants may have prospective clients who reside in a province of Canada in which the registrant or the firm is not registered. Similarly, a registrant may have existing clients who have moved, or are in the process of moving, to another Canadian jurisdiction. In both cases, the matter must be brought to the attention of the sales supervisor to verify if orders from this client can still be accepted.

A registrant may be faced with similar situations to the above where the client resides in, or is moving to, a jurisdiction outside of Canada, in particular the U.S. It
is extremely important that these be reviewed prior to setting up the account or changing the address, as there is less likelihood that the registrant or the firm is licensed to operate in the jurisdiction. There may be legal, income tax and non-resident tax considerations.

(ii) Source of Client

It is important to know how the client came to the firm and the registrant. First of all, it is a good idea to track referrals. Second, prospective clients who are ‘phone-ins’ or ‘walk-ins’ should be treated with caution unless they have been referred by someone known to the registrant. By no means are all such clients dishonest, but there is a higher likelihood of problems in these cases.

(iii) Direct or Indirect Interest

Most firms have specific rules about registrants having any participation with clients in the operation of an account. As a matter of principle, registrants should limit such participation to those situations where the other party or parties are family members. Some examples of a registrant having a direct or indirect interest in the account are where:

- a corporate account is handled by a registrant that is a shareholder, officer or director (indirect interest);
- the registrant is a party in a joint account (direct interest);
- the client has given the registrant trading authority (indirect interest) (note that this is a discretionary account, and it is not permitted unless the proper approvals have been obtained);
- the named client is an estate or trust of which the registrant is a beneficiary (direct interest).

Full disclosure of the registrant’s interest should be made on the NAAF. In cases where the registrant has a direct or indirect interest senior management should be consulted, particularly in the case of the registrant’s officership or directorship of a corporate client. These accounts must be opened as “PRO” accounts.

Regulatory Section

(i) Insider Status

The registrant needs to know whether his or her client is an insider or control person of a publicly trading company. If a person owns more than a certain percentage (usually 10%) of a class of voting or equity shares of an issuer, then that person is generally considered to be an insider. Such a person is likely to be a
board member or a part of management of the company and is also likely to possess inside information from time to time.

Persons who have inside information may not:

- purchase or sell securities of an issuer about which they have inside information;
- pass the inside information along to someone else; or
- induce someone else to trade in the securities.

Insiders may trade when they are not in possession of inside information, but they must file reports with the securities commissions detailing their trading. As a general standard for members of the CSA, insiders are required to report their trades within 10 days after the date of the trade. The registrant should remind the client of the client’s obligation to file insider reports (see Section II, Chapter 2, Insider Reporting Requirements).

It follows that when a registrant becomes aware of this type of information through a client, the registrant should not use it for his or her own personal gain, nor should he or she pass the information on to clients or anyone else. This is called tipping (see also Illegal Insider Trading and Tipping, Section II, Chapter 2).

A control person generally owns more than 20% of the equity of an issuer and can significantly influence the company. Often the question of whether a person is a control person must be legally determined, but the status of a potential control person must be established before that person trades in securities of the company in question. Control persons typically may not sell securities of their company unless they file a prospectus or other disclosure documents with the securities commission and stock exchange where the securities trade. Purchases by control persons must be carefully scrutinized to ensure they do not constitute a takeover bid.

Registrants must identify potential insiders or control persons, and should refer questions concerning trades by insiders or control persons to the member firm’s compliance officers.

Interestingly, in June 2003, a number of the provincial securities commissions recognized the existence of “nominal vice presidents” for insider reporting purposes. These are individuals who in the normal course of business do not receive or have access to information regarding material facts or material changes concerning their employer (or any issuers that their employer would have this information about) before the material facts or material changes are generally disclosed and who are not insiders in any capacity other than as a result of holding a nominal title. Any person who meets the “nominal vice-president” criteria, upon approval from the regulators, is exempt from filing insider reports regarding their employer or any issuers that their employer would have knowledge of material facts or material changes about.
(ii) Undisclosed Interest

If the registrant receives an affirmative answer to the question, “Does anyone other than the client named above have any financial interest in the account?”, he or she must obtain additional information on all parties and an explanation as to why it is not disclosed in the name of the account. Under no circumstances should such an account be opened or any transaction entered into without discussion with and approval of senior management of the firm.

(iii) Trading Authorization

If anyone other than the account holder has authority to trade for the account, the IA must determine exactly what authority is being delegated. Is it limited to the entering of orders, or is it broader and inclusive of payments of monies and deliveries of securities? While most firms have a standard trading authority form to accommodate one person appointing another person to act for them, this is usually limited to the entering of orders. A General Power of Attorney is typically required if the authority delegated is broader. Signatures for all authorized individuals are required.

The IA must always keep in mind that his or her responsibilities are to the account holder(s) and not to any other person having trading authority. Investment objectives and risk factors for each investment must still be appropriate for the client. Similarly, if the IA has any concern about a proposed activity, such as issuing a cheque from the account payable to other than the client, this should be discussed with management prior to carrying out the instructions.

An affirmative response to the question, “Is this a discretionary or managed account?” requires that the IA either be approved as a Portfolio Manager or be otherwise permitted to exercise discretion. Those IAs who are in fact qualified as Portfolio Managers should open managed accounts in accordance with the firm's specific policies. IAs must not solicit discretionary authority. Those IAs that do receive unsolicited requests for discretionary accounts, and are qualified to handle discretionary accounts, must obtain management approval before opening any account where discretion is granted. No unauthorized discretionary trading is permitted.

Banking Information

Banking information is required to be collected under The Proceeds of Crime (Money Laundering) and Terrorist Financing Act. The firm’s credit department may also wish to check banking information if there are concerns about a new client being a credit risk.
Documentation

Documentation is often required in addition to the NAAF. Two primary factors determine the documentation required:

(i) the type of account that is being opened; and
(ii) the type of client opening the account.

Under IDA rules and securities legislation, advisers are required to provide clients with additional documents that disclose:

- The risks associated with borrowing money to finance the purchase of securities (Leverage Risk Disclosure Statement).
- The IDA’s “Investor Protection for Clients of IDA Member Firms” brochure.
- The risks associated with trading in strip bonds (Strip Bond Information Statement).
- Service fees.

If a registrant or a firm engages in certain activities or business structures, an IA is also required to provide clients with additional documents that disclose:

- The risks associated with trading futures or options.
- That the firm is an introducing broker in a relationship with a carrying broker.
- That the firm shares premises with a financial services entity.
- That the IA is an agent rather than an employee of the firm.
- That the firm trades or advises with respect to their own securities or securities of issuers related or connected to the firm and a list of those securities (Statement of Policies).
- Referral fees.

The following are the main documents that may be required (in addition to an NAAF) when opening an account:

General Documents

(i) Margin Agreement: When a margin account is opened, the client must sign a margin agreement before any business is transacted. This agreement defines the terms of the account, such as the rules for the extension of credit and the right of the firm to sell securities or close out the account if proper settlement is not made. The original is permanently retained by the IA’s firm and a copy is given to the client.

The IA should ensure that the client understands the rules governing margin accounts and the risks of margining. Where no margin agreement is on file, the account will be treated as a cash account.
(ii) **Cash Agreement:** This is required by some firms to document the client’s agreement to do business within industry rules applicable to cash accounts. It is the IA’s responsibility to ensure that the client understands the rules that apply to a cash account, and the firm’s right to take action where settlement is not made properly. (See Section II, Chapter 4, *Operating Cash and Margin Accounts.*)

(iii) **Guarantee:** This form is required when an account is guaranteed by an individual other than the account holder, e.g., one spouse guaranteeing an account in the other spouse’s name. The SROs have specific requirements for guarantees. Therefore, if a client submits his or her own guarantee, it must be approved before it can be used. In general, the SROs limit the accounts that may be guaranteed by IAs or other employees or directors of a firm to those of their immediate families (spouse, parent, sibling or child). For a partner, director or officer to guarantee a client account, the following conditions must be met:

- The SRO having prime audit jurisdiction in Canada over the member firm shall approve the Guarantee by separate written approval. Similarly, SRO approval is also required for the release of such a Guarantee.
- The Guarantor shall not be permitted to transfer cash, securities, contracts or any other assets from the accounts of the Guarantor in respect of which the margin reduction is based without the prior written approval of the SRO.
- If a guaranteed account has been restricted and subsequently fully margined, no trading other than liquidating trades shall occur in the account until the Guarantee is released in writing by the applicable SRO.

Likewise, clients cannot guarantee accounts of partners, directors, shareholders, IAs or other employees of a firm unless they are immediate family members. (See also Section II, Chapter 4, *Operating Cash and Margin Accounts.*)

Care must be exercised in accepting a corporation’s guarantee of a client’s account. Normally, a firm’s legal advisor would review this type of guarantee to ensure that the guarantee has been duly authorized by the corporation and the corporation is within its powers in guaranteeing the account.

Also, no general guarantee of accounts which does not name such accounts and no commingling of a group of accounts is acceptable unless supported by proper documentation to establish the common identity and liability of such group of accounts.

Where a member firm is using a guarantee for margin purposes at year-end, the guarantee must be confirmed to the external auditors in writing by the guarantor.
Trading Authorization Documents

(i) **For an Individual’s Account:** When more than one person is a beneficial owner and/or more than one person has authority to place orders, proper legal documentation must be obtained. Such documentation must state whether full or specified limited authorization is extended to such person(s). Full authorization allows for the withdrawal of funds and/or securities; one type of limited authorization allows no withdrawals.

Registrants should read these documents carefully. The documents will identify the person(s) having authority to enter orders and will state whether there is any investment activity restriction (e.g., restricted to trading in stocks, restricted to cash settlement, etc.). If the document does not specify this information, the registrant should discuss the proper method of handling the account with his or her supervisor.

Some examples of accounts where trading authorization would be an issue:

- Mr. and Mrs. Simon Nabokov: A joint account requiring documentation. While most joint accounts are accounts with the right of survivorship (where both account holders have equal privileges and responsibilities), some restrictions may apply in terms of account withdrawals and trading. Therefore, the IA would want to know if both Mr. and Mrs. Jones have the authority to enter orders and whether they are both entitled to make withdrawals.

- David Alan Summerhill using a nominee name (“DAS Account”): Nominee accounts must be clearly identified as such, and the firm’s principal office in Canada must maintain a file containing written documentation identifying the beneficial owner.

- Mr. John Earle’s account, where Harold Green has authority to place orders: Proper documentation must be obtained, duly signed by John Earle granting authority to Harold Green and stating the extent of Green’s authority.

- Authorization for a Joint Account with Right of Survivorship: This type of account provides that at the death of either of the joint owners, the entire interest in the account becomes that of the survivor, and the estate of the deceased has no further interest. A special agreement is required for this type of account.

- Joint accounts should only be accepted from persons who are permanent residents of areas whose laws recognize the joint tenancy concept. In Quebec, it is recommended that the risks of opening such an account be discussed with legal counsel. See also the section concerning handling of estates (below).

When an account with trading authorization is opened, the registrant should ensure that all parties receive copies of confirmations unless a written directive to the contrary is received from the beneficial owner(s).
(ii) **Authorization for a Corporation, Partnership, Trust, etc.:** When opening such accounts, the IA should consult a partner, director or branch manager of the firm to assess what legal documentation must be obtained. The legal documentation must state whether full or limited authority has been granted, and identify who has authority to enter orders.

- **Corporate Accounts:** Depending on the business relationship already established, such clients may be required to file a copy of the corporate charter and by-laws and a duly certified copy of the by-laws and/or resolutions under which trading authorization was granted. The latter document should carry the Secretary’s signature (and, in Alberta, the corporation’s seal).

Such documentation is usually required in order to:

(i) assure the firm that the corporation has authority to open the type of account requested (i.e., cash or margin);

(ii) ensure that any restrictions on the types of securities that have been authorized for investment are being respected; and

(iii) guarantee that persons entering orders do so with proper authority.

- **Partnership accounts:** Authorization, duly approved by all partners, should be obtained.

- **Estate accounts:** At the death of a client, no instructions should be carried out on behalf of any joint tenant or legal representative of such individual until proper documentation has been obtained. This documentation may include a certified or notarized copy of the deceased’s will, possibly the original or probated will as well, and a certified or notarized copy of a court certificate evidencing appointment of an Executor or Administrator.

(iii) **For Discretionary Authority:** SROs prohibit IAs from accepting authorization for discretionary accounts unless certain regulatory requirements are met. Where such accounts are accepted by partners or directors of member firms, a Discretionary Agreement must be signed by the client and the NAAF must be approved by the firm’s designated partner or director (see Types of Accounts, above; also Section II, Chapter 2, *Sales and Trading Conduct*). For managed accounts, a Managed Account Agreement is required (refer to previous sections on Managed Accounts).

### Other Documents

There are situations where the requirements for the form cannot be determined by either the name of the client or the type of the account. It is some other factor that gives rise to the need for a special document. Two examples of this type of situation would be General Powers of Attorney or Simple Trading Authority where
one person is appointed to act for another. If registrants are in any doubt as to documentation required for an account, the compliance department or legal counsel should be consulted.

**Recommendation and Comments**

In signing his or her name, the registrant is attesting to the accuracy of all of the information on the form to the extent that it accurately reflects the information provided by the client. If there is any additional information that the registrant believes is relevant to the opening of this account, comments should be added.

**Approval**

The branch manager or the firm’s designated person must approve all NAAFs. The person approving the account has a right to expect that the information on the form is complete and accurate, and that they can therefore make a judgment as to whether the type of account, investment objectives and risk factors are in keeping with the client's overall circumstances.

**Separate NAAFs and Supporting Documents**

One NAAF can cover all cash and margin accounts for one client unless the client specifies different objectives for different accounts rather than one overall set of objectives. Also, separate NAAFs are required for accounts in which the client has differing interests. For example, if a client has a personal account, a joint account with his or her spouse and an account for a personal holding company, there should be different new account forms for the account(s) of each. The same principle covers supporting documents such as margin agreements and guarantees. Where the parties directly owning the account differ, separate supporting documents and agreements must be obtained.

Provided that the risk tolerance and objectives are the same, one NAAF can be used for a cash and RRSP account or cash and RRIF account. If the risk tolerance and objectives are different, this will need to be documented in a separate NAAF. At the very least, NAAFs should show separate objectives and risk tolerances for those types of accounts. Futures accounts also require a separate Futures Account Application Form.

Many firms have a separate Option Account Application Form for those clients wishing to deal in options. Others have a separate section on a general NAAF which includes the additional information required with regards to options trading, such as anticipated types of transactions and trading restrictions placed by the Designated Registered Options Principal.
Some firms provide new and prospective clients with an all-purpose document package that includes both a new client application form and an area for the client to sign the agreement(s) relevant to the type(s) of account(s) being opened, such as margin and options agreements.

It is permissible for required disclosure documents and the terms and conditions of the various types of agreements to be provided to the client in separate forms or a brochure. However, the client signature area must clearly state:

- what kind of account(s) is (are) being opened;
- that in signing the client is acknowledging receipt of the terms and conditions of any relevant agreement(s);
- that in signing the client is acknowledging receipt of any required disclosure document(s).

For example, a client opening an options account on a general-purpose NAAF must sign it in a way that clearly indicates the desire to open such an account, agreement with the terms of an Options Trading Agreement and acknowledgement of receipt of the Risk Disclosure Statement for Futures and Options. A client cannot simply check a tick-box requesting an options account and then sign once in a place which does not further specify what type of account is being opened.

Two methods to ensure a proper client signature are:

- having the client sign the form twice: once for the general form and once as accepting the terms of the options agreement and acknowledging receipt of the Risk Disclosure Statement for Futures and Options;
- providing alternative spaces for one client signature depending on the type of account or accounts being opened, for example one place for a client opening only a cash account, another for a client opening a margin account, and a third for a client wanting to open a margin and options account.

**Electronic Signatures**

In most Canadian jurisdictions, electronic commerce legislation currently in force now clarifies that electronic signatures are legally valid. The IDA now permits the use of electronic or digital signatures where a signature is required with respect to agreements, contracts or transactions with and between the member and its clients, registrants, the IDA, other members and any other person or company where a signature is required. Although each jurisdiction has similar requirements, members are advised to refer to the applicable provincial legislation to ensure that they satisfy the requirements. Members are also advised that where no electronic commerce legislation exists in a particular jurisdiction, electronic signatures would not be legally valid. Consent is also required prior to the use of an electronic signature.
According to the legislation, the document or information in electronic form must meet the following requirements:

- It must be accessible by the other party in order for it to be usable for subsequent reference;
- It must be capable of being retained by the other person;
- It must be organized in the same or substantially the same way as the specific non-electronic form;
- The electronic signature must be reliable for identifying the person; and
- The association of the electronic signature with the relevant electronic document is reliable.

In respect to the latter two points, a client signature must be obtained on a signature card or some kind of account agreement in order to meet the requirements of section 7(a) of the regulations under the federal Proceeds of Crime (Money Laundering) Act. The member firm may, in fact, choose to have its clients sign the NAAF as a means of meeting this money laundering requirement.

II. Client Records

IAs have a responsibility to maintain current records on the accounts of all active clients. While most firms now provide computerized systems for record keeping, it is essential that the following information be readily at hand.

New Account Application Form

Prior to execution, the registrant must ensure that a proposed trade is within the investment objectives and risk tolerances for the client. A copy of the New Account Application Form (NAAF) should be retained for this purpose; these days a client’s NAAF can usually be pulled up on the registrant’s computer. Copies are usually given to the branch manager and to the client, while the firm’s head office retains the original.

Registrants must also be alert to when a client has had a material change in circumstance necessitating an update of the NAAF.

Portfolio Record

This document shows each client’s current holdings and provides a quick reference when the IA is speaking to the client. Many firms’ systems also record the average cost base on each security position in the client’s account.
Security Cross-Reference

This is an alphabetical list of all securities held by clients, showing clients’ names under the securities they hold. It enables the IA to contact all clients concerned should something important develop in regard to a particular security.

Correspondence

All incoming correspondence that is received at the firm’s premises is deemed to be the property of the firm and the IA’s name as the addressee is only as an agent of the firm. All such correspondence must be retained as part of client records. Many firms have policies that provide for the opening of all incoming mail by non-sales staff reporting directly to the branch manager. This provides a check on the IA’s business activities.

In order to avoid any confusion in this regard, it is strongly suggested that IAs avoid using their business address for any non-business-related mail.

Removal of Records

Member firms may restrict IAs from removing or distributing client records and internal firm reports. In many cases these restrictions arise from requirements of the IDA, exchanges and provincial Acts governing the retention of such records. IAs must consult with their branch managers before removing any original or copy of any document from company premises.

Consolidation of Back Office Activities

The IDA has made it allowable to consolidate back office activities between an IDA member and its affiliated Canadian financial institution. The IDA has affirmed that common staff are allowed to handle securities clearance, settlement, maintenance of records and/or other operational functions on behalf of both the IDA member and its affiliate. However, IDA regulations require member firms to maintain an adequate system of books and records. These records must be separate and distinct so that customer assets are not co-mingled with another legal entity’s customer assets unless the requirements of an introducing/carrying broker arrangement are met.

Records of Orders

Full details of a trade must be sent promptly and directly to a client in the form of a confirmation. The specific form of such confirmations is determined by the member firm in consideration of the firm's policies, the rules of the Securities
Commissions as well as the various SROs. (See also *Confirmation of Trades* in Section II, Chapter 5).

Though normally covered by a member firm's operating procedures, the SROs also have rules covering the retention of records for varying time periods after a trade order has been received and/or completed. IAs who have been given some responsibility in this area, particularly in smaller branches or sub-branch offices, must become familiar with the applicable regulations.

### III. Summary

The opening of an account provides an opportunity for the IA to determine the client’s financial and personal situations, risk tolerance and investment objectives, and thereby to fulfill the KYC and suitability rules. In addition, many potential credit or legal problems, as well as potential involvement in money laundering or terrorist financing activities, may be detected at this early stage, thus avoiding more serious situations later in the client-broker relationship. Completion of the New Client Application Form ensures that all important information about the account is recorded. All records are the property of the member firm.
SECTION II: DEALING WITH CLIENT ACCOUNTS

Chapter 2

Sales and Trading Conduct

Introduction

In addition to the ethical and compliance-related standards discussed in the beginning of this Handbook, there are general and specific regulatory requirements related to the purchase and sale of securities. Registrants must understand both the basic principles that apply to any professional dealing with members of the public and the specific ethical principles that the securities industry upholds. Additionally, the registrant must adhere to the regulations of the SROs and securities commissions concerning salesperson conduct.

In all circumstances, registrants are required to exhibit professional conduct that would not bring the securities industry, the exchanges, the IDA or member firms into disrepute.

Learning Objectives

After reading this section you should understand:

- which sales practices are required
- which sales practices are considered acceptable
- which sales and trading practices are prohibited
- why certain trading practices are considered manipulative
- other issues such as confidentiality and compensation

I. Review of Basic Principles

A registrant in the securities business accepts a responsibility to both the client and the member firm with which the registrant is employed. The registrant must accept, understand, and display in his or her conduct high standards of integrity.
The Code of Ethics and Standards of Conduct at the beginning of this Handbook provide a framework for responsible dealings with clients. We begin this chapter with a brief review of a registrant’s duties when placing orders.

**Know Your Client**

The registrant must always keep in mind that the client's interests are paramount. To this end, registrants must constantly refer to the client information on the current NAAF to ensure that all recommendations are suitable given the client’s investment objectives and risk factors. It is the registrant’s duty under the Know Your Client rule to give appropriate cautionary advice if a client places an order that appears unsuitable based on this information. The registrant must also ensure that the recorded objectives and risk factors continue to be suitable for the client and that there has not been any material changes in circumstances that would require updating the NAAF (see *Opening Accounts* in the previous chapter).

There have been some recent changes in the Canadian securities industry regarding suitability requirements. In February 2000, the Quebec Securities Commission issued a staff notice that provided relief from pre-trade suitability reviews of unsolicited sales from a long position. The IDA granted the same relief in Quebec only. Such liquidating trades may be executed by registered IRs who have completed the CSC and CPH but have not yet completed their training period.

The Know Your Client (KYC) rule states that salespersons must use diligence to learn the essential facts relative to every client and every order. Information concerning the client’s financial status (both income and net worth), family and other commitments, and financial goals is required in order for registrants to provide appropriate investment recommendations in keeping with the client’s profile (e.g., investment objectives, financial circumstances, personal goals). In some extreme cases, clients may want to place unsolicited orders for investments that are unsuitable given their circumstances. In these situations, registrants who have suitability obligations should note the clients’ insistence on going through with the trade in writing. An even better course of action would be to ask the client for written instructions, change the NAAF and fax it to the client for their signature. In some circumstances it may be prudent to refuse the trade. The IDA’s initiative to apply suitability requirements on a “trade-by-trade” basis does not mean that registrants should refrain from warning clients in situations when their orders appear inappropriate.

In February 2004, the MFDA issued a Member Regulation Notice stating that in the event that a client enters an unsolicited order that appears to be unsuitable based on the information provided on the New Account Application Form or “Know-Your-Client” form, the representative is obligated to provide appropriate cautionary advice to the client. The MFDA advises dealers to adopt "appropriate safeguarding procedures" where the client insists on proceeding with such trades.
Moreover, registrants must be proactive in regularly updating information about their clients to ensure that they do not ignore relevant changes to their clients’ circumstances. For example, changes such as the purchase of a home or a divorce may alter a client’s investment needs. The NAAF should be updated whenever a material change to the client’s objectives or financial circumstances occurs. A large number of regulatory problems occur due to the failure of registrants to update the client information form. For example, a trade could be made which looks unsuitable based on the information on the NAAF, but which in fact is not unsuitable if one is aware of some new information about the client. The best protection for a salesperson is to ensure that the paperwork is always up-to-date. Any material changes to a client’s NAAF should require the NAAF to be updated or perhaps even be re-approved. All material changes, especially things like a name change or an address change, must be submitted to the IA in writing by the client and this documentation must be reflected in, and attached to, the NAAF.

Salespersons may also be in an awkward position when asked by a third party to effect trades in another person’s account. For example, a husband may ask to make trades for a wife’s account or a child may ask to trade in an elderly parent’s account where there is no appropriate signed authority and it is not a joint account. In these situations, the registrant may not “know” the client. The registrant may know the person making the request well and may suspect, but does not know, that the account holder would approve. This situation commonly leads to regulatory charges. It is necessary in such a situation to obtain the direct instruction or a signed trading authorization of the account holder and to ensure that all trades are suitable for a client’s account.

A. Client Suitability Considerations

The following variables relating to a client should first be considered in determining whether a proposed trade is suitable:

- net worth
- earnings
- age
- dependants
- degree of risk in proposed transaction
- knowledge of securities (or options or commodity) markets
- investment objectives
- temperament
- accessibility
- existing portfolio
- existing non-securities investments (i.e., pension, real estate, etc.)
- time horizon of the investment (when is the money needed?)
B. Security Attribute Considerations

Once a registrant is satisfied that all relevant information about the client is known, the client's needs must be matched to the risk/return attributes of the securities or mutual fund being considered for purchase. This could include a consideration of a number of the following variables:

- Is it a new issue (still in primary distribution)?
- How long has the product, company or fund been in existence?
- What are the normal fluctuations of the security's or fund unit’s price?
- What is your research department's evaluation (technical and/or fundamental) of the security and how positive do you feel about it?
- Is the purchase speculative? (Speculative investments generally have no history of earnings and are entirely dependent on the outcome of unpredictable future events, such as drilling results)
- What is the company's track record (i.e., past earnings, dividend payments, etc.)?
- How current, available and reliable is corporate or market information?

C. Transaction Considerations

Suitability standards require a matching of client needs and security attributes to variables in the nature of the trade, which may include some of the following:

- What is the proposed transaction? Does it involve a stock, a bond, an option, a futures contract?
- Is it a purchase or a sale?
- Is it a cash or a margin transaction?
- Is it a minimum risk transaction?
- Is it a large order in a thin issue?
- Is it a short sale?
- What degree of trade control is there? Can it be exercised (options)?
- Is the issue under investigation or review (e.g. a cease trading order)?
- Is it a hedge to protect an existing position or a speculation?

Most industry experts would agree that each element of the above categories must be considered in order to make a proper evaluation of suitability. But given the amount of individual interpretation involved, it is highly unlikely that two experts applying a suitability analysis to the same client at the same time would recommend the same trades or end up with the same portfolio. Professional requirements, however, do demand that in making a suitability analysis you ask yourself:
• Has the IA diligently analyzed each factor in a professional and competent manner?
• If necessary, will I be able to defend the analysis as meeting an acceptable professional standard? Or to quote IDA Regulation 1300.1:

> Every member shall use due diligence:
> (a) to learn the essential facts relative to every customer and to every order or account accepted;
> (b) to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
> (c) to ensure that recommendations made for any account are appropriate for the client and in keeping with his investment objectives.

It is important to note that the IDA regulation pertains not only to every account, but to every order as well.

In June 2001, the IDA proposed Regulation 2500 to address the unique issues and concerns pertaining to day trading. Prior to this proposal there were no by-laws or regulations governing such activities, but since there were a number of day trading firms seeking IDA approval, the need for rules dealing with investor protection was apparent.

Among the various provisions, the proposed regulation would obligate registrants to establish whether a day trading account is appropriate for a particular client prior to the account being opened. As well, clients must be duly warned of the risks associated with day trading and their protection from financial loss must be augmented through implementation of strict leverage limits in the form of margin requirements.

**Recommendations**

The IA has a responsibility to ensure that recommendations made to clients to buy or sell securities are made competently. These recommendations can be generated by the firm's research department or based on other information that can be substantiated and is relevant.

A balanced presentation must be given to the client. All relevant information, including both positive and negative factors about the securities under discussion, must be disclosed prior to the execution of a trade.

As professionals, IAs must be aware of new developments that may affect the client's investments. There is a particular obligation on the part of the registrant to do research and keep up to date where the firm's research department does not follow a security and the recommendation is from the IA alone.
In making a recommendation, no assurance must be given or guarantees made as to:

- future market price of a security;
- future payments of dividends or interest;
- ability of the client to sell a security at a stated price other than in the case of a retractable or callable security;
- listing of a security on an exchange at a future date.

In light of the amendments to Regulation 1300.1, the IDA has provided some guidance as to what may or may not constitute a recommendation. Generally, the IDA feels that determining whether a particular transaction is in fact “recommended” depends on an analysis of all the relevant facts and circumstances of each particular case. This analysis should be based upon whether or not a reasonable person in similar circumstances would understand that a recommendation had been made.

Examples of what may constitute a recommendation include:

- providing information that is individually tailored to a specific customer or class of customers.
- a firm “data mining” their customers’ habits and investment preferences based on past investment decisions and this information being used to target investment-related information to those customers.
- a firm promoting a specific security or a specific trading strategy to a customer.
- a firm holding itself out as taking into account the customer’s objectives and financial situation with respect to any transaction.
- a customer entering an order online pursuant to a recommendation made by the firm via the telephone.

Some variables that have no impact on determining whether a recommendation has been provided or not are:

- supplying a waiver or a disclaimer to a customer stating that the information provided by the firm does not constitute a recommendation is not a determining factor.
- a firm categorizing itself as a “discount broker” because the firm may still be considered to be providing recommendations depending on the facts and circumstances of the particular situation.
- charging a lower commission to a customer.
- whether a transaction is classified as a “buy” or “sell”.
- the lack of the existence of a previous relationship between the firm and the customer.
II. Rules of Conduct

Sales Practices Prohibited by the Securities Acts

Experience gained over many years has shown the need for provisions regulating certain sales practices. Any competent and honest salesperson may earn a respectable income while performing a valuable service without being materially impeded by these provisions. It is the unethical, dishonest high-pressure operators who will find that such laws are designed to curb their style of selling.

It is extremely important that all salespersons study the rules applicable to their province and conform carefully to all requirements. IAs are responsible for keeping up-to-date on, and abiding by, any changes in the law.

Securities Acts contain the basic requirements to “Know Your Client” and make responsible recommendations. There are other specific rules contained in securities legislation, which are discussed on the following pages.

Calling at or Telephoning Residences

The telephone has always been a favourite device for selling highly speculative, promotional securities. Most of the Acts and regulations endeavour to curtail such abuses.

Under the Acts of British Columbia and Manitoba, registrants are prohibited from calling at or telephoning residences other than those of regular clients or those who have requested information regarding a security if the call is for the purpose of trading in securities (other than securities which are exempt from registration). In Manitoba, registrants can call for the sole purpose of making an appointment.

In Alberta, Saskatchewan, New Brunswick, Newfoundland and Labrador, Nova Scotia and Ontario, the Administrator may, by order, restrict any individual IA from calling at or telephoning private homes for the purpose of soliciting trades in securities. Prince Edward Island and Quebec have no specific legislation regarding these activities, however, in every province the Administrator has the power to suspend or impose conditions upon the registration of an IA where such restrictions are considered necessary to protect investors.

Sales Made From One Province to Another Province or Country

Due to the very broad definition of trading in many of the Acts, the filling of even an unsolicited order from a client living in another province may constitute trading in that other province. This could bring about action by the Administrator in the
province if the IA is not registered there. This could result in the Administrator of the IA’s own province canceling the IA’s registration or failing to renew it.

Various state and federal officials in the U.S. are constantly on the alert to detect any unauthorized attempt to sell in the U.S. either by the telephone or by mailing promotional literature. If U.S. authorities obtain evidence of any attempted illegal sale in their areas by Canadians, they issue “cease and desist” orders to the offender in question and notify the appropriate Canadian Administrator. As in the case where the offender trades illegally in another province, such action may result in the cancellation of the IA’s registration or other penalties.

A proposed understanding between the federal and some state authorities in the U.S. and Canadian securities regulators will allow Canadian IAs to deal with Canadian clients who have moved to the U.S. or are traveling there (see Section I, Chapter 3).

Sale of Unqualified Securities

It is illegal for a registrant to trade in securities which have not been duly qualified for sale in the province in which the client resides, unless, of course, the securities fall within one of the exemptions set out in the Act of the province. Provincial qualification generally takes the form of the filing of a prospectus pursuant to the securities laws of the province. IAs must ensure that any security they recommend that is not listed for trading on an exchange is qualified for sale in their province.

Mutual fund securities are considered to be always in the course of distribution and a prospectus approved by the Administrator in the province in which the trade takes place must be supplied to every purchaser.

Churning

The Quebec Act is the only one that contains an express prohibition against churning. It provides that no dealer or advisor may multiply transactions for the account of a client solely to increase remuneration. Violation of this provision can lead to prosecution and the cancellation of the dealer’s or salesperson’s registration. Churning may constitute failure to deal fairly, honestly and in good faith with a client, as required under other Acts.

Illegal Representations to Effect a Trade

Registrants are subject to penalty for making statements that are deliberately false in any material way. IAs, like all others, are subject to the prohibitions in the Criminal Code against fraudulent dealings. Specific legislation has been enacted to stop
registrants from making certain types of statements regardless of their intent or how
good their motives may have been when the statements were made.

The following prohibited representations should be noted:

• Except in the case of retractable securities (i.e., those which the issuer may be
required by the holder to redeem or repurchase), it is unlawful in all provinces
to represent that any person will resell or repurchase a security or that the
purchase price will be refunded.

For information only The Acts of British Columbia, Manitoba,
Newfoundland and Labrador, Nova Scotia, Ontario, Quebec and
Saskatchewan provide an exception to this rule where the representation
is contained in an enforceable written agreement (in Manitoba, this
agreement can only be with a company, not an individual) and the
security has an aggregate acquisition cost of more than $50,000
($150,000 in Saskatchewan). In New Brunswick the representation is
permitted where the maker of the representation, at the time of making
such representation, delivers to the person to whom the representation is
made, a letter or photocopy thereof from the issuer of the security setting
forth such representation in clear language.

• In all provinces except New Brunswick and Prince Edward Island, there is a
specific prohibition against giving an undertaking respecting the future value of a
security (in all provinces there are some situations where a future price may be
able to be determined (e.g., callable and retractable securities). For example, a
salesperson cannot tell clients that a security will double in price in two months.

• In all provinces it is prohibited for any person or company to represent that any
security will be listed on a stock exchange or that an application to list the
security has or will be made, unless the Administrator consents in writing to such
representations. The Administrators normally consent to such a representation in
the final prospectus upon receipt of notice from the stock exchange that the
securities have been conditionally listed. In New Brunswick the maker of the
representation, at the time of making such representation, must deliver to the
person to whom the representation is made a copy of a letter from the issuer of
the security giving information about the application/listing in clear language.

Other communications that have been specifically prohibited in many provinces
include the following:

• No registrant is permitted to use the name of another registrant on signs,
advertisements, etc., unless the other registrant so authorizes in writing, or is a
partner, officer or agent of the registrant (all but New Brunswick, Prince Edward
Island and Quebec).
• Ontario, Manitoba, Newfoundland and Labrador and Nova Scotia do not permit individuals to advertise that they are registered as individuals to sell securities. Alberta, British Columbia and Saskatchewan will allow it provided that it is true. British Columbia requires the category of registration also be disclosed and Saskatchewan requires that any conditions or restrictions on the registration are disclosed.

• With the exceptions of British Columbia and Alberta, registrants should not or cannot advertise that they are registered with a provincial securities regulator or that the provincial regulator has approved their qualifications. Registration certificates cannot be displayed by the registrant or the branch. The display of course completion certificates is permitted.

• No person is permitted to represent that the Administrator has approved the investment merits of any security or the financial standing, fitness or conduct of anyone registered under the Act in question (all but New Brunswick and Prince Edward Island).

Improper Sales Practices

In addition to the above, the following are considered prohibited sales practices:

• Scalping - undisclosed selling of a security by a person or entity such as an investment adviser, securities research analyst, or financial newsletter who simultaneously recommends that you buy the security;

• Bucketing - confirming a transaction where no trade has been executed;

• High-pressure or other selling of a nature considered undesirable;

• Violation of any statute applicable to the sale of securities;

• Leading a client to believe that he or she can suffer no loss through opening an account or trading in the account or in any security.

Manipulative Trading Practices as Defined by SRO Rules

SROs, particularly the stock exchanges, define trading practices that are not acceptable. All employees of member firms must observe these prohibitions. The following are trading practices that must be avoided, as they do not follow the principles of a fair and transparent market:

• Any conduct which has the effect of deceiving the public, the purchaser or the vendor of any security as to the nature of any transaction or as to the price or value of the security;

• Creating or attempting to create a false or misleading appearance of active public trading in a security (i.e., fictitious orders for the same security placed with a variety of securities houses);
• Entering or attempting to enter into any scheme or arrangement to sell and repurchase a security in an effort to manipulate the market;
• Causing the last sale or last bid or offer for the day in a security to be higher or lower than warranted by the prevailing circumstances with the intent to manipulate closing price quotations;
• Using or attempting to use any manipulative or deceptive scheme or contrivance to influence the market price of a security;
• Making a fictitious transaction in a security or knowingly giving or receiving an order involving no beneficial change of ownership of a security;
• Misleading or attempting to mislead any SRO or any board of governors or committee of an SRO on any material point;
• Making a practice, directly or indirectly, of taking the side of the market opposite to the side taken by clients.

Discretionary Trading

Regulations prohibit trades where the IA exercises discretion with respect to any element of quantity, security, price, or time. IAs must obtain the specifics of price, quantity, security and timing of the order from the client.

While regulations do provide for temporary discretionary accounts, these must be for valid reasons and must be documented in advance in the prescribed form. In addition, a designated person of the member firm must approve every order prior to execution. IAs should consult with the branch manager should a situation arise which would seem to require temporary discretion.

Managed accounts are another form of discretionary trading, however IAs are not allowed to operate such accounts. Only properly qualified and licensed Portfolio Managers may operate managed accounts and member firms are required to set up special procedures and supervision for these accounts.

Unauthorized discretionary trading has been one of the most common offences committed by IAs. Disciplinary measures for this type of infraction are appropriately severe.

Priority of Client Orders

Orders for the accounts of partners, directors, officers, IAs and employees of a member firm are generally considered Professional, Employee or Non-Client Orders and will rank behind any client order of the same member firm for the same security, at the same time, at the same price. This is known as the preferential trading rule. In order to ensure that client orders are given priority, member firms require that all non-client orders be identified. This is often done by marking the
order PRO, EMP or N-C. If there is any doubt as to whether an account should be classified as non-client, the IA should consult with his or her firm’s compliance department for a ruling. (See also Types of Orders in the next chapter.)

III. Principal vs Agency Transactions

When a member trades as principal, this means that they are buying from or selling to clients against the member’s own inventory. When acting as agent, a member is buying or selling on behalf of its clients from or to a third party, which may be another member firm or individual.

While there are exceptions, unlisted (over-the-counter) securities are usually traded on a principal basis and exchange-listed securities are usually traded on an agency basis. The decision to act as principal or agent lies with the member firm. The individual IA has no input.

Principal Transactions

A member firm may act as principal in the execution of an order provided that:

- there is not a posted bid or offer at a better price;
- the member has taken reasonable steps to ensure that the price obtained for the client is the best available price at the time, taking into account relevant market factors; and
- the price is justified by the condition of the markets.

A principal trade is not permitted if the member could have obtained a better price for the client as an agent.

Regulations require that where a member has traded in a listed security as principal, this must be clearly stated on the confirmation notice. In addition, member firms must notify clients that the firm may be engaging in transactions on a principal basis. Typically, clients are so notified when they open an account. As the form of such notice varies from member to member, IAs should obtain a copy of the current notice that is used by their firm.

Client Priority Rule

In order to provide the best possible service to clients and to increase market liquidity, certain exchanges have established rules governing Client-Principal Transactions. While these rules impose certain specific conditions that must be fulfilled before a member firm acts as principal on a listed equity, the underlying concept is that the client must do as well or better than if the trade had been done on an agency basis.
Off-Floor Rule

Members of exchanges are required to trade on-exchange except in certain circumstances. The *off-floor rule* permits principal transactions outside of an exchange:

- for the purpose of distributing a block of shares that has been purchased by a member; and
- with the intention of making the distribution to 25 accounts or more; and
- where not more than 50% of the offering is being placed with one client.

Principal transactions may also be made outside of an exchange where the trade is between a client’s RSP and regular accounts.

An IA must not participate in any off-exchange transactions without prior approval from his/her branch manager or compliance department.

Agency Transactions

Other than placing the order and negotiating the commission, an IA typically has no other involvement in the execution of any transaction in a listed stock. While some firms may permit an IA to direct an order to a particular exchange when a stock is interlisted, this is normally the decision of the trading department (or the computer will do it automatically). Many automated order entry systems are programmed to direct an order to the best market; therefore an IA may do his or her client a disservice by trying to override this direction.

An IA may not direct that an order be done with another member firm, crossed internally or otherwise. These directions are also the responsibility of the firm's trading department or computerized trading system, which is obliged to obtain the best possible fill for the client.

Other than fixed income products, most other unlisted transactions are done on an agency basis. Mutual funds are a prime example. Transactions are done with the member firm acting as agent between the client and the mutual fund company.

IV. Concerns about Client Trading

Registrants should be concerned not only about their own trading practices, but also about any unusual or suspicious trades by clients. The reasons for this are both financial and regulatory. Financially, the firm’s capital will suffer if a client has left a bad debt. In terms of regulation, any market manipulation or other Securities Act violation which has been perpetrated by a client through an IA and a member firm could result in regulatory action against the client, the IA and the firm.
depending on the degree of negligence or culpability as determined by a regulator. In an extreme case, this could include prosecution under the *Criminal Code*.

The following are examples of situations in which trading activity may be a cause for concern. Should an IA have reason to believe that any such activity is in process, or has already taken place, the situation should be brought immediately to the attention of the branch manager or a compliance officer of the firm.

**Example A:**

A group of clients is trading in a particular security and the security is not one normally followed by the IA and/or the member firm’s research department. The IA must particularly note if one of the group has trading authority for some or all of the others. In addition, the IA must remain alert to detect other indications that the clients are connected and are acting in concert. This might include use of the same mailing address, same employer, or same last name or phone numbers. Similarities in the timing and pricing of orders would be another clue. Clients engaging in this conduct may be manipulating the price of the stock by trading among themselves or may be attempting to give the appearance of an active market.

**Example B:**

A client, or group of clients, regularly purchase, or bid for, a particular security late in the trading session. This may be an effort to *high close* the stock to give a false impression of higher value through manipulating the price. Such manipulation might occur every Friday (so as to impact the weekend quotes in the newspapers), or even on the last day of every month.

**Example C:**

A client, or group of clients, regularly sells a particular security late in the trading session. This may be an effort to *low close* the stock. Some of the reasons for low closings include market participants attempting to circumvent exchange rules regarding private placements or unscrupulous short sellers attempting to manipulate the profit and loss (or margin rates) on securities they have shorted.

**Example D:**

A client wishes to place an order and specifically instructs the IA to contact someone at another member firm or another third party in order to complete the transaction. This is a prime example of a possible attempt to *wash trade* in which there is no real change in ownership but a false impression of trading activity is given.
Another variation may involve the client being on both sides of the transaction, either through a corporate name or through an associate. When the stock either rises or drops sharply, the account with the losing position may simply default leaving the member firm with a bad debt. The client may keep the profits from the account with the profit.

**Deliveries and Payments**

The registrant is personally responsible for ensuring that the client’s instructions regarding payment, registration and delivery are properly and promptly executed. No matter what margin or credit checks the firm may provide, registrants also have a responsibility to make sure that the firm is not at financial risk because of a client dealing beyond his or her financial resources or failing to make payment or delivery of securities on the settlement date.

The registrant must be alert for situations such as clients attempting to sell securities before they have paid for them, or clients asking for prepayment before the settlement date. In dealing with new or relatively unknown clients, registrants should exhibit particular care to review any securities certificates delivered by the client in order to establish their authenticity and/or to give proper notification to Operations personnel so that they may do so.

At all times, the registrant must observe the firm’s rules regarding the transfer of monies or securities from one account to another and the delivery of monies or securities to a client. The registrant must refer these matters to the responsible authority within the firm.

**V. Account Activity and Money Laundering Red Flags**

Account transactions should be viewed in the context of other account activity and a determination of whether a transaction is actually suspicious will depend on the customer and the particular transaction, compared with the customer’s normal account activity.

As far as transaction red flags are concerned, suspicions should be aroused if a client:

- repeatedly purchases securities with deposits of money orders, cashier’s cheques/other bank instruments or third party instruments, especially in amounts that are slightly less than $10,000, or if the instruments are sequentially numbered;
- delivers bearer securities or requests certificates registered to third parties;
- pays for purchased securities from the bank accounts of third parties, particularly foreign accounts;
• makes frequent and large redemptions where the proceeds are wire-transferred to a foreign bank account or unrelated third party;
• wire transfers to, or from, tax havens and secrecy jurisdictions or countries that are on a list of non co-operating jurisdictions should be duly noted and/or reported.

Be skeptical of customers whose instructions appear to have no regard to normal economic or investment considerations. For example, being unfamiliar with a financial product’s performance and specifications, but still wanting to purchase the product or constantly buying and selling different securities with no discernible purpose or benefit. Such activity might be an attempt to blur an audit trail.

Non-trade activities used to blur an audit trail include registering securities or issuing cheques in third party names, transferring funds or securities between apparently unrelated accounts or to apparently unrelated accounts at other dealers, or taking delivery of bearer or street form securities. Similarly, suspicions may also be raised if an account receives third party cheques or bearer or street form securities, the origin of which is not known or which are recently issued or sequentially numbered.

Often a transaction can seem suspicious if it is inconsistent with the client’s usual pattern of activities or financial standing, or if there does not appear to be any economic gain for the client in the transaction. Be leery of all suspicious transactions regardless of the sum of money involved because there is no monetary threshold for making a report on a suspicious transaction. A suspicious transaction may involve several factors that appear individually insignificant, but when viewed together with other events or transactions may indicate the possibility of a money laundering related offence.

VI. Dealing with Confidential Information

Registrants who deal with clients may come into possession of confidential information in a number of different ways, including:

• where a registrant opens a client account, the registrant comes into possession of confidential personal and financial information about the client;
• where a registrant executes transactions in a client’s account, the registrant comes into possession of confidential information about client transactions;
• where a registrant is privy to information concerning his or her firm, such as proposed firm transactions, strategic or competitive information, firm security holdings or firm financial performance;
• where a registrant functions as an advisor for publicly traded corporations or other entities planning to raise money, execute a merger or acquisition or other material transaction which has not been generally disclosed to the public;
• where a registrant acts as a director of a public corporation, material non-public information about that company’s affairs may come into his or her possession.

National Instrument 33-102 Regulation of Certain Registrant Activities, came into force August 2001 and it clearly stated that registrants must keep all information about retail clients confidential and cannot disclose the information to any third party except under certain conditions. These conditions include for audit or record-keeping purposes, when permitted or required by law or by a recognized SRO, to collect a debt owed by the client or unless before disclosing the information the retail client is told:

• the name or identity of the third party;
• the nature of the relationship between the registrant and the third party;
• the nature of the information that will be disclosed; and
• the intended use of the information by the third party, including whether the third party will disclose the information to others.

The retail client must provide consent to the specified disclosure of the confidential client information. The client has the right to revoke the consent at any time and no registrant can require a retail client to consent to disclosing confidential information unless the disclosure is reasonably necessary to provide the specific product or service that the retail client has requested.

Obligation to Maintain Confidentiality

Registrants have an obligation to maintain confidentiality of information. The registrant should not discuss the existence of a client relationship, any particulars about a client, or any information about a client transaction with anyone other than those within the firm who have a need to know the information. The registrant may occasionally be required to divulge information pursuant to a request from a regulatory authority, and should do so in consultation with the firm’s legal counsel or compliance officer.

Where a registrant acts as an advisor to companies contemplating or preparing to undertake a major financial transaction such as the issuance of new debt or equity securities, the takeover of another company, merger with another company or other transactions which might reasonably be expected to affect the market price of the company’s securities, the registrant:

• may not disclose to any other person an undisclosed fact about any of the parties involved in the transaction;
• may not trade in securities of issuers involved in the proposed transaction based on undisclosed material non-public information; and
• may not induce others to trade in those securities. (See the discussion of Insider Trading, below.)
A registrant may also come into contact with confidential information concerning his or her employer. The registrant must:

- hold in confidence all information received about the employer;
- not participate in the spreading of rumours about the employer or others in the securities business; and
- keep the firm informed of matters that might be of interest to his or her firm, subject to confidentiality considerations.

Where a registrant functions as a director of a public corporation, his or her first duty is to that public corporation and the director may not reveal any privileged information received as a result of his or her role as a director. Disclosure of such inside information (see below) to clients or directors, partners, officers or employees of the registrant’s employer must be strictly avoided.

Any position, office or business activity a registrant proposes to assume or participate in, other than direct employment with the securities firm, should be disclosed to the securities firm. The securities firm should confirm whether the activity might form a conflict of interest with the person’s duties as a registrant, and consider whether industry regulations permit such activity. For example, the TSX V prohibits employees other than partners or directors of member firms from becoming directors of listed issuers without the permission of the exchange.

**Illegal Insider Trading and Tipping**

Insiders are persons who are in a position to obtain information about companies that the rest of the public cannot obtain. This information could provide an unfair advantage to these persons when they are making a decision to buy or sell securities of the company. Therefore, securities legislation prohibits insiders to make use of confidential information in their own securities trading. The legislation also covers those who are “tipped” about confidential information in advance of its general release to the public.

In addition, *The Canada Business Corporations Act (CBCA)* and the regulations of members of the CSA require insiders of a reporting issuer to file reports of their trading in securities of the issuer within 10 days after the date of the trade.

The general principles of the law relating to insiders are described below. However, when a practical problem arises, great care must be taken to determine which of the Acts, the *CBCA* and the various provincial corporate statutes apply to the situation. The provisions of these various statutes differ slightly.
Who are Insiders?

For purposes of the reporting provisions of the Acts, insiders are defined to include the following:

- the directors of the issuer;
- the senior officers of the issuer, who are defined as the chair or vice-chair of the board of directors, the president, any vice-president, the secretary, the treasurer or the general manager of the issuer, or any other individual who performs functions for the issuer similar to those normally performed by an individual occupying any such office, and each of the five highest paid employees of the issuer, including any individual referred to above;
- any person or company (excluding underwriters in the course of public distribution) beneficially owning, directly or indirectly, or controlling or directing more than 10% of the voting rights attached to all voting securities; and
- any director or senior officer of a company that is a subsidiary of the issuer or is itself an insider due to ownership, control or direction over more than 10% of the voting rights attached to all voting securities of the issuer involved.

The Acts and the CBCA contain provisions that deem certain persons or companies that become insiders of an issuer to have been insiders of the issuer for a period of up to six months before the event.

What is Inside Information?

Inside information is considered to be non-public material information about the securities of an issuer. “Non-public” means that the information has not been generally disclosed to the marketplace.

According to The Ontario Securities Act when used in the context of an issuer other than an investment fund (including mutual funds), a “material change” means a change in the business, operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of any securities of the issuer. This also applies to a decision to implement a material change that is probable to occur but has not yet happened.

When used in relation to an issuer that is an investment fund, a “material change” is a change that would be considered important by a reasonable investor in determining whether to purchase or continue to hold any securities of an issuer. This also applies to a decision to implement a material change that is probable to occur but has not yet happened.

The Ontario Securities Act defines a “material fact”, when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of securities.
Prohibition of Insider Trading and Tipping

The Acts prohibit trading based on inside information. The Acts also prohibit passing along inside information to another party (known as “tipping”). This prohibition applies to persons in a special relationship with a company. Persons or companies in a special relationship with a reporting issuer include:

(i) insiders, affiliates or associates of the issuer, or insiders of the person or company proposing to make a takeover bid or carry out a business combination;

(ii) a person or company that is engaging in, or proposes to engage in, professional or business activity with the issuer or with a person or company referred to in (i);

(iii) directors, officers or employees of the issuer or of a company that is referred to in (i) or (ii); and

(iv) a person or company that learns of the material fact or change from any of the above and knows or ought to have known that the other is in such a relationship.

Persons in a special relationship with a company can therefore include accountants, lawyers, underwriters, etc.

For the purpose of the Acts, an associate generally includes a spouse, a relative, a relative of the spouse sharing the same house as the insider, a partner, a trust or estate in which the insider acts as trustee or has a substantial beneficial interest and a company of which the insider controls more than 10% of the equity shares. An affiliate generally includes a parent or subsidiary or a company with common ownership with the insider.

No person can purchase or sell securities of an issuer with knowledge of inside information about that issuer, or inform another person of a material fact or change relevant to the issuer that has not been generally disclosed. No one can inform another person of an undisclosed material fact or change with respect to the issuer. This is called tipping. The person who gives the information is the tipper and the person who receives the information is the tippee. The tipper and the tippee are both liable if any trading occurs based on this passing of information.

Liability is imposed by the Acts and the CBCA on persons who make improper use of undisclosed confidential material information in their securities trades. Insider trading and tipping activities carry potential liability to compensate a seller or purchaser of securities for damages and for fines or imprisonment where the person or company utilizing inside information has profited by the contravention.

As stated previously, the maximum penalties for insider trading under The Ontario Securities Act were increased in December 2002 from a fine of $1,000,000 and imprisonment for two years to a fine of $5,000,000 and imprisonment for five years.
less a day. Alberta has equivalent penalties as well. The OSC also has the power to order the payment of an administrative penalty of up to $1,000,000 and to order the disgorgement of monies obtained as a result of non-compliance if a person or company fails to comply with Ontario’s insider trading laws. Other jurisdictions, such as British Columbia, still have maximum penalties of fines of $1,000,000 and imprisonment for terms that range from three years to five years less a day.

The Ontario Securities Act exempts insiders from liability where:

- no one who made or participated in the making of the decision had actual knowledge of the material fact or change and no advice was given to them by someone who had that knowledge;
- the transaction was entered into as agent pursuant to a specific unsolicited order;
- the transaction is part of an automatic plan previously entered into;
- the transaction is made to fulfill a binding, previous obligation; and
- the insider reasonably believed that the other party to the transaction (or the tippee) knew of the information.

Exemptions in other provinces vary. Any exemption should be specifically reviewed if a question arises. Whether or not a person is technically caught within the legislative prohibitions, it is improper to trade on the basis of confidential information.

On March 29, 2004, Bill C-13 received Royal Assent. This bill is aimed at strengthening measures to investigate, prosecute and deter capital markets’ fraud and manipulation and restore investor confidence in these markets. Even though illegal insider trading and tipping were already prohibited under the Canada Business Corporations Act and under the provincial securities acts, the new insider trading offence under the Criminal Code is intended to deal with the most serious cases that merit stiffer criminal penalties. The offences can carry prison terms of up to 10 years for illegal insider trading and five years for tipping.

To protect him or herself and the firm from inadvertently breaching securities regulations, the registrant must try to assess whether a proposed sale may constitute unlawful distribution to the public from control stock. If there is the slightest suspicion of an attempted unlawful distribution to the public, the registrant must consult senior management before executing the sale. Since the definition of a control position is imprecise, many firms require either a legal opinion or a Securities Commission ruling before executing large transactions or other sell orders in which an area of doubt exists. Under the Know Your Client rule, the onus is on the IA to assess whether or not a client may be an insider in a publicly-traded company, even if the client does not disclose his or her status as an insider. This may be done by inquiring directly of the client, or ideally having the client sign a
letter stating that he or she is not an insider, if it appears that the client may, in fact, be an insider.

Where a client or a group of clients continue to purchase large amounts of voting shares, there is a need to assess whether the cumulative amount could constitute a change of control or a takeover.

**Information Barriers ("Chinese Walls")**

As mentioned in the discussion of the Standards of Conduct (Section I, Chapter 1), Chinese Walls are information barriers implemented in firms to separate and isolate persons within a firm who make investment decisions from persons within a firm who are privy to undisclosed material information which may influence those decisions. In general, all firms are required to develop, implement and enforce reasonable policies and procedures to safeguard inside information and ensure there is no improper trading. Although specific procedures are not mandated, those adopted must be in writing and be appropriate and sufficient in the circumstances. Procedures should address the following areas:

- education of employees;
- containment of inside information;
- restriction of transactions; and
- trading surveillance.

Procedures to contain inside information include the establishment of physically separate areas where persons who routinely handle inside information are located, security over files, security over the electronic transmission of information and prohibiting the discussion of the information except where necessary, and recording who becomes privy to the information, when and why.

Persons within the organization may also be limited in the types of securities transactions that they may execute in the securities of an issuer about which the organization has inside information. Such securities may be included on restricted lists after information is publicly disclosed (or grey lists or watch lists if a firm is in discussion with an issuer but has not yet committed to a business arrangement before information is publicly disclosed, even if the deal has been inked). Certain employees may not be permitted to buy or sell the securities of the issuer, research activities may be curtailed, and recommendations to clients about the securities may be prohibited. Grey lists generally have very restricted dissemination because the addition of an issuer to this list would signal that something may be happening. Restricted lists are more broadly disseminated so that sales and trading staff know that they are under specific restrictions, such as to unsolicited client orders.

Confidential information is an issue for ALL dealers, not just those engaging in corporate finance or investment banking activities. Members that do not engage in
corporate finance or investment banking should identify the possible means by which they or their personnel may come into possession of confidential information that could be used for insider trading, such as through trading by issuers, research or relationships between personnel and corporate insiders. Procedures should be established for bringing the receipt of such information to the attention of management and dealing with it appropriately. In November 2005 the IDA released Member Regulation Notice #0337 which provided guidelines for the containment of confidential information.

It is imperative that all registrants be familiar with their firm’s policies in this regard.

Insider Reporting Requirements

Insiders must inform the relevant securities commissions:

- when they become insiders; and
- when they transact in securities of the company of which they are insiders.

The System for Electronic Disclosure by Insiders (SEDI)

SEDI is a system that allows certain issuers, their insiders, and their representatives or authorized agents to electronically file insider trading reports over a secure Internet-based system. A SEDI issuer is any reporting issuer, other than a mutual fund, that files disclosure documents electronically through SEDAR, the System for Electronic Document Analysis and Retrieval.

A filing through SEDI satisfies the insider reporting requirements of all CSA jurisdictions and harmonizes the filing deadlines in all Canadian jurisdictions so that insiders are required to report trades within 10 days of the transaction. With this system insiders can file their reports 24 hours a day, seven days a week and they will not be required to pay any filing fees.

Insiders of SEDI issuers are responsible for filing accurate and timely information about their transactions, which includes the:

- type of security;
- date of the transaction;
- type of transaction, such as a buy or sell;
- value or number of securities involved in the transaction; and
- the type of currency.

SEDI issuers are also required to file issuer event reports on SEDI within one business day of events such as mergers, amalgamations, stock splits and consolidations, among other events.
The intended advantages of the SEDI system include being very convenient to use as insiders only need to file one report to comply with all provincial regulators and the fact that it is available 24 hours a day/seven days a week. In addition to that, the public also has greater access to insider reports through SEDI’s website shortly after the reports are filed.

On February 1, 2002, Canada’s securities regulators suspended the operation of SEDI due to technical difficulties. It was determined that the best solution was to take SEDI off-line for diagnostic and repair work until the problem was remedied. As of June 9, 2003, the CSA required insiders to resume reporting through SEDI. To fulfill their reporting requirements, insiders must complete Form 55-102F5 electronically via the SEDI website at www.sedi.ca.

VII. Commissions and Other Compensation

Upon entering an order, the IA determines the commission to be charged and this is what ultimately will appear on the confirmation notice to the client. This is also the basis for the IA’s compensation. Any profit or loss in the firm trading or inventory accounts is unrelated.

Virtually all transactions in fixed income investments are done on a principal basis. When a client purchases a bond or stripped coupon, the price is typically marked up from inventory price and the amount of the mark-up is the firm’s profit. The IA then receives some portion of this profit as compensation for doing the transaction.

Most member firms give IAs a certain amount of flexibility as to how much mark-up they may take on a given transaction. In some firms, there are general guidelines suggesting what is appropriate. These depend to some extent on the size of the transaction, the type of product, and the term to maturity. Other firms may leave it entirely up to the IA to determine what is to be charged to the client.

Member firms usually provide guidelines as to the amount of commissions that may be charged on unlisted agency transactions.

In all cases the IA must ensure that any mark-up taken is fair and reasonable and will stand the test of complete and open scrutiny.

Representatives may be employed on the basis of salary, commission, or both salary and commission. If all or part of an IA’s remuneration for services rendered in obtaining securities business is in the form of commission, SRO rules state that the portion of the total commission received shall be at the discretion of the member firm. SRO rules also state that the only remuneration that IAs can accept for their services must be the remuneration provided by the member. IAs cannot accept any gratuity or other payment from a third party.
“No [RR, IR, partner, director, officer,] branch manager or assistant or co-branch manager shall accept, or permit any associate to accept, directly or indirectly, any remuneration, gratuity, advantage, benefit or any other consideration from any person other than the Member or its affiliates or its related companies in respect of the activities carried out by such [RR, IR, partner, director, officer,] branch manager or assistant or co-branch manager on behalf of the Member or its affiliates or its related companies and in connection with the sale or placement of securities on behalf of any of them.” (IDA rules 4.13, 7.5,18.6.)

**Gifts to Clients**

Members or registered representatives are allowed to give a gift to encourage prospective clients to open accounts. Registrants should note, however, that any gift or reward program given by a registered representative must receive prior approval by the member firm. Also note that the gift or reward must be available to all prospective clients, who must be given full disclosure of any terms or conditions when opening the account or in any advertising or promotional material.

**Mutual Fund Incentives**

SRO rules address mutual fund incentives specifically. It had long been the practice for mutual fund companies to entice salespeople to sell their fund through the granting of non-cash incentives such as travel. In order to maintain a salesperson’s objectivity where recommending mutual funds to clients, it is no longer acceptable for salespeople to accept any non-cash sales incentive in connection with the sale or distribution of mutual funds. Non-cash compensation may not be received by the salesperson directly, nor may it be received by the member firm and passed along to the salesperson. For the purposes of this rule, non-cash sales incentives include trips, goods, services, gratuities, advantages and benefits.

Salespersons are allowed to receive, through their firms, commissions and fees on the sale of mutual funds and service fees and trailer fees where applicable.

**National Instrument 81-105**

This instrument and its companion policy, NI 81-105CP, are initiatives of the CSA and came into effect on May 1, 1998. They address mutual fund sales practices and procedures, with an emphasis on (i) disclosure of sales practices that may influence sales decisions and (ii) prohibition of practices that were not in the interests of mutual fund purchasers. Any distributor of mutual funds is bound by these
instruments, which demonstrate “zero tolerance” towards improper sales practices in the mutual fund industry.

NI 81-105 addresses many areas of compensation from fund managers to both sales representatives and their employers. In general, salespeople and their employers may not accept any type of payment (monetary or non-monetary) from mutual fund companies. Benefits of any kind could bias investment recommendations in favour of particular fund companies. There are a few exceptions, for example, both “front-end” and “trailing” commissions may be paid. Mutual fund dealers may receive payment of commissions for the distribution of funds from the fund organization when:

- the obligation to make the payment arises at the time of the trade (i.e. not before or after);
- the prospectus or simplified prospectus of the mutual fund discloses the range of rates of commissions that may be paid and the method of calculation used in determining the amount of those commissions; and
- the rate of the commission does not increase:
  (i) based on increases in the amount or value of securities of the mutual fund sold, or of mutual funds in the same mutual fund family as the mutual funds sold, or of any or all of the foregoing;
  (ii) based on increases in the amount or value of securities of the mutual fund, or of mutual funds in the same mutual fund family as the mutual fund, or of any or all of the foregoing, held in accounts of clients of the participating dealer; or
  (iii) for a particular period of the year in which the commission is paid or earned.

Trailing commissions based upon the aggregate value of securities of the mutual fund held in accounts of client of the dealer can also be paid, however there are certain conditions (see NI 81-105 for details). Bonus commissions may not be paid.

**Disclosure**

Section 3.1(b) and 3.2(b) of NI 81-105 require the disclosure of the method of calculation used in determining the amount of sales commissions and trailing commissions. These disclosures can be of a general nature, describing in most cases that the amount of a commission is calculated through multiplying a specified rate of commission by some aggregate dollar amount of securities sold or held as at a specified time.

Mutual funds are required to disclose the equity interests held by any representative that holds more than 5% of the outstanding shares of a non-public member of a fund organization. Individuals must also disclose any equity interests they may
have in a member of the organization of a mutual fund. This information must be contained in a disclosure document to be provided to purchasers, and if an equity interest has been disclosed the purchaser must give written consent to the trade.

Non-monetary Benefits

Conference and seminars organized by mutual fund companies for dealer sales representatives are permitted, but restricted to locations within Canada and the continental U.S. An exception is made for “due diligence” trips organized by fund managers to international locations where a fund’s portfolio advisor is located and carries out the portfolio management for the fund. In addition, travel expenses of dealer representatives may not be paid by the fund company. In the case of dealer-sponsored conferences, restrictions apply only where the dealer is seeking monetary contributions from fund companies.

Section 5.4 of NI 81-105 permits a member of the organization of a mutual fund to pay to IFIC, IDA or their affiliates or associates (“associations”) direct costs incurred by these associations relating to conferences or seminars organized by the associations, subject to the geographical restrictions noted above.

In addition, business development activities sponsored by mutual fund companies are permissible, provided that they “do not cause a reasonable person to question” improper influence on a sales representative’s investment advice. The representative’s travel, accommodation and personal expenses may not be paid by the fund company.

Non-monetary benefits of a promotional nature that are of nominal value (e.g., pens, calendars, coffee mugs) may be provided, as long as the provision is not so extensive or frequent that it may improperly influence the advice being given by a salesperson.

Soft Dollar Arrangements

Soft dollar practices involve the use of client brokerage fees by an investment manager to obtain certain products and services to aid the manager in its investment decision-making process. Through the typical soft dollar arrangement, clients are able to offset research and other approved costs (i.e. quotation services) with direct commissions. Upon a client’s request, the firm purchases the approved items with “hard” dollars and provides it to the client. In exchange, clients pay in “soft” dollars (i.e. brokerage commissions) by directing some portion of their trades through the firm.
Rebate of Commissions

A mutual fund dealer or its representatives may pay redemption charges owing by an investor if the investor agrees to transfer his or her investment from one fund to another, but only if the transfer meets certain conditions.

NI 81-105 allows a dealer or its representative to pay all or part of a redemption fee or commission payable by a fundholder upon redemption of securities in one family and purchase of another if:

- the dealer or its representative provides the fundholder with written disclosure of:
  - a reasonable estimate of the amount of the fee or commission being paid by the participating dealer on the redemption;
  - a reasonable estimate of the amount of the redemption charges to which the fundholder will be subject in connection with the securities of the mutual fund being acquired, expressed both as dollar amounts and as percentages of the value of the securities being redeemed, and the times at which those charges would be made; and
  - general tax consequences of the redemption (i.e., tax effects of a redemption at different marginal rates).

This disclosure must be provided before the redemption and the fundholder must provide written consent to the redemption; and

- the dealer is not a member of the organization of the mutual fund whose securities are being acquired.

No member of a mutual fund organization, other than a participating dealer acting in compliance with (i) and (ii) above, may pay any portion of a fee or commission resulting from redemption of the securities of one fund family and purchase of those of another fund family.

Note that in some cases, what is advertised as a “rebate” on commissions for mutual fund sales may technically be considered a negotiated commission, if the true amount of commission is known to the investor before the trade takes place.

VIII. Personal Financial Dealings

It is important that IAs deal with clients in a professional manner (see Section I, Chapter 1, Standards of Conduct). To this end, IAs should report all of the following situations to the branch manager before entering into them. In turn, the branch manager must ensure that the firm’s policies and procedures are followed:

- where the IA acts in any capacity in relation to a transaction in any security, whether or not publicly traded, where the transaction is not processed in the
usual manner through the firm’s books.

- in any business relationships outside of the member firm.
- regarding additional services such as acting as custodian of the client’s financial assets, preparation of tax returns, payment of bills, etc., regardless of whether a consideration is paid for such services.
- in any relationship where the IA and the client are linked in the profits or losses of an account. This would include, but is not limited to, joint accounts, investment clubs or corporate accounts.
- when acting in any capacity other than an investment advisor for the client such as Executor or Executrix; Trustee; Officer or Director of a company owned or controlled by the client; etc. and ethical considerations.

**Carrying Accounts at Other Firms**

Registrants are not permitted to hold (in their own or other names) or to exercise control over accounts at other firms unless they have first obtained the express written permission of their employer. A statement showing all transactions in the account at the other member firm must be provided to the employer by the firm carrying the account at least monthly. All such accounts must also be designated as non-client accounts and as such must be reviewed monthly if they generate a statement, as per the IDA’s Policy 2.

If the securities transactions are being handled by a bank or trust company, it is the registrant’s responsibility to ensure that such transactions are entered through his or her own firm, unless otherwise approved, and that all transactions are entered as non-client orders.

**XI. Summary**

Registrants are required to exhibit professional conduct that reflects well on themselves, their firms and the industry. Sales and trading practices are therefore regulated by provincial legislation and by the SROs. Unauthorized discretionary trading is one of the most common violations investigated by SROs and is punished severely.

Special considerations must be given to situations where a firm is acting as principal rather than agent, when client trades appear to be suspicious or unusual, when confidential information is involved, and when registrants are investing for themselves. The issue of commissions and other compensation to salespeople is also subject to regulatory guidelines. These situations involve potential conflicts between the interests of clients and those of the firm and the registrant.
SECTION II: DEALING WITH CLIENT ACCOUNTS

Chapter 3

Placing Orders for Securities

Introduction
This chapter will deal with the mechanics of placing orders for securities, including types of orders, settlement and delivery, trade confirmations and handling errors and changes.

Learning Objectives
After reading this section you should understand:

• how to place an order
• the implications of different order types
• the settlement and delivery process
• how to handle errors or changes in orders

How Securities are Traded

Trading Units
A trading unit is the number of shares of an equity or the dollar value of a bond, debenture or note that is traded as one unit, called a board lot or a standard trading unit. The quantity of a security that makes up a board lot is determined by the regulation services provider or individual marketplace on which the security is traded. In the case of unlisted securities, this determination is made by the IDA.

Under the Universal Market Integrity Rules (UMIR), the term “board lot” is no longer used and has been replaced with the term “standard trading unit”. This terminology change was necessary due to the fact that different marketplaces may use different sizes for board lots.
Example:

For most equities, one board lot is equal to 100 shares. Two board lots would equal 200 shares. If a bond sells in board lots of $250,000 (face value), an order for $750,000 worth of this bond would equal three board lots. **Exhibit 6** shows various security price ranges and their accompanying board lot sizes for listed securities (under IDA Regulation 800.21), which includes listed rights and warrants. Orders (or portions of orders) to buy or sell that are not in multiples of 100 shares are considered to be *odd lots*.

---

**Exhibit 6**

<table>
<thead>
<tr>
<th>Listed Securities – Security Prices and Board Lot Sizes</th>
</tr>
</thead>
<tbody>
<tr>
<td>LISTED SECURITIES ON TSX AND TSX V</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Security Prices</th>
<th>Board Lot</th>
<th>Odd Lot</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $0.10 per unit</td>
<td>1,000</td>
<td>1 to 999</td>
</tr>
<tr>
<td>At $0.10 or more per unit and less than $1.00 per unit</td>
<td>500</td>
<td>1 to 499</td>
</tr>
<tr>
<td>At or more than $1.00 per unit</td>
<td>100</td>
<td>1 to 99</td>
</tr>
</tbody>
</table>

The IDA specifies trading units for debt securities and unlisted securities. The requirements are as follows (IDA Regulation 800.21):

**Security** | **Trading Unit**
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Government of Canada Treasury Bills and other GOC direct and guarantees maturing in less than 1 year</td>
<td>$250,000 par value</td>
</tr>
<tr>
<td>2. GOC direct and guarantees with term 1 to 3 yrs.</td>
<td>$100,000 p.v.</td>
</tr>
<tr>
<td>3. GOC direct and guarantees with term over 3 yrs.</td>
<td>$100,000 p.v.</td>
</tr>
<tr>
<td>4. Provincial bonds and guarantees</td>
<td>$25,000 p.v.</td>
</tr>
<tr>
<td>5. All other bonds (municipals and corporates)</td>
<td>$25,000 p.v.</td>
</tr>
<tr>
<td>6. Bonds, convertible debentures and debentures issued $5,000 p.v. with attached stock warrants, rights or other appendages</td>
<td>$5,000 p.v. irrespective of value of appendages</td>
</tr>
<tr>
<td>7. Common and preferred stock not listed on a recognized stock exchange</td>
<td>500 shares if market price is below $1/share</td>
</tr>
<tr>
<td>100 shares if market price is at $1 and below $100</td>
<td></td>
</tr>
<tr>
<td>50 shares if market is $100 or over</td>
<td></td>
</tr>
</tbody>
</table>
Example:

An order for 550 shares would likely include 5 board lots and an odd lot of 50 shares.

It may be more difficult to fill orders for odd lots; therefore the price obtained may not be as good as that obtained for even board lots. The traders who typically execute these orders are permitted to discount the amount they pay for purchases of odd lots and obtain a premium for odd lots they sell.

The TSX requires that orders to buy or sell odd lots of actively traded securities be filled either by an offsetting client order or by a Registered Trader (a trader who is registered with the TSX and meets specific qualifications). The Registered Trader must fill odd lot orders at the quoted bid or ask price. Where offsetting client orders are present the fill representing the best price will be given. On the TSX V, odd lot orders are filled by odd lot dealers within the premiums or discounts as prescribed by the exchange.

Exhibit 7 shows normal settlement periods for securities. The IDA has proposed shortening the settlement period to T + 2 for all debt securities with maturities less than three years, in order to facilitate client trades selling one short-term debt instrument and buying another, as well as hedging strategies. As of September 2004 this change had not yet been implemented.

<table>
<thead>
<tr>
<th>Security</th>
<th>Settlement Date/Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government of Canada treasury bills</td>
<td>Same day (T + 0)</td>
</tr>
<tr>
<td>Provincial government treasury bills</td>
<td>Same day (T + 0)</td>
</tr>
<tr>
<td>1 to 3 year Government of Canada direct and guaranteed bonds</td>
<td>T + 2</td>
</tr>
<tr>
<td>All other securities</td>
<td>T + 3</td>
</tr>
</tbody>
</table>

Minimum Quotation Spreads

When a client sells a security at the market, he or she will receive the bid price, which is the price a prospective buyer is willing to pay. When a client buys the security, he or she pays the ask (sometimes referred to as “offer”) price which is the price at which a prospective seller is willing to sell. Minimum quotation spreads
define the minimum acceptable range between bid and ask prices when quotations are given for securities. This range is determined by the exchanges.

Example:

If the minimum quotation spread for a stock is one cent, bid and ask prices in a quote must be at least one cent apart, e.g., $2.34 – $2.35. The TSX’s requirements for minimum quotation spreads slightly differ from those of the TSX V.

<table>
<thead>
<tr>
<th>Exhibit 8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Quotation Spreads (Between Bid and Ask Prices)</td>
</tr>
<tr>
<td>TSX and TSX V</td>
</tr>
<tr>
<td>Security Selling:</td>
</tr>
<tr>
<td>Under $0.50</td>
</tr>
<tr>
<td>$0.50 and over</td>
</tr>
</tbody>
</table>

I. Placing an Order

With the advent of computerized trading systems there is a wide variance among member firms as to how orders are actually entered. In some firms, IAs are able to enter orders from a computer terminal at their own desks, while in other firms a written order must be presented to the branch order desk. For this reason, we will not address the specific details of how orders are to be entered, but will show the basic elements of an order entered by a written trade ticket. It is up to the IA to ensure that he or she complies with the specific procedures of their firm for submitting orders.

For each purchase and sale instruction received from a client, an order form must be completed in accordance with rules enforced by provincial authorities, the exchanges and the IDA. Orders should not be passed to the trading desk orally. The following information must be detailed on the order ticket:

- client’s name and/or the account number;
- quantity and description of the security (most often shown by symbol);
- notation as to price (e.g., limit, market, on stop, etc.);
- notation as to whether the order is Professional (PRO or N–C or EMP);
- notation as to whether the order is a short sale or discretionary order.

Clarity and accuracy are of paramount importance in completing order forms since correcting errors is expensive both for the firm and possibly for the registrant.
Errors caused by a misunderstanding of the client’s instructions or by poorly written order ticket instructions need not occur. The registrant should:

(i) write clearly;
(ii) repeat each order back to the client (very important as many client-registrant disputes are merely a misunderstanding as to whether a formal order was given or in connection with some aspect of the order);
(iii) look up the proper stock symbol if in doubt, or else write the name of the security in full;
(iv) before giving an order to the trading desk, consider:
   • whether the order is a buy or sell order. Furthermore, the registrant should check that the correct order form is used.
   • whether the security description is correct. As many public companies have several kinds of securities outstanding, the specific security being bought or sold (e.g., Class A or B common, 2\textsuperscript{nd} preferred, warrants, rights, etc.) must be clearly specified.

Errors made in the completion of order tickets may result in trading losses when the errors are corrected. In most cases, these losses will be charged to those making the errors.

Following is a sample of an order ticket. Given the move towards computerized trading in the investment industry, paper tickets are being phased out; however, it is important to recognize and understand the basic elements of an order.

### Sample Order Ticket

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>200</td>
<td>ABC</td>
<td>MKT</td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>1234566</td>
<td>17</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the above example, a client wishes to purchase 200 shares of Alpha Beta Company (ABC) at the market price, as a day order. In this particular example, Bill Smith is a new client and the securities firm with which he is dealing has already assigned an account number to him, which is entered in the appropriate box. Some houses, however, may allow initial orders to be entered for new clients prior to an account number being assigned to the client. In such cases, the NAAF and the initial order will have been approved by a partner, director, officer or
branch manager. The client’s name and the registrant’s number are considered sufficient identification on the order ticket pending the assignment of an account number. Once an account number has been assigned to a client, it must be shown on the order form.

Note: Some firms make a practice of having a director, partner, officer or branch manager initial the order ticket for a new client’s first order.

II. Types of Orders

Generally speaking, order types are categorized by their:

- Duration: how long is the order valid for?
- Price restrictions: have any limits been set on the price?
- Special instructions: are there any special conditions attached to the order?
- Other: are there any changes to the original order or is the client a Pro?

Orders must contain certain basic elements (discussed in the previous section), or at least those covered under the categories of duration and price, if no special or other terms are attached.

Orders Categorized by Duration

(i) **Day Order:** An order to buy or sell which, if not executed, expires at the end of the trading day on which it was entered.

*Example:*

“Buy 100 shares of XYZ for my account at $10 or less.” No time limit is specified, therefore the order is valid until the close of business on that day, or until filled, whichever is sooner.

(ii) **Good Till Cancelled (GTC) or Open Order:** An order to buy or sell that remains in effect until it is either executed or cancelled. Note that a GTC order will remain in the TSX system until the date that it is filled or a maximum of one year from its date of entry, whichever happens first. Many firms will not allow open orders and will insist on an end date (see Good Till Date/Good Through Date Order, below), after which the order may be renewed on the client’s instructions.

*Example:*

“Sell 100 shares of XYZ whenever the price reaches $20 or more.” The order stays open until the price of XYZ reaches $20 or more, at which time it will be filled.
Good Till Date (Good Through Date) Order: An order that is valid until filled or cancelled or until the close of business on a specified expiry date. This type of order is particularly useful with clients who are hard to reach or are leaving on vacation or a business trip.

Example:
“Sell 100 shares of XYZ if the price reaches $20 or more on or before March 30.” The order is open until filled at $20 or more, or until the close of business on March 30, whichever is first.

Orders Categorized by Price

(i) Market Order: An order to buy or sell securities at the prevailing market price. By definition, any order that does not have a specific price limit is a market order.

Example:
“Buy 100 shares of XYZ Inc. at market.” Since no price limit had been specified, the order will be filled at the current bid or ask price, depending on whether the order is to buy or sell.

(ii) Limit Order: An order to buy or sell a security at a specified or better price. A limit buy order permits the purchase of shares at the limit price or lower. A limit sell order permits the sale of shares at the limit price or higher.

Example:
“Buy 100 XYZ Inc. at $20 or less” would be filled if the order could be executed at $20 or less. The order would be cancelled at the end of the trading day (if no time limit was specified) if the stock remained above $20.

(iii) Stop Loss Order: An order that is specifically used in connection with a sell order where the limit price is below the existing market price. The order becomes effective when the stock drops to the specified level. The purpose is to reduce the amount of loss that might be incurred or to protect at least part of a paper profit when a stock’s price declines.

Example #1:
“Sell my XYZ stock if the price drops to $20 or below.” The order would be triggered as soon as the stock’s price fell to $20 or lower.

Stop loss orders become market orders when triggered, and can then be filled at any price. However, some firms require that all stop loss orders be entered with both a trigger price and a limit price.
**Example #2:**

“Sell my XYZ stock if the price falls to $20 or lower, but at no lower than $15” would mean that the order would not be triggered until the stock traded at $20 at which time it would become a limit order to sell at $15 or better. If the trader could not sell the XYZ stock for more than $15, the stock would not be sold.

(iv) **Stop Buy Order:** The opposite of a stop loss sell order. An order to buy a stock at or above a certain price. A stop buy order may be used for two reasons: (i) to protect a short position when the stock’s price is rising; and (ii) to ensure that a stock is purchased while its price is rising. A short seller who protects the short position with a stop buy order is following the same logic as a person owning a stock who uses a stop loss order. In the second case, a client may wish to buy a stock only after it has demonstrated a certain upward price move, which is usually associated with a technical analysis buy signal.

**Example:**

XYZ stock is currently trading at $30 per share and a client decides that he would like to buy it – but only if it moves up to $35. A limit buy order of $35 would immediately be filled because the trader is obliged to buy the stock at $35 “or better” and the prevailing market is $30. But by entering the order as a stop buy at $35, the stock will not be purchased until it trades at $35 or above.

The same caveats noted for stop loss orders also apply to stop buy orders. IAs should consult with their firms’ equity trading departments for clarification as to policies and procedures regarding the use of all stop orders.

Both “stop loss” and “stop buy” orders are filled on a best efforts basis.

**Orders Categorized by Special Instructions**

The following orders all have various special instructions for their execution. Member firms’ automated order systems may or may not accept these orders, therefore the IA should determine his or her firm’s procedures for orders that require special handling. Many member firms will restrict or refuse to accept some or all of such orders, particularly in fast markets. Registrants should note that special terms orders are executed on a best efforts basis, which means that once the client puts one of these restrictions on the order, he or she is not guaranteed a fill at the posted bid/offer price.

(i) **All or None Order (AON):** An order for which the entire amount of stock must be bought or sold or no part of the order will be executed. With this type of an order, the client will not accept partial fills. IAs should be aware that such an order is filled on a best efforts basis only. A stock may trade at
or through the order price without the order being executed as a result of putting such restrictions on the order.

**Example:**

“Buy 2500 shares of XYZ at $20 on an all or none basis.” There may not be 2500 shares of XYZ selling at $20. Even if there are 2000 shares selling for $20, the client will not accept only part of the total shares ordered. If 2500 shares of XYZ cannot be found at this price, no shares of XYZ will be purchased for the client.

(ii) **Fill or Kill Order (FOK):** An order in which as much as possible must be filled immediately, after which the order is cancelled. It makes no difference how much of the order remains unfilled.

**Example:**

“Buy 2500 XYZ at $20, on a fill or kill basis.” Only 1500 shares of XYZ can be purchased for $20. Once this is done, the order is no longer valid, even though only 1500 of the 2500 shares ordered were purchased.

(iii) **Switch Order:** An order for the *sequential* sale of one security and the use of the proceeds to purchase another security. Note that the second order is not “live” until the first order is filled. IAs should clarify whether the client will accept partial fills so that as a board lot is sold, a board lot of the second security may be bought even if the price of the second security is less than that of the first. This type of order is common in mutual fund transactions.

**Example:**

“Sell 100 XYZ and use the proceeds from this sale to buy shares of CDE.” Assume that XYZ can be sold for $20 per share, and CDE is selling at $18 per share. The client will (theoretically) have enough money from the sale of 100 XYZ shares to buy 111 shares of CDE. The IA should clarify whether the client wishes a fill of one board lot (100 shares) of CDE, or whether they want the extra shares of CDE that could be purchased with the proceeds of the sale of XYZ. Odd lot shares usually cost more than those purchased in board lots, so the client will likely get slightly less than 111 shares of CDE.

(iv) **Contingent Order:** An order that will become a working order after a primary order is filled. A primary order and one or more contingent orders are entered into the trading system simultaneously; however, the contingent orders become effective only after the primary order is filled. Contingent orders may be entered either at an exact price or at a specified distance from the price at which the primary order was filled. These types of orders may be used to automatically place protective stop orders and/or limit orders at a profit objective, contingent on the terms and strategies of the primary order. (Note that contingent orders are mostly used as part of derivatives trading strategies.) Such orders can be entered:
• at market
• at the same price
• with a certain point spread
• with matching quantities

**Example:**

“Buy 1,000 shares of XYZ at market, and sell 10 calls at the current offer price.” In this case, the contingent order to sell 10 calls will wait on the sidelines until the 1,000 shares of XYZ are purchased, ensuring that the client's option position is "covered".

A contingent order for two related stocks (i.e., XYZ convertible preferred and XYZ common; XYZ stock and XYZ warrants) at the market or at a certain spread is sometimes referred to as a spread order.

(v) **Delayed Delivery Order:** A special term order in which there is a clear understanding between the buying and selling parties that the delivery of the securities will be delayed beyond the usual three-day settlement period, to a date specified in the order. This type of order is mostly used with institutional accounts.

Delayed delivery sell orders are often entered at a discount from the prevailing market price, and because agreement must be reached with the buyer on delivery, some delay in reporting a fill may be experienced.

**Example:**

On August 31, a client enters an order to sell 100 shares of ABC at $23 on a 30-day Delayed Delivery basis. If the order were filled on August 31, delivery and settlement would be made 30 days later, on September 30.

(vi) **Short Sale Order:** An order to sell stock that the seller does not currently own. The client will borrow the stock from the member in the expectation that the price will go down. The stock can then be bought back by the client at a lower price than he or she received for it. Note that there is a risk that the stock may actually increase in price, and will have to be purchased by the short seller at a loss. There is also a risk that the member will have to return the borrowed stock before the short seller wishes to buy it. If the member cannot borrow the stock from another lender, the short seller will be forced to buy the shares at the current market price.

**Example #1:**

“Sell short 100 XYZ at $20.” The sale is made, and the client receives the proceeds of $2000. The member firm provides the XYZ stock for delivery to the buyer. The price of XYZ declines to $17.00, at which time the short seller buys the stock to replace that provided by the member firm. The client
spends $1700 to replace stock for which she received $2000, therefore, she made a $300 profit (excluding commissions).

**Example #2:**

The same short sale is made, but in this case the price of XYZ stock increases to $22. The short seller must replace the XYZ stock loaned by the member firm and must buy at $22. She has spent $2200 and only received $2000, therefore she has a loss of $200 (plus commissions).

It is against stock exchange rules for a seller not to declare a short sale at the time of placing the order, and the IA must clearly indicate on the order that it is a short order.

Most exchanges have specific regulations that govern how short sales may take place. In general, short sales must be made at a price that is the same as or higher than the last trade in that security. The computerized systems of most firms will tell the trader/IA at what price a short sale may be made or when a short sale at a specified price may be traded.

The TSX requires short sales to be made at a price that is not lower than the last trade of a board lot of the security. This rule is also known as the *Last Sale Rule* and it has been adopted as the standard rule under UMIR.

**Example #3:**

“Sell short 100 XYZ at $25.” If XYZ is being traded through the TSX and the most recent board lot sold at $25 or more, the sale can be made.

Before UMIR, the TSX V applied an *Uptick Rule*, which required a short sale order to be executed at a price that is either (i) higher than the last price at which a board lot of the security traded; or (ii) the same as that last price if that price was higher than the last different price at which the stock traded. With UMIR in place, short sales on both the TSX and TSX V are based on the TSX’s *Last Sale Rule*.

**Example #4:**

“Sell short 100 ABC (on the TSX V) at $10.” The last board lot of ABC sold at $10. The price had fallen from a previous trade of $10.10. Therefore, since the most recent board lot price of $10 is less than the previous price of $10.10 (i.e., the stock has fallen in price), the short sale cannot be made at $10 but must be higher than $10.

**Other Types of Orders**

(i) **Cancel/Change Former Order (CFO):** A cancellation and amendment to a previously entered order. Most firms require IAs to submit all changes to
orders in written form. In many firms, the automated order systems will accept CFO orders right from the IA’s computer terminal.

Registrants must use care when dealing with clients who wish to change orders. An order may already have been filled, and the client should be so advised at the time the CFO is being entered. Particular care must be taken with the use of CFO orders in fast markets.

Example:

A client wishes to buy 100 shares of XYZ at market. The IA enters the order, but two minutes later the client calls back and changes it to a limit buy order for 100 shares of XYZ at $20. The IA advises the client that the order has been put through to the trading desk but that a CFO order will be entered in hopes that the previous order has not yet been executed. The IA enters the new order and notes that it is a CFO. When the trading desk receives this order, they check to see if the previous order has been filled. If not, the trader cancels the market order and the limit buy order is activated.

(ii) **Professional (PRO)/Employee (EMP)/Non-Client (N-C) Order**: An order entered for the account of a partner, director, officer, shareholder, IA or other employee of the member firm. Such orders should be marked EMP, PRO, or N-C. Bear in mind that in some firms, N-C may be confused with N/C (No Commission). If these orders are competing with client orders at the same price, the client orders are given priority. (See also Section II, Chapter 2.)

Example:

An order is placed to sell 100 shares of XYZ at $20. In this case, the account holder is an employee of the member firm. Thus, the order must be marked PRO (or EMP/N-C). If any client orders to sell XYZ at $20 are outstanding, these will be filled before the employee’s order.

### III. Settlement of Trades

#### The Clearing System

The Canadian Depository for Securities Limited (CDS) operates for SRO members and participating banks and trust companies. Its purpose is to provide participants with a central facility through which to make deliveries in settlement of security transactions. Participants deliver certificates (physically or more often, electronically) to other parties against receipt of payment.

Normally, in the course of an active trading day, a participant will be both buyer and seller of any one stock. If a member accepted the responsibility of settling the numerous transactions with all the members traded with during the day, a very large number of cheques and certificates would have to be circulated among members.
Instead, the operation is handled by CDS. In this way, the number of certificates and the amount of cash that has to change hands among the various members each day is substantially reduced. This clearing system establishes and confirms a credit or debit cash balance for each member firm, compiles their clearing settlement sheets and instructs each member of the securities it must deliver to balance its account.

**Advantage with Securities Sold**

Any advantage that belongs to a security (such as a dividend payable) passes with the security to the new owner, unless otherwise declared at the time of sale. The corollary to this is that in some cases, an obligation or liability is passed on to the purchaser. An example would be in the case of installment receipts, which require mandatory payment of the second installment.

**Accrued Interest to Seller**

The seller retains all accrued interest on bonds and debentures to the date the bonds or debentures are sold unless otherwise arranged at the time of the transaction. The payment of this amount is normally accomplished by way of an additional amount to be paid by the purchaser, which is reflected on the purchaser's trade confirmation. Paying the seller is necessary because the next coupon or interest payment will come to the purchaser.

**Trading Ex-Dividends and Ex-Rights**

Trades are ex-dividend, ex-rights or ex-subscription privileges, as the case may be, on the second full business day preceding the record date or the date of the closing of the transfer books. Should the record date or closing date occur on a holiday or half-holiday, this rule applies for the third preceding full business day.

**Cash Trades**

These are trades that settle before normal settlement date. They occur because these transactions will normally settle after the record date, and the purchaser will not receive the dividends or rights. Transactions may be made “for cash”, which means that a shorter settlement date may be agreed by the buyer and seller. In this case, the agreed settlement date will determine whether the trade is ex-dividend. If the trade settles on or before the record date, the trade is made with the dividend. If settlement is after the record date, the trade is ex-dividend.
Exceptions

The exchanges may in any particular case or cases provide that trades shall be ex-dividend, ex-rights, or ex-subscription privileges at any other time.

Rights on Stock

IAs should be aware that there are different rules relating to the trading and settlement of rights with the different exchanges. In addition, policies and procedures vary from one member firm to another. On those infrequent occasions when an IA encounters a rights issue, he or she should check with the trading department and/or securities cage (reorganization department) to confirm the rules and procedures applicable to that particular rights issue.

Reducing Outstanding Orders When Shares Go Ex-Dividend, Ex-Rights etc.

When a security is quoted ex-dividend, ex-rights, ex-subscription privileges or ex-interest, the following types of orders must be reduced by the member firm by the value of the payment, right or privilege on the day the security trades ex:

- open buy orders (the buyer price will take into account any advantage that goes with a security)
- open stop loss sell order (for short seller, the price at which they are willing to sell will reduce by the advantage)

The following types of orders are not reduced:

- open stop buy orders (a limit is set on the upward price movement of the stock - this will not be affected by any reduction in advantage)
- open sell orders

Transfer of Securities

When transfer of ownership of a security is required, certain procedures must be carefully followed. Under normal conditions and in very simplified form, the bond or stock certificate (often now in electronic form) is delivered to the particular agent authorized by the issuing company to transfer ownership. The “transfer agent”, which is usually a trust company, then makes the necessary changes to the company’s bondholder or shareholder records and produces a new certificate reflecting the change in ownership. Naturally, extensive controls must be in operation to ensure that transfer of ownership is made only to those entitled to receive it.
To ensure proper and legal transfer, it is necessary for the person whose name appears on the face of the certificate to “sign-off” the certificate which puts it in negotiable form. This signing-off procedure can, in some instances, be very complex. Further information regarding the transfer of securities should be obtained from the firm’s stock cage (back office) manager or a transfer agent.

Normal transfer requirements are divided into two general areas: Simple Transfer and Transfer Involving Legal Documentation.

**Simple Transfer**

*Example:*  
John D. Jones, beneficial owner and a registered shareholder of 100 shares of ABC Company, sells these shares. The face of the certificate indicates “John D. Jones” as registered shareholder. Mr. Jones must sign-off the certificate exactly as it is registered (e.g., “John Jones” is not acceptable), date it, and have his or her signature witnessed.

The member firm or other authorized company or individual receiving this certificate guarantees the signature of Mr. Jones, and may either deliver the certificate to the appropriate transfer agent for official change of ownership or deliver the certificate to the receiving firm.

**Transfer Involving Legal Documentation**

In this instance, the beneficial owner and/or registered shareholder is not an individual, but is instead a corporation, partnership, investment club, etc. The transferring of securities out of the name of a deceased person or securities registered in trust or sales by an executor are also legal transfers.

The requirements for such transfers are governed by the laws of each province and in some cases by federal laws. No securities in the name of a deceased person should be sold or relocated until such time as the proper legal documentation has been obtained.

To be accepted as good delivery, stock certificates must be presented to the transfer agent with the proper legal documentation accompanying each certificate. Registrants should acquaint themselves with the legal requirements for such transfers in order to assist both clients and the member firm’s stock cage in arranging prompt transfer. *The Canada Business Corporations Act* and the various provincial Corporations Acts set forth the requirements that must be satisfied before a transfer agent can effect a legal transfer on the books of a company.
Changes in Beneficial and Economic Ownership

It is the position of Market Regulation Services (RS) that trades involving a change of beneficial and economic ownership must be traded on a marketplace. For instance, a member that interposes itself between the trades of a client (e.g., the dealer purchases as principal from the client and sells as principal to the client) creates two transactions, which similarly creates a change in beneficial and economic ownership. Such trades are not permitted as off-marketplace transactions. Conversely, trades that do not involve a change in beneficial and economic ownership must be executed off-marketplace as such trades constitute a deceptive and manipulative method of trading. For example, a transfer of stock between an individual and a wholly-owned corporation, although constituting a change in beneficial ownership, does not constitute a change in economic ownership and therefore must be done off-marketplace. This would also apply to a client transferring securities from their personal account to their RRSP whether or not the transfer was in the form of a sale of the securities to the RRSP or a contribution of the securities to the RRSP as a premium.

In addition, large volume or value trade transactions between spouses, for income tax or RRSP purposes may only be executed off-marketplace (without prior permission from RS) if the trade:

- does not constitute a legal or beneficial change in ownership of the security;
- is not an action to evade tax or securities laws and does not contravene UMIR, or the rules and policies of the exchange upon which the trade would otherwise occur; and
- is executed at a price that is within the context of the market for that particular security at the time of the trade.

Trades between spouses that are executed for tax reasons are viewed to constitute a change in both beneficial and economic ownership and therefore would have to be executed on a marketplace. This requirement applies when a person sells securities to the RRSP of their spouse however, the contribution of securities to a spousal RRSP does not constitute a trade (as there is no valuable consideration) and must be executed off-marketplace.

On the other hand, security transfers that are gifts or charitable donations are to be executed off-marketplace, even if the transfer is facilitated by a member because such transfers are done without consideration or payment and therefore do not constitute “trades”.

Failure to Deliver Listed Securities

Securities not delivered by settlement date are called fails. The firm expecting delivery of the security (receiving broker) may demand delivery and, if the broker
who owes the security (delivering broker) can neither borrow the security nor otherwise arrange delivery, that broker may be bought in.

Closing-out contract or buy-in procedures may be instituted by the receiving broker after one trading day has elapsed following settlement date. By-law provisions allow the security to be purchased, by a designated official, on a cash and, in most cases, a same-day delivery basis. The security is presented to the receiving broker and the purchase price (usually at a premium on a cash transaction) is charged to the broker who failed to deliver it.

Registrants must be familiar with the buy-in procedures in order to be able to advise clients who are unable to deliver securities. Also, since securities required to complete buy-in contracts are displayed on the exchange ticker system, the registrant may be able to advise the client of the advantages of selling at a cash premium to complete some other buy-in contract.

IV. Errors

There are two types of errors: those caught before the trade is executed and those caught after the trade is executed.

• Before the trade is executed:

  (i) These normally require a CFO order to be entered and, if in time, the incorrect order will be cancelled and the correct order will be entered.

• After the trade is executed:

  (i) Where the quantity, security and price are correct and the only error is the account number or commission amount, the securities or proceeds of a sale will simply be switched to the proper account, or the commission amount adjusted.

  (ii) Where there is an error in one of the other terms of the order such as quantity, security, or price, a financial gain or loss may result. These errors must be corrected in accordance with the firm's error policy and procedures. Errors must not be settled privately between the client and the IA or by switching the trade to a personal account.

Example:

A client places an order to buy 100 common shares of XYZ. The IA enters the order but uses the wrong symbol and the trader buys 100 shares of XYZ preferred shares. When the IA calls the client to confirm the purchase, the error is discovered. In this case, the firm would move the preferred shares to the firm’s error account and buy the client the common shares at the price the client would have paid at the time the order should have been executed. There may be a loss on
the transactions if the preferred shares are sold for less than the purchase price or the common shares are purchased for more than the amount that the client should have paid. The IA may be charged for these losses.

In the case of an error caught after a trade confirmation has been sent, a cancel confirmation and new confirmation are issued.

V. Summary

Placing orders for securities involves knowledge of order types, procedures for settlement and delivery and knowledge of the proper procedures for error correction before and after an order has been executed. Efficient and correct placement of orders will go a long way to ensure clients’ satisfaction and loyalty to the investment advisor and the firm.
SECTION II: DEALING WITH CLIENT ACCOUNTS

Chapter 4

Cash and Margin Account Rules

Introduction

This chapter introduces the details of operating cash and margin accounts. IAs are responsible for ensuring that clients settle the purchase and sale of securities. The IA must be able to evaluate the status of client accounts to inform clients when funds or securities are owed into the account or whether funds or securities may be withdrawn.

Learning Objectives

After reading this module, you should understand:

- the purpose and application of the Cash Account Rule
- the restriction process on overdue cash accounts
- the operation of long and short margin accounts
- how to deal with special margin situations

I. Accounting for Client Transactions

Before analyzing the operation and status of different types of accounts, the registrant must understand the basic accounting for transactions in client accounts. Basic accounting practices are common to all types of client accounts. The transactions that might appear in a client account include:

- client deposit or withdrawal of funds;
- client deposit or withdrawal of securities;
- crediting of dividends and interest earned by securities held long in the account;
- charging of dividends and interest earned by securities held short in the account;
Chapter 4 – Cash and Margin Account Rules

- charging of interest on cash which the client has borrowed from the member firm;
- crediting of interest on cash balances which the client has deposited in the account;
- purchase or sale of securities in the account; and
- other miscellaneous transactions such as the payment of fees.

The cash part of a client account works as a bank statement does. When a client deposits money, a credit to the account is made. When dividends or interest are paid to the client, a credit also results. If a client sells a security, the proceeds of the sale are a credit to the account.

When a client withdraws or spends money, a debit is made to the account. Dividends or interest which the client must pay related to short securities and interest which the client pays to the firm for borrowed money are all debits to the client account. The purchase of a security results in a debit to the client account.

Depositing or withdrawing securities does not affect the cash balance in an account, but it does affect the market value and loan value of securities in the account. These valuations will be taken into account when determining the overall status of the account. The concepts of loan value and overall account status are explained below under Margin Accounts.

An example of a client account and the basic cash transactions that might affect it follows:

Example:

<table>
<thead>
<tr>
<th>Description of Transaction</th>
<th>$ Debit</th>
<th>$ Credit</th>
<th>$ Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Client makes an initial deposit of $10,000 in the account</td>
<td></td>
<td>10,000</td>
<td>10,000 CR</td>
</tr>
<tr>
<td>2 Client purchases two equity securities for $4,200</td>
<td>4,200</td>
<td></td>
<td>5,800 CR</td>
</tr>
<tr>
<td>3 Client receives dividends on the securities held</td>
<td></td>
<td>500</td>
<td>6,300 CR</td>
</tr>
<tr>
<td>4 Client withdraws $2,000</td>
<td>2,000</td>
<td></td>
<td>4,300 CR</td>
</tr>
<tr>
<td>5 Client sells one equity security for $2,500</td>
<td></td>
<td>2,500</td>
<td>6,800 CR</td>
</tr>
<tr>
<td>6 Client receives interest on credit balance in account</td>
<td></td>
<td>50</td>
<td>6,850 CR</td>
</tr>
</tbody>
</table>
II. Cash Accounts

Cash accounts are accounts where customers do not utilize financing from the dealer. Purchases and sales of securities are settled by the delivery of funds or securities, respectively, on or before settlement date.

The Cash Account Rule governs the operation of cash accounts. It is identical for all Canadian SROs and states that:

According to the IDA, “payment by a client in respect of any cash account transaction may be by:

(i) cash or other immediately available funds;
(ii) the application of the proceeds of the sale of the same or other securities held long in any cash account of the client with the member provided that the equity (trade date brokers include unsettled transactions) in such account exceeds the amount of the transaction; or
(iii) the transfer of funds from a margin account of the client with the member provided adequate margin is maintained in such an account immediately before and after the transfer.”

This rule was designed to:

• eliminate poor credit practices without restricting normal business relations with clients; and
• ensure that all member firms are on an equal basis in extending credit to clients.

Some of the credit practices the Cash Account Rule is designed to prevent are:

• the acceptance of purchase orders from clients who have no intention of making payment in full and, in fact, may not have the resources to do so;
• the acceptance of sell orders from clients who have no intention of delivering the security sold and who may in fact be making an undisclosed short sale; and
• the carrying of undermargined accounts under the guise of cash accounts.

If clients do not make settlement on time, the IA and the member firm are subject to the risk of financial loss.

Violations of the Cash Account Rule generally fall under one of two types:

1. Failure to adopt practices that ensure cash account compliance standards are achieved.

   Examples:

   (i) Cash accounts are not restricted when the money balance has been outstanding for over 20 business days.
(ii) Accounts that are required to be restricted from trading, for reasons other than that set out in (i) above, are not so restricted.

(iii) Accounts not complying with the cash account settlement requirements are not transferred to a margin account in a timely manner.

(iv) Members intentionally allow accounts that should otherwise be restricted to continue to trade on the basis that the salesperson is liable to the firm for any bad debts of their clients.

(v) A practice is followed of settlement through a subsequent sale of securities in the account without adequate equity existing in the account.

2. Trading done to avoid or artificially delay settlement.

*Examples:*

(i) A practice is made of selling and then buying on the same day, or shortly thereafter, the same or similar share position in a total dollar amount that approximates the outstanding balance and lacks economic benefit; the effect of which is to re-age the outstanding balance.

(ii) A practice is made of buying and then selling, on the same day, or shortly thereafter, a sufficient quantity of highly liquid securities, which is not in keeping with the general nature of trading in the account, and lacks economic benefit; the effect of which is to re-age the outstanding balance.

(iii) Debit balances are transferred to another account, resulting in the re-aging of the outstanding balance.

(iv) Cancel and correct journal entries are made in the client account, which result in the re-aging of the outstanding balance.

**Purchases of Securities**

If a client purchases securities, they must be paid for on or before the settlement date, normally three business days after the date of purchase. If the client does not pay, the firm will sell the securities that were purchased for the client. If the securities have increased in value, the firm will recover the amount it is owed and any balance remaining will be paid to the client. If the securities have declined in value, the firm will reduce the amount the client owes by the proceeds of the sale and will pursue the client for payment of the balance.

*Example: Securities increase in value.*

A client purchases 100 shares of Placer Dome on Monday, May 1, for $20 per share. By May 8, the client has not paid for the shares. Shares of gold producers can be volatile, so the firm decides to sell the shares, now worth $22.75 per share.
Section II: Dealing with Client Accounts

Purchase Price $2000 Debit
Commission 100 Debit
Balance client owes 2100 Debit
Proceeds of sale 2275 Credit
Commission 100 Debit
Balance 75 Credit

It is not likely that a client would not pay for a profitable purchase, but if they did not, the firm would sell the securities, pay the balance to the client and close the account. Even though the firm did not suffer a loss, the client did not operate the cash account properly so the account should be closed.

Example: Securities decline in value.

Same facts as above, except the price of Placer Dome on May 8 is $19.60.

Purchase Price $2000 Debit
Commission 100 Debit
Balance Client owes 2100 Debit
Proceeds of sale 1960 Credit
Commission 100 Debit
Balance 240 Debit

The client owes the firm $240.

Sale of Securities

If a client sells securities, they must be delivered to the firm by settlement date. If the client does not deliver the securities, the firm will buy the securities to fulfill its obligations to deliver them to the purchaser. The firm may be able to borrow the securities for a time, but will ultimately have to purchase the securities. On a sale, a decline in value of the securities will reduce or eliminate a loss if the client does not deliver the securities.

Example: Securities decline in value.

Same facts as in the purchase scenario above, except the client sells Placer Dome and the price of Placer Dome on May 8 is $18.60.
The client owes the firm $60.

**Example: Securities increase in value.**

Same facts as above, with the price of Placer Dome on May 8 at $21.00.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Price</td>
<td>$2000</td>
<td>Credit</td>
</tr>
<tr>
<td>Commission</td>
<td>100</td>
<td>Debit</td>
</tr>
<tr>
<td>Balance owed to client</td>
<td>1900</td>
<td>Credit</td>
</tr>
<tr>
<td>Cost of purchase</td>
<td>2100</td>
<td>Debit</td>
</tr>
<tr>
<td>Commission</td>
<td>100</td>
<td>Debit</td>
</tr>
<tr>
<td>Balance</td>
<td>300</td>
<td>Debit</td>
</tr>
</tbody>
</table>

The client owes the firm $300.

If a client sells securities and does not deliver them, the sale could be considered to be a short sale. In certain extreme cases, the registrant and the member firm may be sanctioned for allowing the client to make a short sale without declaring it as such.

### Special Cash Accounts

Registered accounts such as RRSPs and RRIFs are also, by definition, cash accounts. However, as the legislation governing these accounts specifically prohibits debit balances and short positions, the Cash Account Rule would not normally be encountered in their operation.

DAP/RAP accounts would usually settle in full on the settlement date, with an exchange of monies and securities between the member and the settlement agent designated by the client. Registrants must check their firm's policies in this regard, as many firms will only allow certain settlement agents to be designated by clients. They may also limit which investment vehicles can be settled on this basis (e.g., not Treasury Bills, CSBs, mutual funds, options, etc.).

The following industry requirements are minimum standards. Many member firms have more stringent policies. Registrants should check with the credit departments of their firms as to company policy.
Detailed Rules for Cash Accounts

Normal settlement for each transaction in regular cash accounts must be made by payment (for purchases) or delivery (for sales) on the prescribed settlement date.

Payment may be made by:

(i) depositing cash or applying other immediately available funds such as transferring a free credit balance in another cash account; or the proceeds from the sale of the same or other securities held long in any cash account of the client. In this case the equity, which is the value of cash plus the value of the long securities in the account (trade date brokers include unsettled transactions), must exceed the amount of the transaction being settled; or

(ii) transfer of funds from the client’s margin account. Adequate margin must be maintained in the margin account immediately before and after the transfer. The funds must be transferred from the margin account to the cash account if they are to be recognized for settlement purposes.

Isolated methods of settlement permitted by the IDA include:

(i) the settlement of a purchase of securities with the sale of the same security when the equity (excluding all unsettled transactions) in the account is less than the amount of the transaction being settled. This means that occasionally a client may buy and sell the same securities without fully paying for them. This must not take place regularly in a cash account.

(ii) the transfer of a purchase transaction in a cash account to a margin account prior to payment in full. Note that sales cannot be moved to a short margin account after the fact because of the short selling rules that must be followed at the time of sale.

Restrictions on further trading occur when any portion of the money balance is outstanding for 20 business days or more past the prescribed settlement date (this does not apply to debits balances of $500 or less). This means that the client may not enter into any transaction other than a liquidating trade in any account.

Restrictions may be lifted and trading can only resume when one of the following is done:

(i) Payment of any delinquent money balance is made in full; or

(ii) All open and unsettled transactions in any cash account of a client (who does not already have a margin account) have been transferred to a new margin account which is properly established by the completion of all necessary documentation (adequate margin must be maintained in such an account immediately after the transfer); or

(iii) The client has executed a liquidating transaction in the account with the effect that any balance owing is paid.
Dealing with Overdue Cash Accounts

The IDA, which is one of the SROs that sponsors the Canadian Investor Protection Fund (See Section I, Chapter 2), has a detailed and uniform set of minimum capital requirements which reflect, among other things, the size, type and volatility of business being conducted by member firms. The capital requirements for members who carry overdue cash accounts have the effect of tying up portions of the member's capital. As a result, such capital cannot be utilized in profitable areas of the business. Thus there is considerable financial pressure upon members to have clients make normal settlement. If accounts do become overdue, charges against the member's capital become increasingly onerous in order to make firms and their IAs insist that clients settle outstanding items immediately or to encourage firms to close out such overdue accounts.

While registrants are not normally involved in calculating a firm's capital requirements, it is important that they understand what the clients’ obligations to make payment are and how overdue accounts affect the firm. The registrant must be able to read a client status slip (or screen with account status information) and pass accurate information to clients. Clients must understand the implication of transactions which they make and when payments or deliveries of securities must be made.

The IA must also have an appreciation of the capital charges that the firm may face as a result of overdue accounts. The firm may even make a charge against the IA’s commission if the member has to provide capital for delinquencies in the IA’s client accounts.

The purpose of a capital charge on member firms is to recognize and provide for risk related to cash accounts which do not settle on the prescribed basis and which are not closed out. This risk is measured by:

(i) the length of time the transaction is overdue, which involves two methods of calculating capital charges, and

(ii) the quality of the securities in the account, which is reflected by the margin rates that are later imposed.

The cash account rule can be easiest understood by looking at the timing of transactions in an account, since the new rule is based on the “aging” of the transactions. The duration of deficiency in an account, determines how the account will treated and what funds need to be put up. There are two ways do deal with delinquent accounts depending on whether the account is overdue for less than six business days.
Cash Accounts Overdue For Less Than Six Business Days

For cash accounts overdue for a period of one to five days, the IDA requires that the securities in the account be given a weighted value and compared against the amount of the deficiency. The market value of securities determines the value available to support the cash account debit balance prior to settlement date plus six business days. The weightings are used to ensure that the relative quality of any collateral held within the account is considered when establishing what credit may be extended since market value alone is insufficient to determine collateral value. The following weightings are to be used in this calculation:

<table>
<thead>
<tr>
<th>Security Type</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities with a margin rate of 60% or less</td>
<td>100.0%</td>
</tr>
<tr>
<td>Listed securities with a margin rate of greater than 60%</td>
<td>33.3%</td>
</tr>
<tr>
<td>NASDAQ National Market and NASDAQ SmallCap Market securities with a margin rate of greater than 60%</td>
<td>33.3%</td>
</tr>
<tr>
<td>All other securities with a margin rate of greater than 60% (including over the counter bulletin board securities)</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Let’s first look at a simple example involving an account that holds only one security and is overdue three business days past the settlement date. We will assume that the security is eligible for reduced margin, so the margin rate is 30%, which according to Table 2 means that it will carry a 100% weighting.

**Example #1:**

1,000 shares of QRS were purchased at $37 on Tuesday, January 23. Three business days later, the settlement date of Friday, January 26 passed without payment by the client. A statement is mailed to the client on January 31, at which time the account is three business days overdue. In the meantime, QRS has declined from its $37 purchase price to $36.50.
Consider the account statement below:

<table>
<thead>
<tr>
<th>Cash Accounts Galore Inc.</th>
<th></th>
<th>Period ended: January 31, 200X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr. Robert Brown</td>
<td>Account Type:</td>
<td></td>
</tr>
<tr>
<td>156 Akmar Avenue</td>
<td>Regular Cash Account</td>
<td></td>
</tr>
<tr>
<td>City, Prov., W3N 2N2</td>
<td>Canadian Funds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oldest outstanding trade</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3 Business Days</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Commission</th>
<th>Value Date</th>
<th>Bought/Receive</th>
<th>Sold</th>
<th>Security</th>
<th>Entry Balance</th>
<th>Amount</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>100.00</td>
<td>Jan 23</td>
<td>1,000</td>
<td>QRS Co.</td>
<td>37,000</td>
<td>37,100 DR</td>
<td>37,100 DR.</td>
<td></td>
</tr>
</tbody>
</table>

The client owes $37,100.

The member’s equity calculation is as follows:

\[
\begin{align*}
\text{Market value of securities} & \quad \$36,500 \\
\text{Money balance} & \quad 37,100 \text{ DR.} \\
\text{Deficiency of market value} & \quad \$600
\end{align*}
\]

The member must provide the $600 deficiency from its own capital.

It is important to realize that the capital calculation becomes increasingly complex if the client has more than one cash account and/or numerous securities, since the net market value of all securities in all the client’s cash accounts is used to determine whether or not the client’s total position requires a call upon the member’s own capital.

To illustrate how the cash account rule works, let’s look at a more complicated example beginning with the account of Client X who presently has five stocks in the account:

<table>
<thead>
<tr>
<th>Table #3</th>
<th>Securities Positions for Client X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security (1)</td>
<td>Amount (2)</td>
</tr>
<tr>
<td>ABC Co.</td>
<td>1,000</td>
</tr>
<tr>
<td>DEF Co.</td>
<td>200</td>
</tr>
<tr>
<td>GHI Co.</td>
<td>5,000</td>
</tr>
<tr>
<td>JKL Co.</td>
<td>2,000</td>
</tr>
<tr>
<td>MNO Co.</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
From Table 3 we can see the status of Client X’s account. Column 4 provides us with the market values of each security, which is calculated by multiplying the number of shares (Column 2) by the market price (Column 3). From this value we can obtain the weighted market values (Column 6) by using the IDA security weightings from Table 2 (also Column 5). In Column 7 we are given the appropriate margin rates for each security. The loan value attributed to each stock is then calculated by multiplying the market value (Column 4) by the margin loan rates in Column 7.

Let’s say that Client X actually has a debit balance of $30,000 that is presently unsettled between one and five business days after normal settlement. To determine the status of an account with a debit balance between one and five business days after normal settlement we use the weighted market values of the securities from Table 2. In this case, the total weighted market value of the security positions is $49,865 (Column 6), so the account has a weighted market value excess of $19,865 ($49,865 - $30,000) and no margin would be required.

**Cash Accounts Overdue for Six or More Business Days:**

The cash account rule requires that any cash accounts that are overdue for six or more business days after the settlement date be treated as though they are margin accounts with any margin deficiency becoming a charge to the firm’s capital. This calculation is made beginning on the sixth business day after the settlement date.

By multiplying the value of securities by the applicable margin rates we can determine the value available to support a debit balance in a cash account outstanding six days or more after the settlement date. The equity in the account is the sum of the weighted net market value of securities in the account and the net money balance. If the account has a debit balance, the client should be informed of the need to make payment. If the client is short securities, delivery is required. Any negative equity becomes a charge to the member firm’s capital.

In effect, the rule treats the account as though it were a margin account with any margin deficiency becoming the charge to capital (see the section on margin accounts).

Let’s go back to our example of Client X and refer to Table 3. If there were any transactions in the account that were unsettled six business days or more after the normal settlement date, the deficiency in the account would have to be covered by a margin excess or the firm would have to cover any shortage with their own capital. In the case of Client X, let’s again assume a debit balance of $30,000. As we can see from Column 8, the total loan value of the security positions in the account is $31,100. Therefore, the account has a loan value excess of $1,100 and no margin would be required.

Note that capital charges start before the account is restricted.
Detailed Rules for DAP/COD Accounts

Normal settlement of a purchase transaction in the accounts for which the client has made arrangements with the member, on or before settlement date, for delivery by the member against payment in full by the client must be made on the later of:

(i) the prescribed settlement date; or
(ii) the date on which the member gives notice to the client that the purchased security is available for delivery.

Normal settlement of a sale transaction in a DAP/COD account for which the client has made arrangements with the member, on or before settlement date, for receipt of he security by the member against payment to the client, must be made on the prescribed settlement date.

Isolated methods of settlement include the transfer of a purchase transaction in a DAP/COD account to a margin account within six business days after the prescribed settlement date. Note that sales cannot be moved to a short margin account after the fact because of the various short selling rules that must be followed at the time of sale.

Restrictions on further trading occur when any portion of the money balance (over $500) is outstanding 5 business days (15 business days for clients situated other than in continental North America) from the date on which the transaction is required to be settled. This means that the client may not enter into any transaction other than a liquidating trade in any account (not including registered accounts such as RRSPs & RRIFs).

Restrictions may be lifted when one of the following is done:

(i) the transaction has been settled in full; or
(ii) all open and unsettled transactions in any cash account of the client (who does not already have a margin account) have been transferred to a new margin account which is properly established by the completion of all necessary documentation and adequate margin is maintained in the account immediately after such a transfer.

Overdue DAP/COD Accounts

The client obligations and capital charges for these accounts are the same as previously noted for cash account transactions that are outstanding less than six business days. However, for DAP/RAP accounts where one or more transactions are outstanding six business days or more past the settlement date, the margin treatment is different. Margin must be calculated on each transaction as though each transaction was in its own margin account.
Exceptions to the Cash Account Rule

A few exceptions to the application of the Rule should be briefly noted:

(i) **The Cash Account Rule:** The Cash Account Rule does not apply to the accounts of non-member brokers, financial institutions as defined by SRO rules, members or their related affiliated companies.

(ii) **Materiality:** Account restrictions apply only to overdue debt balances resulting from trading activity. Debits relating to such items as dividends, interest and fees do not trigger account restrictions. Trade-related debit balances of $500 or less do not trigger restrictions nor are they required to be treated like a cash account for capital purposes. In both cases, however, such debit amounts must be included in the account balance when determining the capital charges for the account.

(iii) **Guaranteed Account:** Even if a cash account is guaranteed by another account which has sufficient funds to cover the delinquent account, the overdue account must be restricted when it is 20 days or more past the settlement date. The restriction will be lifted if sufficient funds are transferred to the overdue account. The guarantor account itself will not be restricted if the guaranteed account is restricted.

(iv) **Trade Date Margining:** Capital charges described above are based on clients’ settlement date balances. A member may elect to determine these capital charges on the basis of trade date money balances and security positions. When this election is made, the charge against capital as overdue for less than six days shall commence on trade date.

(v) **Confirmation and Commitment Letters:** Capital charges do not apply if a client has provided the member on or before settlement date with an irrevocable and unconditional confirmation from a recognized clearing organization or letter of commitment from a financial institution to the effect that such organization or institution will accept delivery from the member and pay for the securities to be delivered. In such cases, settlement will be considered to be provided for by the client.
### Exhibit 9
#### Summary of Current Cash Account Rules

**Settlement Dates for Cash Accounts**
(all stock transactions, most bond transactions)

1. **Regular Cash Account**
   Three business days after the trade date.

2. **DAP Cash Account**
The later of normal settlement date or when the firm gives notice to the client that the securities are available for delivery by the broker.

**Methods of Settlement for Cash Accounts**

1. **Normally**
   By: (i) Cash;
   (ii) Sale of a security as bought or a different security provided there is equity in the account that exceeds the amount of the transaction; or
   (iii) Transfer of surplus funds from a margin account.

2. **Isolated Exceptions**
   By: (i) Transfer of a transaction in an ordinary cash account to a margin account prior to payment in full;
   (ii) Transfer of a transaction in a DAP account to a margin account within six business days after the settlement date; or
   (iii) Sale of the same security when equity in the account does not exceed the amount of the transaction.

**Restrictions on Overdue Cash Accounts**
If a money balance in the cash account is outstanding **20 business days** or more after settlement date for a regular cash account, and **5 business days** after the security is available for delivery in the case of a DAP account (**15 business days** for DAP accounts outside continental North America), the client is restricted from further transactions unless and until:
   (i) Payment is made in full;
   (ii) All open and unsettled transactions have been transferred to a **NEW** margin account;
   (iii) A liquidating transaction has been executed.

**Capital charges to Members on Overdue Cash Accounts**

**Less Than Six Business Days Overdue** – Member’s capital is charged with the equity deficiency calculated by determining the difference between (a) the net weighted market value of all settlement date security positions in the customer’s cash account(s) and (b) the net money balance on a settlement date basis in the same account(s).

**Six Business Days or More Overdue** – Member’s capital charged with margin deficiency that would exist if all of the client’s account were margin accounts.
III. Margin Accounts

Margin accounts allow clients to buy and/or sell securities on credit and initially pay only part of the full price of the transaction. The investment dealer lends the remainder of the transaction price to the client, charging interest on the loan, and then holds the securities that have been purchased by the investor as collateral. Interest on the loan is calculated on the debit balance each month on a daily basis. Member firms usually charge margin clients interest based on the rates the firm is charged on loans made to them by the chartered banks.

The term *margin* refers to the amount of funds the investor must personally provide. The firm grants credit or loans based on the market value and quality of the securities held in the account.

- A *long margin* account allows the client to partially finance a securities portfolio by borrowing money from the member firm.
- A *short margin* account allows the client to sell securities short by arranging for the member firm to borrow securities to cover the short position.

The SROs regulate the amount of credit which investment dealers may extend to clients on the purchase of securities (both listed and unlisted). SRO rules specify the requirement for margin agreements and the maximum amount the firm may finance or the maximum *loan value* of each type of security. These regulations are rigidly enforced. Some investment dealers do not accept margin accounts, and a number of other firms maintain margin requirements substantially higher than the rates covered in the following regulations.

As of the end of August 2004, Canadians had nearly $9.0 billion outstanding debt in client margin accounts, which is more than three times the level of a decade ago. As a result of the huge increase in the use of margin, investors must be aware of the potential risks and rewards of using a margin account.

The potential risks to investors of using margin are that:

- investors could lose more money than what they paid for the securities.
- investors do not have sole control over the securities bought on margin.
- investors have to be prepared to deposit more assets in the margin account with short notice if the value of the securities purchased on margin declines.

On the other hand, the potential rewards of using margin if the price of the securities purchased does not decline are that:

- investors can typically buy more securities than they could if they did not get this loan.
- investors can increase their rates of return on their assets invested.
• investors can repay these loans at anytime without penalty.
• investors can use these loans for purposes other than buying more securities.
• investors can use their margin accounts for other security transactions (e.g. short sales or options trading).

**Margin Agreements**

As described in Section II, Chapter 1 (*Account Opening Procedures*), member firms must have clients with margin accounts sign a Margin Agreement, which defines the rights and obligations of each party. Clients must:

• maintain adequate margin in the account;
• repay the amount loaned upon demand; and
• pay interest on the debt.

Under a Margin Agreement, the client gives the firm powers to take action if the client does not maintain proper margin in the account. The firm has the right to use the client’s securities as collateral against the amount the member firm has loaned to the client. The firm may, among other things:

• pledge the client’s securities to raise money to fund the amount loaned to the client;
• realize on the client’s securities and other assets to cover the purchase of short securities;
• utilize a security in the client account to make a delivery on a short sale; and
• liquidate client securities and other assets to cover any amount owing by the client.

The firm will normally give the client an opportunity to fully margin his or her account before any action is taken.

If the price of a margined security falls to the point where the account becomes undermargined, the broker issues a *margin call* (a request for sufficient funds to bring the account up to full margin). Calls may be sent to clients in writing, but due to time constraints, clients might be contacted by telephone, courier or fax.

Prior to “selling out” (i.e., selling the securities in a long margin account to cover a margin deficit) or “buying in” (in the case of a short margin account, buying the shorted securities), every effort is made to notify the client. A copy of the notice is kept on file. This documentation is considered necessary from the point of view of the firm’s relations with its clients, even though the Margin Agreement specifies that the firm has the right to sell out or buy in part or all of the client’s margined
securities without notice, should the firm find this necessary due to dramatic and adverse price fluctuations.

The IA should encourage clients with margin accounts to avoid marging close to prevailing price limits (i.e., keeping the minimum amount of margin on deposit in the account). Where additional funds or securities with excess loan value are on deposit, a cushion of protection is provided against the inconvenience of having to respond to frequent margin calls after minor adverse price fluctuations. It also reduces the possibility that the firm will be forced to sell out or buy in.

The SROs prohibit member firms from accepting transfers from other member firms of any undermargined account, unless that member holds sufficient funds or collateral to the credit of the account to margin it when it is taken over.

Long Margin Accounts

An Introduction to Margin Rates

As a result of the merger between the Toronto Stock Exchange (TSX) and TSX V, the margin rules for listed securities have been revised. In August of 2002, it was determined that TSX V’s Tier 3 and inactive Tier 2 securities should not be eligible for margin. Tier 3 securities are ineligible because they were not subject to any due diligence reviews prior to their transfer from the CDN to TSX V, and the inactive Tier 2 securities are ineligible because they failed to meet sufficient minimum listing requirements.

Exhibit 10 summarizes the maximum loan values which firms may extend for long positions in equity securities listed on any recognized Canadian or U.S. exchange, the Tokyo Stock Exchange (First Section), or the London Stock Exchange in England. Note that the margin required of the client is the complement of the maximum loan value. Loan values listed below are subject to change, as the exchanges can prescribe higher margin requirements for specific securities when warranted by prevailing market conditions.
Exhibit 10
Margining Long Positions in Listed Equities

<table>
<thead>
<tr>
<th>Share Price</th>
<th>Maximum Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities eligible for reduced margin (see below)</td>
<td>70% of market value</td>
</tr>
<tr>
<td>$2.00 and over which are not eligible for reduced margin</td>
<td>50%</td>
</tr>
<tr>
<td>$1.75 to $1.99</td>
<td>40%</td>
</tr>
<tr>
<td>$1.50 to $1.74</td>
<td>20%</td>
</tr>
<tr>
<td>Under $1.50 and securities classified as TSX V Tier 3 and inactive Tier 2 issuers</td>
<td>No loan value</td>
</tr>
</tbody>
</table>

These rates apply both at the time of the original transaction and on an ongoing basis. If the price of the margined stock falls, the loan value decreases and the client may be required to post additional margin.

Securities Eligible for Reduced Margin

In the past, a security’s option eligibility was the criterion used for reduced margin requirements. Option eligible securities are those that qualify as underlying securities for either Canadian or U.S. exchange-traded put and call options. To qualify as an option eligible security, a company’s shares must meet certain criteria:

- There must be a minimum of 3,600,000 publicly held shares.
- There must be a minimum of 1,000 shareholders.
- They must be listed on a Canadian exchange at a market price of at least $5.00.
- Market capitalization must be at least $100,000,000 (including all common and preferred shares).
- The security must have been listed for at least 12 months.

In May 2000, the IDA changed its criteria for reduced margin. Instead of granting reduced margin requirements for securities based on their option-eligibility, the IDA now produces a quarterly list of “securities eligible for reduced margin”. Inclusion is restricted to those securities that demonstrate both sufficiently high liquidity and low price volatility based on meeting specific price risk and liquidity risk measures. For instance, the list of securities eligible for reduced margin based on the first quarter of 2000 was created according to the following parameters:
### Price volatility measures
- Calculated price volatility margin interval $\leq 25\%$
- Market value per share $> 2.00$ per share

### Liquidity measures
- Dollar value of public float greater than $50$ million
- Average daily trade volume for each month in the quarter ended $\geq 10,000$ shares per day
  
  OR
  
- An equivalent average daily traded value amount for each month in the quarter ended $\geq 500,000$ per day (to accommodate high price securities)

### Other
- Listed on a Canadian exchange for six months
  
  OR
  
- Listed on a Canadian exchange for less than six months with:
  - Market value per share $\geq 5.00$
  - Dollar value of public float greater than $500$ million; and
  - In the discretion of IDA staff, the issuer company is in an industry sector known for low price volatility.

Securities eligible for reduced margin qualify for up to 70% of their value in dealer loans.

More information about margin rates will be presented further on in this section.

### Operating a Long Margin Account

To evaluate the status of a margin account, it is essential to have a clear understanding of the following concepts:

(i) **Loan Value** – the maximum amount of financing that the investment dealer will supply;

(ii) **Margin Position** – the status of an account with respect to margin requirements and actual margin deposited;

(iii) **Equity Position** – whether or not the dealer loan is fully secured by client equity in the account.
Loan Value

The basis for the financing arrangement in clients’ margin accounts is the concept of loan value, which is the amount that the dealer is willing to put up. Securities that the client may hold in his or her account have a loan value that is the complement of the margin rate prescribed by regulation. If the margin rate on a security is 2%, for example, its loan value is then 98% of its market value. In some cases a firm will establish a more conservative loan value for certain securities than the regulatory requirements; however, the concept is the same. For example, regulations may set a 30% margin rate that gives a 70% loan value, but a firm may set a higher margin rate of 40%, yielding a 60% loan value. Therefore the firm is willing to lend less than the regulations permit.

The regulatory maximum loan value is the maximum amount of financing which a member may give to a client, based on the market value of a security which the client holds in their account. For example, if a client holds a security worth $80,000 in his account and that security has a 70% loan value (30% margin requirement), the maximum amount the member firm may lend the client on that security is 70% of $80,000 or $56,000. Therefore, if a client opens a margin account and purchases the above-described security, he or she must deposit the difference between the $80,000 purchase price and the $56,000 loan value as an initial margin deposit of $24,000.

If the market value of the security rises, the customer will not have to deposit additional margin. The loan value will grow and exceed the amount of the customer’s indebtedness to the broker. For example, if the value of the security rises 5% to $84,000, the loan value of the security will rise to $58,800. If the debit balance in the account remains at $56,000, the customer will have $2,800 worth of excess margin. If the value of the security falls to, say, $75,000, the loan value of the security will fall to $52,500. The loan value of the security is then less than the debit balance of $56,000 in the account by $3,500. The broker would make a margin call to the client to request an additional deposit of this amount in order to bring the debit balance in the account and the loan value into line. See the following example for a further example of the calculation of loan value in a client account.
Loan Value Calculation

A client has a margin account, which started with a credit balance of $1,500. The client has purchased 100 shares of Plastic Co. (PLA) for $30.40. The total cost of the shares is $3,040.

Client Account Status

| Loan value of PLA ($3,040 x 70%) = | $ 2,128 |
| Balance in the account | 1,540 Dr. ($1,500 less $3,040) |
| Excess loan value | $ 588 |

The account is in good standing because the loan value of the shares exceeds the balance owed by the client (cost of the shares minus the money already in the account).

Margin Position

**Fully-margined** describes a situation where the loan value is equal to or greater than the amount financed in the account (the debit balance). The term **excess margin** is used to quantify how much greater (i.e., excess margin of $4,500 indicates that the client account is eligible for $4,500 of firm loan that is not currently required in the account).

**Undermargined** describes a situation where the loan value is less than the margin required. The terms **margin deficiency** or **margin call** quantify how much the margin required is over the loan value (i.e., a margin call of $3,000 means that the client must deposit $3,000 more to the account to meet margin requirements).

**Example:**
A margin account contains three long securities and a debit balance of $19,000. The securities are:

<table>
<thead>
<tr>
<th>Stock</th>
<th>Qty</th>
<th>Price</th>
<th>Market Value</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Ltd.</td>
<td>100 shares</td>
<td>$55/share</td>
<td>$5,500</td>
<td>$3,850 (70%)</td>
</tr>
<tr>
<td>DEF Co.</td>
<td>1000 shares</td>
<td>$6/share</td>
<td>$6,000</td>
<td>$3,000 (50%)</td>
</tr>
<tr>
<td>GHI Inc.</td>
<td>500 shares</td>
<td>$70/share</td>
<td>$35,000</td>
<td>$24,500 (70%)</td>
</tr>
</tbody>
</table>

Total Loan Value: $31,350
Debit Balance: $19,000
Excess Margin: $12,350

If the debit balance were any amount greater than $31,350, the account would be undermargined.
Equity Position

In order to determine the equity position the account balance must be combined with the total market value of all securities in the account.

Equity position = Total market value of securities [+ any Credit Balance or – any Debit Balance]

Fully-secured describes a positive equity position. If the securities were liquidated, their market value would cover any debit balance owing.

Partly-secured describes a negative equity position when securities are held in the account. If the account were liquidated, there would still be money owing.

Unsecured is the term used to describe an account with a debit balance and no securities. While similar to partly-secured, an unsecured account does not fluctuate (the only change would be that debit interest accrues, resulting in an increase in the debit balance), whereas a partly-secured account can change; for the better if market prices increase, and for the worse if they decline.

Example:

Use the same facts as above. The total market value of the securities is $46,500. Any debit balance greater than $31,350 but less than $46,500 would leave the account in an undermargined but fully-secured position. If the debit exceeded $46,500, the account would be partly secured.

Long Margin Account Case Study

For the sake of clarity, only one stock is used in the following case study. Member firms may require more margin than regulatory minimums for clients who hold concentrated positions. The risk in a concentrated account (one which has securities of one issuer or all issuers from the same industry sector) is greater as the client is more vulnerable to market events which affect that security or industry.

Day 1

A client buys 1000 shares of XYZ (a security not eligible for reduced margin) for a total cost of $20,000 (let’s ignore commissions for the purposes of this example). The client also deposits $10,000 into the account.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>XYZ</td>
<td>$20.00</td>
<td>$20,000</td>
<td>50%</td>
<td>$10,000 CR</td>
</tr>
</tbody>
</table>
The debit balance is $10,000 ($20,000 Dr for the purchase of XYZ less the $10,000 Cr for the deposit of funds) so the account is fully secured. The net equity is $10,000 ($20,000 market value less $10,000 debit balance). The account is also (barely) fully margined with a debit balance of $10,000 covered by a loan value of $10,000. There is no excess margin.

**Day 2**

The price of XYZ doubles and the account now looks like this:

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>XYZ</td>
<td>$40.00</td>
<td>$40,000</td>
<td>50%</td>
<td>$20,000 CR</td>
</tr>
</tbody>
</table>

The debit balance is still $10,000 so the account is fully secured and fully margined. There is excess margin of $10,000 (loan value of $20,000 less the $10,000 debit balance) with a net equity in the account of $30,000 (market value of $40,000 less the $10,000 debit balance).

**Day 3**

The client decides to take advantage of the extra buying power (excess margin) in the account and buys another 500 shares of XYZ for a total cost of $25,000. The closing price of XYZ is $50.00. The account now looks like this:

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>XYZ</td>
<td>$50.00</td>
<td>$75,000</td>
<td>50%</td>
<td>$37,500 CR</td>
</tr>
</tbody>
</table>

The debit balance is now $35,000 (previous $10,000 plus new purchase of $25,000) so the account is fully margined, fully secured and with excess margin of $2,500 and net equity of $40,000.

The client's original $10,000 investment now is worth $40,000 (the market value of $75,000 less the debit balance of $35,000 owing to the firm). The equity in the account has increased four times, whereas the price of the stock has increased only two and a half times. This example illustrates the benefit of **leverage**.

**Day 4**

The price of XYZ declines sharply to close at $40.00.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>XYZ</td>
<td>$40.00</td>
<td>$60,000</td>
<td>50%</td>
<td>$30,000 CR</td>
</tr>
</tbody>
</table>

The debit balance is still $35,000 so the account is fully secured, but under-margined, with a margin call for $5,000. The loan value of the account is only
$30,000, and the debit balance is $35,000. The client must deposit funds to bring the debit down to the amount the loan value will support. The net equity is $25,000, which is still two and a half times the original investment of $10,000 while the stock is at only two times the original price.

**Day 5**

The client meets the margin call by depositing $5,000. However the price of XYZ again declines sharply and closes at $30.00.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>XYZ</td>
<td>$30.00</td>
<td>$45,000</td>
<td>50%</td>
<td>$22,500 CR</td>
</tr>
</tbody>
</table>

The debit balance is $30,000 (previous $35,000 less the $5,000 deposited) so the account is fully secured. The account is undermargined (loan value of $22,500 less the $30,000 debit balance) with a margin call of $7,500 and net equity of $15,000.

**Day 6**

The client is unable to meet the margin call and the shares are sold for total proceeds of $30,000, or $20 per share.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
</tbody>
</table>

The account balance is nil, the proceeds of $30,000 being enough to eliminate the debit balance.

Notwithstanding the fact that the price of the shares is at exactly the same level as on Day 1 ($20), the client has lost the $15,000 put into the account. This occurred because of the second purchase of 500 shares of XYZ at a cost of $50 per share. The client sold these, along with those purchased for $20 per share, for proceeds of $20 per share. This example illustrates the danger of leverage, especially in an account invested in only one security. For this reason, IAs must give serious consideration as to whether a margin account is suitable for a particular client, and whether a diversified portfolio of securities is more appropriate.

**More About Margin Rates**

SROs may change regulatory margin rates as conditions warrant. Member firms may also choose to have more stringent margin rates than those prescribed by regulation. They cannot, however, have rates that are less stringent. Factors that affect the regulatory margin rates or the rates that firm’s set for themselves include:
• **Price Volatility**: the more the price is likely to fluctuate, the greater the potential losses on holdings of those stocks or bonds. SROs study the historical price volatility of securities in order to set margin rates and the security eligibility criteria that will capture the likely changes in a security’s price. Price volatility is also presently used as one the criteria for determining which securities are eligible for reduced margin according to the IDA.

• **Issuer**: the more credit-worthy the security’s issuer is, the higher the amount of money that firms are willing to lend to the purchaser. Thus, the margin rate for Government of Canada bonds is much lower than the margin rate for speculative mining and exploration stocks.

• **Term to Maturity**: the longer a security’s life, the more volatile the price may be. Therefore, Government of Canada Treasury Bills require less margin than GOC bonds with, say, 10+ years to maturity.

• **Default**: the more risky a security, the more margin clients will need to put up to purchase it. Corporate bonds for a company that is not meeting current interest payments will require more margin than comparable corporate bonds of issuers who are not in default.

### Margining Long Positions in Unlisted Equities

**A. Unlisted Equities**

Subject to the existence of an ascertainable market among brokers and dealers, the following unlisted securities are accepted for margin purposes on the same basis as listed stocks:

• Securities of insurance companies licensed to do business in Canada;
• Securities of Canadian banks;
• Securities of Canadian trust companies;
• Securities of mutual funds qualified by prospectus for sale in any province of Canada;
• Other senior securities of listed companies;
• Securities which qualify as legal for investment by Canadian life insurance companies without recourse to the basket clause;
• Unlisted securities in which an application has been made to list on a recognized Canadian exchange and approval has been given, subject to the filing of documents and evidence of satisfactory distribution, may be carried on margin for a period not exceeding 90 days from the date of such approval;
• All securities appearing on the current list of OTC margin stocks and published by the Board of Governors of the Federal Reserve System.
• Long positions of all other unlisted equities are not acceptable for margin purposes.
(b) Debt Securities

Most debt securities can be purchased on margin at margin rates that are usually significantly lower than those for listed equities. The SROs group bonds and debentures into ten categories for margining purposes. Within most categories, minimum margin requirements vary according to the quality of the credit and length of time to maturity.

The SROs also accept other categories of debt obligations for margin purposes including: Canadian bank paper (deposit certificates, promissory notes or debentures); acceptable foreign bank paper; acceptable foreign commercial, corporate and finance company notes; floating rate debt; unhedged foreign exchange; NHA insured and conventional mortgages; and mortgage-backed securities.

Detailed minimum margin requirements for all of the above categories and maturities of obligations are fully set out in SRO regulations.

Sample Margin Account

The securities shown in Exhibit 11 are margined at regulatory minimum margin rates at the time of writing. Current regulations should always be consulted for accurate margin rates, as SROs adjust margin rates periodically. In addition, member firms may have internal policies that set higher margin rates for their clients.
### Exhibit 11
**Sample Margin Account**

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Market ($)</th>
<th>Loan Value</th>
<th>Margin Required</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Price</td>
<td>Value</td>
<td>%</td>
</tr>
<tr>
<td>$10,000</td>
<td>GOC bond with 3 to 7 yrs. to maturity</td>
<td>90</td>
<td>9,000</td>
<td>98</td>
</tr>
<tr>
<td>$10,000</td>
<td>GOC bond with more than 10 yrs. to maturity</td>
<td>90</td>
<td>9,000</td>
<td>96</td>
</tr>
<tr>
<td>$10,000</td>
<td>Provincial bond with more than 10 yrs. to maturity</td>
<td>90</td>
<td>9,000</td>
<td>95</td>
</tr>
<tr>
<td>$10,000</td>
<td>Corporate bond with more than 10 yrs. to maturity</td>
<td>90</td>
<td>9,000</td>
<td>90</td>
</tr>
<tr>
<td>$10,000</td>
<td>Corporate bond with more than 10 yrs. to maturity &amp; in default on interest payments</td>
<td>60</td>
<td>6,000</td>
<td>50</td>
</tr>
<tr>
<td>500 shares</td>
<td>Stock listed on a Canadian exchange &amp; eligible for reduced margin</td>
<td>10</td>
<td>5,000</td>
<td>70</td>
</tr>
<tr>
<td>500 shares</td>
<td>Stock listed on a Canadian exchange &amp; not eligible for reduced margin</td>
<td>10</td>
<td>5,000</td>
<td>50</td>
</tr>
<tr>
<td>500 shares</td>
<td>Stock listed on a Canadian Exchange &amp; not eligible for reduced margin</td>
<td>1.70</td>
<td>850</td>
<td>20</td>
</tr>
<tr>
<td>500 shares</td>
<td>Stock listed on a Canadian exchange &amp; not eligible for reduced margin</td>
<td>1.20</td>
<td>600</td>
<td>0</td>
</tr>
<tr>
<td>500 shares</td>
<td>Stock listed on a Canadian exchange &amp; not eligible for reduced margin</td>
<td>3.00</td>
<td>1500</td>
<td>0</td>
</tr>
<tr>
<td>Security Totals ($)</td>
<td></td>
<td>54,950</td>
<td>43,280</td>
<td>11,670</td>
</tr>
<tr>
<td>Money Balance ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 DR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excess Margin ($)</td>
<td></td>
<td></td>
<td>18,280 (43,280 – 25,000)</td>
<td></td>
</tr>
</tbody>
</table>
Short Margin

The dynamics of short margin are considerably different from long margin for the following reasons:

(i) Risk;
(ii) Credit balances;
(iii) Margin required.

Risk

A short position has unlimited risk in that the security sold short could rise, at least theoretically, to infinity. The risk associated with a long position is limited to the potential loss if the security were to fall to zero. The higher potential risk must be considered in determining if short selling is suitable for a client.

Credit Balances

When securities are sold short, a credit balance appears in the short margin account. While a credit balance becomes part of the margin calculation, it is not a free credit balance and will not be eligible for withdrawal by the client or for payment of credit interest. The reason for this is that the client has an obligation to buy back the securities at a future date, which could be a date not of the client’s choosing. Since securities sold short have to be borrowed by the firm in order to make delivery on the sale, the buy in of the securities may be forced on the client because the lender demands return of the securities. Funds must be available for the purchase.

Margin Required

In contrast to a long position, margin is always required for a short position due to the risk factors involved in short selling. Thus, no loan is made to the client – the client must put up more than the value of the short sale (essentially, the client is lending money to the firm to cover potential losses in the short sale). Refer to Exhibit 12 for a listing of short margin requirements.
Exhibit 12
Margining Short Positions in Listed Equities

Short selling is the mirror image of purchasing shares on margin. The proceeds of the short sale are deposited in the client’s account. The client is required to deposit enough margin into the account, in addition to the sale proceeds, to bring the account up to the required minimum.

<table>
<thead>
<tr>
<th>Share Price</th>
<th>Minimum Credit Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities eligible for reduced margin</td>
<td>130% of market</td>
</tr>
<tr>
<td>Listed securities priced at $2.00 and over</td>
<td>150% of market</td>
</tr>
<tr>
<td>Listed securities priced from $1.50 to $1.99</td>
<td>$3.00 per share</td>
</tr>
<tr>
<td>Listed securities priced from $0.25 to $1.49</td>
<td>200% of market</td>
</tr>
<tr>
<td>Listed securities priced under $0.25</td>
<td>100% of market plus $0.25 per share</td>
</tr>
<tr>
<td>TSX V’s Tier 3 securities and inactive Tier 2 securities</td>
<td>No margin value</td>
</tr>
</tbody>
</table>

Example:

Credit Required   = (150% of the market value of the shares) = $15,000
Market Value      = (1000 x $10)                                   = $10,000
Margin Required   = ($15,000 - $10,000)                             = $5,000

Since there is already $10,000 credited to the account from the short sale, the additional margin that the client must provide is $5,000, which is the difference between the credit balance ($10,000) and the credit required ($15,000).

Typically, the additional margin credited to the account will be in the form of cash or excess margin in a long margin account. Member firms usually will not permit trading in a short margin account unless the client has deposited cash or has a pre-existing long margin account with an excess margin position.

There will be considerable variance from one member firm to another as to the policies and procedures related to short margin accounts. IAs should consult with the credit/compliance departments of their firm before dealing with these accounts.
**Example:**

**Day 1**

A client sells short 1500 of XYZ (a security not eligible for reduced margin) for net proceeds of $45,000. The closing price is $30:

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Credit Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>XYZ</td>
<td>$30.00</td>
<td>$45,000</td>
<td>150%</td>
<td>$67,500</td>
</tr>
</tbody>
</table>

The **Margin Position** is:

- Credit Required $67,500
- Less: Credit Balance $45,000
- Undermargined $22,500

The **Equity Position** is:

- Market Value ($45,000)
- Less: Credit Balance + $45,000
- Net Equity $0

The client would be required to deposit $22,500. However, assume that the client has excess margin of $25,000 and net equity of $50,000 in a long margin account with the firm. The excess margin in the client’s long account will cover the short margin account, so a margin call is not required.

**Day 2**

There is a takeover offer for XYZ and the stock closes at $60:

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Credit Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>XYZ</td>
<td>$60.00</td>
<td>$90,000</td>
<td>150%</td>
<td>$135,000</td>
</tr>
</tbody>
</table>

The **Margin Position** is:

- Credit Required $135,000
- Less: Credit Balance $45,000
- Undermargined $90,000

The **Equity Position** is:

- Market Value ($90,000)
- Less: Credit Balance + $45,000
- Required to secure $45,000

A margin call is issued for $65,000, which is the difference between the margin required in the short account ($90,000) and the excess margin in the long account ($25,000).
Both accounts are liquidated (at current levels), if the client cannot meet the margin call. The client would end up with net equity of only $5,000, compared to the $50,000 that existed prior to the short sale ($50,000 – $45,000 = $5,000).

**Combination of Short and Long Positions in a Margin Account**

Some member firms will carry short and long positions together in the same margin account. Determining the net margin position requires combining the loan value and credit required. The credit required can be thought of as negative loan value.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Security</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
<th>Mgn Rate</th>
<th>Loan Value/ Credit Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>ABC</td>
<td>$20.00</td>
<td>$20,000</td>
<td>50%</td>
<td>$10,000</td>
</tr>
<tr>
<td>(1500)</td>
<td>(short)</td>
<td>XYZ</td>
<td>$30.00</td>
<td>150%</td>
<td>($67,500)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$45,000</td>
<td></td>
<td>($57,500)</td>
</tr>
</tbody>
</table>

The *Margin Position* is:

- Credit Required $57,500
- Less: Credit Balance 25,000
- Undermargined $32,500

The client must add to his or her credit balance to bring it to the required $57,500.

**Special Margin Situations**

**Restrictions**

A client whose account is undermargined may not withdraw funds or securities, nor are such withdrawals permitted if they would cause the account to become undermargined. If an undermargined account is not fully margined (sufficiently covered) within 20 business days, the account will be restricted to only those trades which have the effect of reducing the margin deficiency. In practice, however, it is unlikely that an undermargined account would be allowed to remain delinquent for 20 days or more; rather, the firm would sell out the account.

**Convertible Bonds/Debentures**

These securities are a hybrid in that part of their value comes from their yields and part from the market price of the securities into which they are convertible. For this reason, there is a complex formula for calculating margin on convertible bonds and debentures.
Hedge Positions

Implementation of a particular trading strategy may involve the purchase of one security and the simultaneous sale of another into which the long security is convertible. An example would be the purchase of a convertible bond or debenture and the sale of the equivalent number of shares into which the long position is convertible. In addition to regulations, individual firms have specific policies and procedures to govern such activity and IAs should refer to their credit and/or trading departments.

Guarantees

Subject to completion of written documentation in the prescribed form, excess margin in the account of one client may be used to cover the margin required in the account of another client. Care must be taken to ensure that the proper documentation is obtained in order to accomplish what is really intended. If the object is that A and B would guarantee each other, two separate guarantee forms are required (one from A to guarantee B’s account, and one from B to guarantee A’s account). IAs should take particular note that under no circumstances may they be part of a guarantee/guarantor relationship with clients.

It is recommended that IAs consult with their firms’ credit or compliance departments before putting in place any guarantee/guarantor relationship.

Concentration

Regulations prohibit the granting of margin on any security which is part of a control block, which is defined as a sufficient number of shares to materially affect control of that issuer.

In addition, most member firms will have specific policies limiting the amount of margin which they will allow on a given security or group of securities of the same or related issuers. The regulators levy a “securities concentration charge” against member firms that have a high exposure to a single security, or group of related securities, of the same issuer. This charge is designed to protect firms against substantial decreases in value in a short period of time because it is difficult to quickly liquidate large holdings of a single security without adversely affecting the marketplace. Also, in the event of major fluctuations in the marketplace, such as a stock dropping in value to the point where it is no longer marginable, credit extended to holdings concentrated in a single security can adversely impact a firm’s capital.

IAs should consult with their firms’ credit or compliance departments before putting on margin positions where large quantities and/or few different securities are contemplated.
Unlisted Securities Sold Short

Unlisted equities that are not included in the group acceptable for long margin (see above) are still subject to minimum credit balance requirements of the SROs.

Options

The margining of options and related positions is complex. The reader is directed to the Options Licensing Course, the IDA Rulebook or the Montreal Exchange Rulebook.

IV. Free Credit Balances

Free credit balances include monies received from, or held for the account of, clients by a firm that may result from:

(i) a deposit to pay for securities that have not yet been purchased;
(ii) proceeds of securities that have been sold, if the securities that have been sold were already held in the account or have been properly delivered by the client;
(iii) income from securities held in the account, such as dividends or interest paid, which has not been reinvested.

With the exception of registered accounts (RSPs, RIFs, etc.), client free credit balances may be used by the member firm as a financing source for its business. Clients must be so advised on monthly statements. A sample disclosure used by one firm is:

Any free credit balance represents funds payable on demand, which, although recorded in our books, are not segregated and may be used in the conduct of our business.

Legislation governing registered accounts does not permit free credits to be left with investment dealers, unless satisfactory arrangements have been made concerning bonding or insurance and have been approved by the Administrator. Most member firms have arrangements with the legal trustee to hold such funds.

In certain situations where a registrant maintains a securities account for a client which has a free credit balance and a commodity futures account for the same client which contains a debit balance of $5,000 or more, the registrant must transfer the free credit balance from the securities account to the commodity futures account for the same client to eliminate or reduce the debit balance.

The Quebec Securities Act provides that credit balances appearing in the accounts of clients and not given in guarantee are funds payable on demand. In no case may a registrant use them except to finance his or her working capital and even then
only on the conditions prescribed by the regulations in *The Quebec Securities Act*. The member firm must pay a reasonable interest rate, send the client a statement of account indicating that the funds are payable on demand and are used to finance the registrant’s working capital, and must keep the funds only temporarily with a view to investing them in securities.

**V. Summary**

Operation of cash and margin accounts requires that registrants be familiar with all applicable rules regarding settlement procedures and dealer loans. Although leverage provides the opportunity for greater returns than cash purchases or short sales, risk can be unlimited. Registrants must ensure that clients are fully aware of all settlement rules and of the risks involved in buying or short selling securities using dealer loans.

Registrants must also be aware of the restrictions applicable to use of client free credit balances.
SECTION II : DEALING WITH CLIENT ACCOUNTS

Chapter 5

Communications with Clients

Introduction

Since there are stringent regulatory requirements with respect to sales literature or advertising, IAs should exercise care whenever distributing material to clients. Any written material given or sent to clients recommending a specific security may be considered to be sales literature, and should be properly authorized before distribution. Where the firm sends material regarding securities to employees, the IA should ensure that material which is intended for internal use only is not shown to clients or divulged in any manner.

IAs should be particularly careful with respect to requirements for information regarding mutual funds, as there is very detailed legislation and guidelines as to what must be included in mutual fund sales literature. No information concerning mutual funds, particularly mutual fund performance, should be distributed unless it has been authorized by a person fully familiar with the regulatory requirements for mutual fund disclosure.

IAs must also communicate with clients in response to clients’ interest in special products. IAs must be aware of required disclosure of product characteristics and risks and when that disclosure must be made.

Finally, IAs may have to deal with clients who have complaints or disputes with the IA or firm. These communications should be handled with care and in accordance with regulatory guidelines.

Learning Objectives

After reading this module you should understand:

• regulations concerning sales communications
• what is required in a trade confirmation
• guidelines for mutual fund advertising
• requirements for disclosure of fees in sales literature
• guidelines for use of the Internet in advertising dealer/advisor services or individual securities
• requirements for disclosure of characteristics and risks of certain investment products
• how to deal with client complaints

I. General Regulations and Guidelines for Sales Literature

The IDA defines advertising or sales literature as:

“television or radio commercials or commentaries, newspaper and magazine advertisements or commentaries, any published material promoting the business of a Member and any other sales literature disseminated through the communications media, and sales literature includes records, videotapes and similar material, market letters, research reports and all other published material, except preliminary prospectuses and prospectuses, designed for, or used in a presentation to a client or a prospective client, whether such material is given or shown to him and includes a recommendation in respect of a security.”

Firms typically provide registrants with a great deal of material containing information about investments. These materials include:

(i) research reports which are detailed reports on an issuer of securities containing information about the company’s business, its management, its plans and strategies, past financial and market performance and other relevant facts. Research reports might also address several companies in a particular market sector such as financial services or gold mining;

(ii) updates on company performance or news affecting a company’s business;

(iii) new product information such as a description of the nature of an installment receipt or income trust; and

(iv) notices of availability of prospectuses or preliminary prospectuses for a new issue of securities.

Salespersons should be aware that not all information that is provided to them can be forwarded to clients. Care should be taken that material considered to be for “internal use only” is treated accordingly. Additionally, salespersons may not create their own reports or advertising and distribute them to clients without the approvals described below. All written correspondence with clients should be approved by appropriate supervisory personnel and should be retained for a period of at least two years.
SRO rules provide that all advertising and sales literature be approved by a partner, director, branch manager or officer who has been designated by the member firm as responsible for this function. This person must ensure that the material meets regulatory standards, which require, among other things, that:

- the material be true and not false or misleading;
- there be no unjustified promise of specific results;
- there be no unrepresentative statistics to suggest unwarranted conclusions;
- the material may not contain opinions or forecasts not clearly labeled as such;
- the material must fairly present the potential risks to the client.

Recall from the chapter on registration that in most provinces registrants cannot advertise their registration with the provincial securities regulator.

II. Mutual Fund Sales Communications

Mutual fund salespersons will frequently communicate with clients or potential clients verbally or through the distribution of advertisements or other sales communications. Rules governing the permissible content of advertising and sales communications are contained in National Instrument 81-102 Mutual Funds. Similar provisions are also contained in MFDA Rule 2.7 Advertising and Sales Communications.

A sales communication is any type of oral or written communication used to induce the purchase of securities issued by a mutual fund. An advertisement is a sales communication that is published or designed for mass distribution through public media, including websites that promote the business of a member firm. Members are required to ensure that such websites comply with the general restrictions regarding false or misleading advertisements and sales communications.

Under NI 81-101 Mutual Fund Prospectus Disclosure, mutual fund dealers can deliver fund prospectuses, amendment documents and trade confirmations to investors via a system called “Smart Prospectus”. This system creates customized prospectuses for each investor that contains only information about specific funds purchased by that investor, rather than detailed information on the entire fund company.

General Requirements

Securities regulation specifies many attributes that shall and shall not be applicable to sales communications. Sales communications shall not:

- contain an untrue or misleading statement of fact;
• omit a fact which is necessary to keep the communication from being misleading;
• include any statement that conflicts with information contained in the preliminary or final simplified prospectus, or the preliminary or final annual information form of the mutual fund.

The following guidelines should be followed to avoid misleading statements:

• statements are misleading if they lack explanations, qualifications, limitations or other statements necessary or appropriate to make such statement not misleading;
• representations about past or future investment performance will be misleading if they:
  – portray past income, gain or growth of assets that are not justified;
  – contain representations about security of capital or expenses that are not justified;
  – contain representations about future gains or income which are not justified;
  – indicate that past investment performance is a predictor of future gains or income;

Statements about the characteristics or attributes of a mutual fund are misleading if they:

• address only benefits connected with services or methods of operation and do not give equal prominence to risks or limitations;
• make exaggerated or unsubstantiated claims about management skill or techniques, characteristics of the fund or an investment in securities issued by such fund, services offered by the fund or its manager, or effects of government supervision; or
• make unwarranted or incompletely explained comparisons to other investment vehicles or indexes.

Sales communications may make comparisons among funds or between the fund and indicators such as the consumer price index, stock, bond or other index, average or any guaranteed investment certificate or other certificate of deposit, real estate or any other investment of any kind. However these comparisons must:

• include all facts which would materially alter the conclusions a reader would draw from the comparison;
• present data from the same time periods for each item being compared;
• clearly explains any factors necessary to make the comparison fair and not misleading; and

In the case of comparison with a benchmark:
• the benchmark must have existed and been widely recognized and available during the period for which the comparison is made, or
• the benchmark did not exist for all or part of the period, but a reconstruction or calculation of what the benchmark would have been during that period, calculated on a basis consistent with its current basis of calculation, is widely recognized and available.

Sales communications must also:

• bear the name of the person or entity which prepared the sales communication, and may bear the name of the registered dealer distributing the sales communication;
• be in at least 10 point type, including all warnings required to be in the sales communication; these warnings include the admonition that important information about the fund is contained in the prospectus, where a prospectus may be obtained, and that the prospectus should be read;
• state that any rate of return or table illustrating the potential effect of a compound rate of return is used only for the purpose of illustrating the effect of the compound growth rate and is not intended to reflect future values of the mutual fund or returns on investment in the mutual fund;
• make sure that any mutual fund referred to as a money fund, cash fund or money market fund satisfies the definition of such a fund and intends to continue to satisfy the definition; and
• ensure that any fund referred to as a “no load” fund properly qualifies as such.

Use of Performance Data

Performance data is addressed at length in NI 81-102, and is defined as a measurement or description of the investment performance of a mutual fund. Performance data includes ratings, rankings, quotations, and discussion or analysis of rates of return, yield, volatility or other characteristics of the fund. As performance data is potentially so varied, performance data may not be included in a sales communication unless it also includes standard performance data. Standard performance data is a calculation of current and effective yield for money market funds, and total return for other mutual funds. The specifics of these calculations are mandated in NI 81-102.

There are guidelines that address the use of performance data in sales communications, but the overall principle is that any use of this data should not be misleading.

If performance data is included in a sales communication, it must:

• contain standard performance data;
• include all elements of return;
• not reflect any data for a time period prior to the time the securities were distributed to the public under the terms of the prospectus;
• only relate to funds under common management, or to funds with similar investment objectives, or with an index or average;
• reflect any material changes to the fund during the performance measurement period. These changes might include changes in the fund’s management, investment objectives, whether it continues to meet the definition of a money market fund, changes in ownership of the fund, or changes in fees and other charges related to the fund. The disclosure should reflect how the change would have or could have affected the fund’s performance had the changes been in effect throughout the performance measurement period;
• clearly identify the time periods for which the performance data is calculated;
• indicate, where appropriate, how more up-to-date standard performance data may be obtained;
• contain only ratings or rankings provided by an independent organization, and where ratings or rankings are quoted, standard performance data must also be provided;
• contain only credit ratings of the mutual fund’s portfolio prepared by an independent organization, and only the most recent rating may be used. If the fund is rated by more than one independent organization, the lowest rating among those calculated must be used; and
• performance data may not be used in broadcast advertisements.

Warnings

Sales communications that include performance data must also contain certain warnings to users of the communications. The warnings must advise that:

• mutual funds are not guaranteed;
• performance data represents past performance and is not necessarily indicative of future performance;
• indicated rates of return do not take into account sales, redemption, distribution or optional charges or income taxes payable;
• commissions, fees and expenses may be deducted; and
• investors should read the prospectus before investing;

Standard Performance Data

Standard performance data takes two forms. For money market funds, standard performance data is current yield or both current yield and effective yield. For other mutual funds, standard performance data is total return calculated following the specifications in NI 81-102. Standard performance data is useful because it
allows investors to make comparisons among different funds, using information
generated on the same basis. Standard performance data must be printed as
prominently as any other performance data used in a sales communication.

Standard Performance Data

For money market funds, standard performance data:
(i) must describe the specific application of the general assumptions inherent
in the required calculation; and
(ii) must warn users that the yield information assumes reinvestment of
distributions and does not take into account sales, redemption, or
distribution or other charges which might reduce the security holder’s
returns; and
(iii) must be calculated for the most recent 7-day period which is practical for
publication. The 7-day period may not be more than 45 days prior to the
date of the advertisement or other sales communication.

For other funds, standard performance data:
(i) must describe the specific application of the general assumptions inherent
in the required calculation; and
(ii) must warn users that the rates of return are historical annual compounded
total returns including changes in share or unit value. The returns assume
reinvestment of distributions and do not take into account sales,
redemption, or distribution or other charges which might reduce the
security holder’s returns; and
(iii) must be calculated for the 1, 3, 5, and 10 year periods ending on a calendar
month end not more than 45 days prior to the date of publication of the
advertisement or 3 months before use in any other sales communication.

For asset allocation services, standard performance data:
(i) must describe the specific application of the general assumptions inherent
in the required calculation for both the asset allocation service and the
underlying funds; and
(ii) must warn users that the rates of return are historical annual compounded
total returns assuming the investment strategy recommended by the asset
allocation service and after deducting fees for the service. The returns are
based on the performance of the underlying funds including changes in
share or unit value, the returns assume reinvestment of distributions and
do not take into account sales, redemption, or distribution or other charges
which might reduce the security holder’s returns.
Other Required Disclosure – Mutual Funds

In 1998 the CSA introduced NI 81-105 and its Companion Policy (81-105CP), Mutual Fund Sales Practices, which replaced parts of National Policy 39 that dealt with mutual fund sales practices. NI 81-105 gives strict guidelines for the disclosure of fees or other incentives paid to distributors by the organization of a mutual fund in sales communications.

NI 81-105 requires:

(i) Disclosure of Sales Practices: A mutual fund must provide in its prospectus or simplified prospectus a complete description of (a) all compensation payable by members of the organization of the mutual fund to all principal distributors and participating dealers of the mutual fund; and (b) the sales practices followed by the members of the organization of the mutual fund for distribution of securities of the mutual fund.

(ii) Disclosure of Equity Interests: A mutual fund must disclose in its prospectus or simplified prospectus the amount of any equity interest that (a) a member of the organization of the mutual fund has in a participating dealer; (b) a participating dealer and associates of the participating dealer, in aggregate, have in any member of the organization of a mutual fund; and (c) a representative of a participating dealer and associates of the representative, in aggregate, have in any member of the organization of the mutual fund.

For information only:

If a member of the organization of a mutual fund is not a reporting issuer and the securities of the member are not listed on a Canadian stock exchange, the mutual fund is not required to provide the disclosure required in (ii) (c) if it discloses (a) the aggregate equity interests held by all representatives of a participating dealer and their respective associates in the member of the organization of the mutual fund; and (b) the equity interests held by a representative of a participating dealer and associates of the representatives if the representative and his or her associates have direct or indirect ownership of securities representing more than five percent of any class of voting securities, equity securities or partnership units of the member of the organization of the mutual fund.

As of February 2003, a ruling by the Saskatchewan Financial Services Commission exempted mutual funds in Saskatchewan from the requirement to deliver both interim and annual financial statements. Firms are required, however, to make the financial statements available to any security holder who requests them.

The prospectus or simplified prospectus of the mutual fund must also disclose:

(i) the range of rates of commissions that may be paid; and
(ii) the method of calculation used in determining the amount of those commissions; and
(iii) for trailing commissions, this disclosure must include the relevant times or time period used in determining the amount of the trailing commissions.

Sometimes the organization of a mutual fund may pay a dealer the direct costs incurred by the dealer relating to a sales communication, investor conference or investor seminar prepared or presented by the dealer. The identity of all parties paying for a portion of the costs must be disclosed in the sales communication or, in writing, to persons attending the investor conference or investor seminar.

III. Electronic Communications

The Internet has made access to investment information faster and easier, but has also made sales communications more difficult to control, since they can now be very broadly disseminated. The basic rule regarding electronic communications is that disclosure laws for traditional means of communication also apply to electronic means. Therefore, electronic communications:

• cannot be misleading;
• cannot be used to tip or leak material information; and
• must comply with securities laws.

Two major areas of investment activity that are affected by the increase in electronic communications are:

• company issuers (new offerings, investment information, mandatory disclosure filings); and
• dealers/advisors (trading and advising on the Internet).

Issuer Disclosure and Delivery

Companies must comply with disclosure requirements in all jurisdictions in which they are reporting issuers. Note that there may also be consideration of the laws of foreign jurisdictions, since the Internet can be accessed from anywhere in the world. This is especially true for offering documents, such as prospectuses. For instance, if an issuer resident in British Columbia distributes securities to a purchaser that resides in California, the issuer must comply with the laws of all applicable jurisdictions - in this case, the laws of British Columbia, the state laws of California and the federal laws of the U.S.

Effective January 1, 2000, National Policy 11-201 Delivery of Documents by Electronic Means, was implemented as a policy in most CSA jurisdictions. It was adopted concurrently with NP 47-201 Trading Securities Using the Internet and
Other Electronic Means. According to the CSA, the regulatory focus concerning information delivered by issuers through electronic means should be on effective delivery, as developed in an interpretive release issued by the SEC. The basic principle of effective delivery is that the distribution of information through electronic means must result in the delivery to the intended recipients of information equivalent to information provided in paper form.

System for Electronic Document Analysis and Retrieval (SEDAR)

This site (www.sedar.com) contains electronic copies of mandatory filings for all public companies. SEDAR is an Internet-based system developed by the CSA to facilitate:

(i) electronic filing of securities information and the electronic payment of filing fees;
(ii) public dissemination of securities information collected through the filing process; and
(iii) electronic communication between filers, filing agents and the regulatory authorities.

See Section III, Chapter One for more information on document filing through SEDAR.

Company Websites

Most securities issuers also maintain corporate websites to disclose investor relations information electronically. However, because not all investors have access to the Internet, and those that do may not realize that information has been posted, disclosure cannot be solely via the Internet. Therefore, issuers must continue to use traditional (i.e., printed) means of dissemination.

The SROs recommend that more than just mandatory filings be present on the websites of their listed companies. As an example, guidelines for TSX-listed companies are included as supplemental reading in Appendix B.

Registered representatives may be permitted to set up their own websites, as securities regulators do not prohibit this activity. However, given that websites are considered a form of advertising, the format and content on a registrant’s site must receive prior approval from a designated officer, director or branch manager. The firm is also required to maintain an approved hard copy of all material appearing on the site. Additionally, the firm must have IDA approved written procedures in place that refer to the supervision of such websites.
Internet Trading and Advising

In 1997, the B.C. Securities Commission issued a notice that reminded securities market participants that registration and disclosure requirements also apply to persons who trade in or advise about securities through any medium, including the Internet, if they are located in the province or offering or providing advice about securities to investors in B.C. Where a trade or distribution occurs in more than one jurisdiction, the participants must comply with the rules of each jurisdiction.

“A communication made on the Internet may reach both intended recipients and anyone else in the world with Internet access. Where such a communication is made by or directed at a resident of B.C. or a person located in B.C., the registration and prospectus requirements of the Securities Act will apply.”

The notice also states that if the Internet communication is not intended to be directed at a B.C. resident or a person located in B.C., disclaimers should be included at the beginning of the communication to indicate this, either by stating this directly or by indicating the jurisdictions in which the securities being offered are available.

National Policy 47-201 came into force in January 2000. It deals with issues of jurisdiction, registration and other statutory requirements in connection with trading and offering securities via electronic means. Of particular concern is the interjurisdictional nature of the Internet. As with company disclosure, the same regulations apply to Internet trading and advising as to traditional forms of these activities. Registration is required and the applicable laws depend on the location of the advisor and the client.

The policy states that:

(i) Persons or companies offering or soliciting trades of securities on the Internet are considered to be in the jurisdiction of any person or company who can access that document. The exceptions to this would be if there is a disclaimer, stating that the security is not available to residents of a certain jurisdiction, or if reasonable precautions are taken not to sell to anyone in a certain jurisdiction.

(ii) The act of posting a prospectus or offering document on the Internet is considered an act in furtherance of a trade in that jurisdiction. Therefore the person or company posting the document must satisfy the registration requirements of that jurisdiction or refer all inquiries to a registered dealer in that jurisdiction.

(iii) A person or company located in B.C., Alberta, or Quebec is considered to be trading within those jurisdictions even if they are distributing securities entirely outside of those jurisdictions through the Internet. They are therefore subject to the regulations of the applicable jurisdiction.
(iv) Canadian issuers and market participants who post material on a website that can be accessed by persons or companies in foreign jurisdictions must consider the securities laws of those jurisdictions.

(v) Names of all persons or companies that have received a copy of the preliminary prospectus (paper or electronic form) must be recorded.

(vi) The posting of new information on a website during a period of distribution may be construed as advertising, which is subject to restrictions in certain jurisdictions.

(vii) Transmission of a video “road show” (presentation about a security) over the Internet during a waiting period must comply with securities regulations. The information must be consistent with that in the applicable preliminary prospectus; a copy must be made available to all viewers of the transmission; access to the roads how should be controlled to ensure all viewers are identified and have been offered a preliminary prospectus, and all viewers must agree not to copy, download or further transmit the transmission.

Salespersons should be aware that all written communications with clients are to be monitored by their firms. These communications, including e-mail, must meet regulatory standards described above under “general regulations and guidelines”. Salespersons should have communications approved by a branch manager or other supervisor before they are sent, if there is any question about the content of the communication. Copies of approved communications must be maintained for at least two years.

IV. General Disclosure Requirements

Disclosure When Acting as Principal

Firm registrants intending to trade as principals in securities transactions with non-registrants must disclose this information in their communications (including circulars, pamphlets, letters, telegrams or advertisements) and on every trade confirmation. Such statements do not prevent a registrant who acts as a principal from subsequently acting as an agent in the trading of such a security. If a registrant does not make the required disclosure of his or her principal status, the person who either bought or sold the security may rescind the contract, provided in the case of a purchase, that he or she still owns the security.

A registrant that publishes written material containing a recommendation in respect of a security is required to state whether the registrant or any of its officers or directors has within the past twelve months assumed an underwriting liability, or provided financial advice for, consideration to the issuer. The registrant, its officers or its directors must also disclose whether they will receive any fees as a result of that recommendation.
Disclosure When Selling Securities Short

Under the Securities Acts of the provinces, other than New Brunswick and Prince Edward Island, it is an offence for any person intending to sell listed or unlisted securities short not to declare such an intention. All of the exchanges require their Participating Organizations (securities dealers with access to the exchange) when accepting an order for the sale of a security, to ascertain whether such sale is a short or a long sale. The Quebec Securities Act provides that “No person may sell a security short without previously notifying the dealer responsible for carrying out the transaction.” The Acts of the remaining provinces contain similar provisions. While these provisions place a duty on the client to declare that he or she is selling short, there is an onus on the broker to make inquiries at the time the order is placed and to be satisfied that the client’s disclosure is accurate.

Disclosure of Conflicts of Interest

In addition to the product-related disclosures, a Conflict of Interest Policies disclosure document must be provided to all new clients of any member firm which is engaged in dealing, advising or underwriting of its own securities or those of a related or connected issuer. A revised version must be provided to each client when there is a significant change in the information provided in the statement of policies, which may include:

- the policies of the member firm regarding activities it is prepared to engage in as an advisor, dealer and underwriter in respect of securities of the registrant or those related to the registrant;
- a list of related reporting issuers (or equivalent in other jurisdictions) of the member and a description of the relationship with each;
- a statement in prescribed form advising clients of the obligations of dealers and advisors regarding trading in or advising with respect to their own securities or securities of certain other issuers to which they (or parties related to them) are related or connected.

Legislation set out in most provincial securities acts also requires the disclosure of conflicts of interest in research reports. Dealers are required to disclose in any research report or other similar document that makes a recommendation about a security whether the dealer or any of its officers or directors:

- has within the past 12 months assumed an underwriting liability with respect to the securities;
- has within the past 12 months provided financial advice to the issuer for consideration; or
- expects to receive any fees as a result of the recommended action.
The legislation requires the disclosure to be prominent and not included in the fine print or notes on the back pages of a report and that the font type used be “not less legible” than that used in the body of the report. The IDA recommends that member firms check the appropriate sections of the legislation applicable to any reports or other material they are issuing.

Disclosure Relating to Products

Similar to the requirement to provide the purchaser of a new issue with a prospectus, certain products require additional disclosure to clients. IAs are obliged to make inquiries as to their responsibilities in this regard before proceeding to deal in these products:

(i) **Initial Public Offerings**: Investors in newly issued securities must be provided with a prospectus. The prospectus provides a detailed description of the securities offered and a description of the issuing corporation, including its history, operations, and audited financial statements. It is important for registrants to have a fundamental understanding of the content of a prospectus and also to understand why it is imperative that all purchasers of new securities receive it.

(ii) **Mutual funds**: If purchasing a fund for the first time, purchasers must receive a fund prospectus prior to, or concurrent with, the first trade confirmation. Some issuers provide one document that covers their entire family of funds.

(iii) **Strip bonds and strip coupons**: All first-time buyers of strip bonds must be given an information document outlining the special investment characteristics of these securities. These features include:

- price volatility;
- income tax consequences;
- extent of a secondary market; and
- custodial arrangements of strip bonds and coupons.

The above disclosures must be made prior to the entering of the first trade.

(iv) **Insurance Products**: A generic disclosure document is required.

(v) **Derivatives**: Disclosure documents are required for each type of derivative, and they are usually given to the client when an options or futures account is opened.

IAs must also be aware that some products have additional educational and registration requirements, which are prerequisites to deal in them.
Leverage Disclosure

On June 17, 2002, the IDA enacted By-law 29.26 **Leverage Disclosure**, in response to National Instrument 33-102 **Regulation of Certain Registrant Activities**, which states that a registrant is not required to comply with the leverage disclosure rules of the Instrument if the registrant complies with the corresponding rules of a recognized SRO. The By-law requires registrants to provide a Leverage Risk Disclosure Statement: (1) at the time a new account is opened, (2) when a recommendation is made to purchase securities with borrowed funds, or, (3) when the registrant becomes aware that the client intends to purchase securities with borrowed funds. The Statement does not have to be provided if it has been given to the client within the preceding six-month period, or if the purchases are made through a margin account that is operated in accordance with the SRO rules.

The Leverage Risk Disclosure Statement should include the following words:

> “Using borrowed money to finance the purchase of securities involves greater risk than using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same even if the value of the securities purchased declines.”

V. Communicating Trading Information to Customers

Confirmation of Trades

SRO regulations require that after the execution of a transaction the firm promptly send the client a confirmation showing at least the following information:

(i) the quantity, description and price of the security;
(ii) whether the firm was acting as principal or agent;
(iii) if acting as an agent in a transaction, the name of member from or to whom the security was bought or sold;
(iv) the date on which the transaction was done and the name of the stock exchange where executed, if applicable;
(v) any commissions charged; and
(vi) the name (or ID#) of the Registered Representative who took the order.

On January 19, 2000, the IDA Board of Directors approved an amendment that permitted member firms to send client confirmations by electronic means. The amendment relied on provisions outlined in National Policy 11-201 **Delivery of Documents by Electronic Means**.

There are four components to electronic delivery that must be satisfied in order to constitute a good delivery. Clients must receive notice of delivery prior to actually
receiving the document by electronic means, and have easy access to it. In addition, the document must be delivered unaltered and uncorrupted in any shape or form, and member firms must obtain evidence of successful delivery.

In certain provinces equity shares without voting rights, or with limited or restricted voting rights, called “restricted shares”, must be designated and described as such. Subject to certain exceptions, member firm confirmations must include such restrictive share designations.

Under no circumstances may a registrant interrupt or delay the delivery of a trade confirmation to a client without written client instructions and the specific approval of the compliance department or senior management of the employer. This would include instructions such as: “Hold Mail”; or “send c/o IA at the branch”.

**Account Statements**

Member firms must send an account statement to each client with any security positions or money balances at least quarterly. Firms are also required to send a statement of account at the end of each month in which there has been any activity.

In February 2003, the IDA approved amendments to Regulation 200 dealing with account statements. Member firms are no longer under the obligation to prepare and issue monthly statements resulting from the recording of relatively immaterial entries in a customer’s account, such as regular dividend or interest payments.

Under the amended regulations, firms are required to issue statements:

- monthly for all customers in whose account there was an unexpired and unexercised commodity futures contract option, open commodity futures contract, or exchange contract at the month end;
- monthly for all customers who have affected a transaction, or if the firm has modified the balance of securities or cash in the customer’s account, unless the entries refer to dividends or interest; and
- quarterly for all customers having any debit or credit balance or securities held (including securities held in safekeeping or in segregation) at the end of the quarter.

A statement of account must show at a minimum:

(i) all trading activity in the month;
(ii) opening and closing money balance;
(iii) transfers of funds and securities;
(iv) payment of interest or dividends; and
(v) the quantity and description of each security, including “segregated” securities (fully paid securities held by the firm for the client, and separate
from its own securities) or held in the client’s name and stored by the company.

(Note that the latter situation is often, and improperly, referred to as “safekeeping”. True safekeeping requires not only that the securities be held in the client’s name, but that a “safekeeping agreement” exists between the firm and the client.)

The most common type of client account is the Ordinary Cash Account. A Monthly Statement of a fairly active client is shown on the next page. A Delivery Against Payment (DAP) Account is a form of cash account that additionally has standing delivery instructions (usually to a bank or trust company, or member firm) printed under the account name and address. The numbers shown in brackets on the statement are references to specific examples of items highlighted in the explanation that follows. The net amounts for security transactions are rounded off for simplicity and do not reflect exact commission charges.
## Financial Summary

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>OPENING BALANCE</th>
<th>CLOSING BALANCE</th>
<th>MARKET VALUE</th>
<th>EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH CDN</td>
<td>0.00</td>
<td>892.50</td>
<td>11,500.00</td>
<td>12,392.50 (12)</td>
</tr>
</tbody>
</table>

## Your Portfolio

<table>
<thead>
<tr>
<th>HELD IN YOUR ACCOUNT</th>
<th>EST. PRICE DEC. 31</th>
<th>ESTIMATED MARKET VALUE</th>
<th>SEGREGATED/HELD IN YOUR NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td>800 ALPHA TECHNOLOGY LTD. (11)</td>
<td>8.00</td>
<td>6,400.00</td>
<td>800</td>
</tr>
<tr>
<td>300 DELTA ENTERPRISES LTD. (11)</td>
<td>9.00</td>
<td>2,700.00</td>
<td>300</td>
</tr>
<tr>
<td>200 GAMMA LTD. (11)</td>
<td>12.00</td>
<td>2,400.00</td>
<td>200</td>
</tr>
</tbody>
</table>

## Dividend and Interest Summary

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>INTEREST THIS MONTH</th>
<th>INTEREST YEAR TO DATE</th>
<th>DIVIDEND INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH CDN</td>
<td>EXPENSE</td>
<td>INCOME</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>THIS MONTH</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>YTD</td>
</tr>
<tr>
<td></td>
<td>EXPENSE</td>
<td>INCOME</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>120.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>480.00</td>
</tr>
</tbody>
</table>

## Your Account Activity

<table>
<thead>
<tr>
<th>SETTLEMENT DATE</th>
<th>QUANTITY</th>
<th>DESCRIPTION</th>
<th>PRICE OR REFERENCE</th>
<th>AMOUNT DEBIT UNLESS MARKED CR</th>
<th>BALANCE DEBIT UNLESS MARKED CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>MTH</td>
<td>DAY</td>
<td>BOUGHT OR RECEIVED</td>
<td>SOLD OR DELIVERED</td>
<td>DESCRIPTION</td>
<td>PRICE OR REFERENCE</td>
</tr>
<tr>
<td>12</td>
<td>03</td>
<td>800 (1)</td>
<td></td>
<td>ALPHA TECHNOLOGY LTD.</td>
<td>8.00</td>
</tr>
<tr>
<td>12</td>
<td>04</td>
<td></td>
<td></td>
<td>RECEIPT 10388</td>
<td>CR</td>
</tr>
<tr>
<td>12</td>
<td>05</td>
<td>400 (2)</td>
<td></td>
<td>BETA GAS CO.</td>
<td>25.00</td>
</tr>
<tr>
<td>12</td>
<td>07</td>
<td>400 (3)</td>
<td></td>
<td>BETA GAS CO.</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>07</td>
<td></td>
<td></td>
<td>CK O8633</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>12</td>
<td></td>
<td></td>
<td>DEPOSIT</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>15</td>
<td>800 (4)</td>
<td></td>
<td>800 ALPHA TECHNOLOGY LTD.</td>
<td>DIV</td>
</tr>
<tr>
<td>12</td>
<td>20</td>
<td>300</td>
<td>300</td>
<td>DELTA MANUFACTURING LTD.</td>
<td>10.00</td>
</tr>
<tr>
<td>12</td>
<td>22</td>
<td>200</td>
<td></td>
<td>DELTA ENTERPRISES LTD.</td>
<td>9.00</td>
</tr>
<tr>
<td>12</td>
<td>31</td>
<td></td>
<td></td>
<td>GAMMA LTD.</td>
<td>12.00</td>
</tr>
</tbody>
</table>

© CSI Global Education Inc. (2005)
The Monthly Statement records chronologically:

(i) Purchases of securities (1 in Example 1).
(ii) Sales of securities (2).
(iii) Movements of securities (3).
(iv) Cash received into the account (a cheque from the client for a purchase (4a) or credit proceeds from securities sales (4b).
(v) Cheques issued by the broker to the client for securities sold and received in good delivery (5).
(vi) Cheques issued by the client to the broker for the future purchase of securities (5a).
(vii) Dividend and interest payments into or out of the account (6).

In addition to the above, miscellaneous entries which affect the account are also recorded. Items 7a and 7b show the purchase in error and subsequent cancellation of 300 Delta Manufacturing Ltd. at market, $10.00, instead of 300 Delta Enterprises Ltd. at market, $9.00 (8). Abbreviations used with reference to entries are explained on the back of the statement to enable the client to interpret the references and abbreviations on the Statement itself. These would include: CK-cheque issued, CR-cheque received, DIV-dividend, CXL-cancelled trade, SFK-safekeeping, SEG-segregation, INT-interest, EXCH-exchange, RTS-rights, SH-shares, SUB-subscription, TSF-transfer, WTS-warrants, NRT-non-resident withholding tax, and many others.

The first figure (9) on the monthly statement shows the balance, if any, in the account at the beginning of the month and whether it is a debit or a credit. The final figure (10) is the month-end balance owed by or due to the client. In the Your Portfolio section of the statement there is a summary of the client’s security position (11). The Financial Summary section shows in one line the opening and closing balances in the account and gives the Market Value of shares held in the account as well as the Equity position (market value of the securities plus any outstanding cash balance) in the account (12).

A free credit balance represents funds due to the client and can arise from a number of circumstances, such as a deposit made into the account by the client, trading proceeds, and interest and/or dividend payments credited to the account. The SROs require that the monthly statement contain a notice that free credit balances may be used in the conduct of the firm’s business.

**Margin Accounts**

On the example of the Monthly Statement for a Margin Account, the reference numbers in brackets indicate the following transactions during the month:
(i) A client opens a margin account and deposits $15,000 cash.

(ii) The following securities have been purchased on margin and their respective margin rates and loan values are shown. (Note: It has been assumed that regulatory rates apply rather than higher in-house rates).

<table>
<thead>
<tr>
<th>Security</th>
<th>Mkt. Value</th>
<th>Margin Rate</th>
<th>Margin Required from Client</th>
<th>Loan Value from Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian Ltd.</td>
<td>$19,000</td>
<td>50%</td>
<td>$9,500</td>
<td>$9,500</td>
</tr>
<tr>
<td>Sam’s Data</td>
<td>3,225</td>
<td>50%</td>
<td>1,613</td>
<td>1,612</td>
</tr>
<tr>
<td>Northern Mines</td>
<td>15,500</td>
<td>80%</td>
<td>12,400</td>
<td>3,100</td>
</tr>
<tr>
<td>Canadian Ltd. 8.5%</td>
<td>9,800</td>
<td>10%</td>
<td>980</td>
<td>8,820</td>
</tr>
<tr>
<td>Total:</td>
<td>$47,525</td>
<td></td>
<td>$24,493</td>
<td>$23,032</td>
</tr>
</tbody>
</table>

Additional Margin Required* = $33,387.51 – 23,032.00 = $10,355.51

(*See debit balance on statement)

Since Northern Mines at $1.55 per share is close to the $1.50 per share initial minimum margin requirement, the firm advises an additional $3,000 be deposited.

Margin required ($10,355.51 + $3,000.00): $13,355.51

(iii) The client receives a margin call for $13,500 and the client responds.

(iv) The market value of Canadian Ltd. rises to $30.00 per share. Loan value is now (50% of $30 X 1,000 shares) or $15,000. The client elects to take $5,000 of the $5,500 increase in loan value (1,000 shares x ($30 - $19) x 50%) out in cash.

(v) The client buys (on margin) additional 1,000 shares of Canadian Ltd. at $25.00.
### Financial Summary

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>Opening Balance</th>
<th>Closing Balance</th>
<th>Market Value</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Margin</td>
<td>0.00</td>
<td>-50,575.66</td>
<td>74,800.00</td>
<td>24,224.34</td>
</tr>
</tbody>
</table>

### Your Portfolio

<table>
<thead>
<tr>
<th>Held In Your Account</th>
<th>EST. Price Dec. 31</th>
<th>Estimated Market Value</th>
<th>Segregated/Held In Your Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,000 Canadian Ltd. (7)</td>
<td>26.00</td>
<td>52,000.00</td>
<td></td>
</tr>
<tr>
<td>300 Sam’s Data Processing Inc. (7)</td>
<td>10.00</td>
<td>3,000.00</td>
<td></td>
</tr>
<tr>
<td>10,000 Northern Mines Ltd. (7)</td>
<td>0.97</td>
<td>9,700.00</td>
<td></td>
</tr>
<tr>
<td>10,000 Canadian Ltd. 8.5% Sept. 8/09 (7)</td>
<td>101.00</td>
<td>10,100.00</td>
<td></td>
</tr>
</tbody>
</table>

### Dividend and Interest Summary

<table>
<thead>
<tr>
<th>Account</th>
<th>Interest This Month</th>
<th>Interest Year To Date</th>
<th>Dividend Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Margin</td>
<td>240.52</td>
<td>2,430.15</td>
<td>0.00</td>
</tr>
</tbody>
</table>

### Your Account Activity

<table>
<thead>
<tr>
<th>Settlement Date</th>
<th>Quantity</th>
<th>Description</th>
<th>Price or Reference</th>
<th>Amount Debit Unless Marked CR</th>
<th>Balance Debit Unless Marked CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>MTH</td>
<td>DAY</td>
<td>Bought or Received</td>
<td>Sold or Delivered</td>
<td>Description</td>
<td>Price or Reference</td>
</tr>
<tr>
<td>12</td>
<td>01</td>
<td>Deposit (1)</td>
<td></td>
<td></td>
<td>CR</td>
</tr>
<tr>
<td>12</td>
<td>08</td>
<td>1,000</td>
<td></td>
<td>Canadian Ltd. (2)</td>
<td>19.00</td>
</tr>
<tr>
<td>12</td>
<td>08</td>
<td>300</td>
<td></td>
<td>Sam’s Data Processing Inc. (2)</td>
<td>10.75</td>
</tr>
<tr>
<td>12</td>
<td>08</td>
<td>10,000</td>
<td></td>
<td>Northern Mines Ltd. (2)</td>
<td>1.55</td>
</tr>
<tr>
<td>12</td>
<td>08</td>
<td>10,000</td>
<td></td>
<td>Canadian Ltd. 8.5% Sept. 8/09 (2)</td>
<td>98.00</td>
</tr>
<tr>
<td>12</td>
<td>08</td>
<td>Deposit (3)</td>
<td></td>
<td></td>
<td>CR</td>
</tr>
<tr>
<td>12</td>
<td>15</td>
<td>CK 1234 (4)</td>
<td></td>
<td></td>
<td>CK</td>
</tr>
<tr>
<td>12</td>
<td>17</td>
<td>1,000</td>
<td></td>
<td>Canadian Ltd. (5)</td>
<td>25.00</td>
</tr>
<tr>
<td>12</td>
<td>25</td>
<td>Int. – Dec. (6)</td>
<td></td>
<td></td>
<td>INT</td>
</tr>
</tbody>
</table>
Chapter 5 – Communications with Clients

<table>
<thead>
<tr>
<th>Security</th>
<th>Mkt. Value</th>
<th>Margin Rate</th>
<th>Margin Required from Client</th>
<th>Loan Value from Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sam’s Data</td>
<td>$ 1,612</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Northern Mines</td>
<td>$ 3,100</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Ltd.</td>
<td>$ 8,820</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.5% Sept. 8/09</td>
<td>$ 2,000</td>
<td>50%</td>
<td>$ 25,000</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>2,000 Cdn. Ltd.</td>
<td>$ 50,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>$ 38,532</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The client is undermargined by $11,803.14 [$50,335.14 (see debit balance on statement) less $38,532.00]. The client elects to deposit additional securities rather than cash to bring his or her account into a fully margined position.

(vi) Interest is calculated on the debit balance each month on a daily basis. Member firms usually charge margin interest based on the rates members are charged by the chartered banks (6).

(vii) Securities held in the account. Since none is shown in SEG or SFK, it means all are hypothecated to secure the account balance. The member firm is required to hypothecate only enough securities as are reasonably necessary to provide adequate loan value coverage. Excess securities must be placed in segregation and so noted on the statement (7).

Some member firms’ systems provide for additional information to be shown on the monthly statement, such as average price and/or original cost and unrealized gain or loss. Certain portfolio information such as the amounts and percentages invested in different asset categories may also be included.

Other Information for Clients

Safekeeping, Segregation and Street Name

Once a client has purchased securities, they may be registered in the client’s name or in the name of the member firm. If registered in street name, that is, in the name of the firm or its nominee instead of the beneficial owner, securities that have been fully paid for by the client will be held in segregation by the firm. Segregated securities are locked away or otherwise separated from the firm’s own inventory and cannot be used in the conduct of the firm’s own business.

If registered in the client’s name, they may be held for the client by the firm, which is often referred to as safekeeping, although this term is properly used only if based on a signed agreement between the client and the firm. If physical certificates are involved, they will be stored in the firm’s vault until withdrawn or sold.
Portfolio Reporting

Some member firms have additional systems that provide supplementary information to clients regarding their investments. Similarly, individual IAs maintain their own databases and provide information to clients over and above that provided on the statements of account. In all such cases, the IA has an obligation to ensure that such information is accurate, so as not to convey a false impression to the client regarding the performance or status of their accounts. All such statements must be reviewed by the branch manager prior to distribution. Also, a disclosure should be included stating that the statements are not the official statements from the member firm.

Taxation

Member firms are required to do tax reporting on various aspects of the accounts of its clients. This includes:

- dividends & interest (T5s, Dividend & Interest Summaries, etc.);
- capital gains;
- contributions, transfers, & withdrawals from registered plans; and
- withholding, foreign, and other taxes.

IAs should take care that clients who attempt to evade taxes (as opposed to legally minimize taxes) are not permitted to use the firm’s books as a vehicle to do so. Examples of tax evasion would be backdated adjustments of trades or dividends/interest payments. The branch manager should be consulted whenever an IA suspects that a client may be attempting to involve the IA or the firm in tax evasion.

VI. Handling Client Complaints

Disputes with Clients

Client complaints are usually the result of one or more of the following conditions:

- A basic client misunderstanding of how the securities industry operates;
- Poor trade execution or account service;
- Trading or accounting errors left uncorrected;
- Improper handling of client instructions; and
- Excessive account service or trade execution demands being made by a client.

All complaints from clients must be routed to the branch manager and must not be dealt with by the registrant alone. Registrants should understand their firm’s policy
for handling complaints. Except in obvious situations where it would be impractical, clients should be requested to put complaints in writing.

Types of complaints may include:

(i) **Service-related**: This might include, for example, a client with a small account who feels that the IA is not paying enough attention to him/her. In some cases the solution is a change of IA.

(ii) **Administrative**: This might involve an error in client records, and should generally be passed on to branch or head office administrative staff for resolution.

(iii) **Performance-related**: These can vary widely in nature. In their simplest form, performance-related complaints may be solved by a meeting between the branch manager, the IA and the client. A more serious complaint may evolve into litigation and is then passed on the member firm's compliance and/or legal departments (see also *Arbitration*, below).

(iv) **Trading disputes**: These are usually related to a specific transaction and a difference of opinion as to what instructions were given. The branch manager will determine the appropriate resolution to a dispute of this nature, often in conjunction with trading staff and sales management. (See also Section II, Chapter Three, *Errors*)

(v) **IA misconduct**: This may include allegations of churning, unauthorized trading or lack of suitability. The branch manager must bring such complaints to the attention of the compliance department to ensure that the matter is fully investigated and documented. IAs can protect themselves against such allegations by:

- maintaining records of client contact and trading instructions;
- accepting instructions only from those who have trading authority for the account; and
- keeping client NAAFs up to date so that they reflect the client's current circumstances, objectives and risk factors.

In June 2001, the IDA Board approved amendments to Policy No. 8 relating to reporting requirements of members and registrants. This “whistleblowing” policy would require that member firms report items such as material changes in registration information, all client complaints (except service complaints), securities related claims, civil litigation claims, settlement agreements, internal investigations, etc. The Policy was revised based on industry-wide consultations and will result in a more comprehensive reporting system that considerably enhances regulatory oversight and investor protection. Amendments to Policy No. 8 came into force on October 15, 2002.

MFDA member firms must promptly report all client complaints involving allegations of forgery, theft or misappropriation of funds or securities to the MFDA. In addition, any award or settlement paid as a result of a private settlement
or securities-related (both on book and off book) litigation or arbitration must be reported if:

- it resulted in an award or settlement against the firm that exceeded $25,000; or
- it resulted in an award or settlement against an employee or agent of the firm that exceeded $15,000.

**ComSet**

In conjunction with Policy 8, ComSet (Complaints and Settlement Database) also became effective as of October 15, 2002. While Policy 8 deals with reporting and recordkeeping requirements, ComSet is a web-based database system through which member firms are required to report certain Policy 8 matters such as:

- every public complaint received in writing (except service complaints);
- every complaint from the public, no matter what the form, if it relates to allegations of theft, misappropriation of funds or securities, fraud, forgery, market manipulation, money laundering, insider trading, unauthorized trading;
- every time the firm is advised or becomes aware of an investigation or a proceeding in regards to;
- criminal investigations relating to a registrant or the firm, domestically or internationally;
- regulatory investigations relating to a registrant or the firm, domestically or internationally; and
- every time the firm is subject of a lawsuit relating to securities related transactions.

The information reported to ComSet is used to assist the IDA in fulfilling its regulatory role by identifying areas for compliance review, matters which should be investigated, industry trends, and regional issues. ComSet also permits regulatory oversight to ensure that member firms are dealing effectively with Policy 8 matters.

A total of 1,896 events were reported for 2004 via ComSet, as at December 31, 2004. The following chart is the breakdown of the matters reported by event type:

<table>
<thead>
<tr>
<th>Event Type</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Civil Claims</td>
<td>499</td>
</tr>
<tr>
<td>2. Criminal Charges</td>
<td>9</td>
</tr>
<tr>
<td>3. Customer Complaints</td>
<td>1,276</td>
</tr>
<tr>
<td>4. Denial of Registration or Approval</td>
<td>2</td>
</tr>
<tr>
<td>5. External Disciplinary Action</td>
<td>20</td>
</tr>
<tr>
<td>6. Internal Disciplinary Action</td>
<td>44</td>
</tr>
<tr>
<td>7. Internal Investigation</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,896</td>
</tr>
</tbody>
</table>
The Enforcement Department of the IDA monitors, on a daily basis, all reported matters on ComSet. As a result of information received via ComSet, 659 files were initiated in the IDA’s Central Complaints Bureau. The subject nature of the 1,896 ComSet events reported during the year were as follows:

<table>
<thead>
<tr>
<th>Subject Nature</th>
<th>Files</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsuitable investments</td>
<td>776</td>
</tr>
<tr>
<td>Unauthorized or discretionary trading</td>
<td>231</td>
</tr>
<tr>
<td>Misrepresentation</td>
<td>79</td>
</tr>
<tr>
<td>Transfer of accounts</td>
<td>38</td>
</tr>
<tr>
<td>Other</td>
<td>772</td>
</tr>
</tbody>
</table>

Since December 2002, member firms having Quebec clients have an obligation to file an annual report to the Autorité des marchés financiers (AMF) regarding client complaints received in the calendar year.

For the year 2004, the AMF and the IDA agreed that members could fulfill their obligations by sending the AMF a statistical report based on complaints (number, nature and responsible officer) reported through ComSet.

**OSC Tipping Program**

In May 2005, the Ontario Securities Commission (OSC) initiated a program of encouraging tips and leads from investors, industry professionals and other stakeholders regarding potential violations of securities regulations. The OSC acknowledged that some of their biggest investigations have started with a tip. The new procedure will review all issues such as possible violations by industry professionals or firms, fees and services, etc. People making a tip via the OSC website or phone may reveal their identities and provide supporting documents or they may wish to remain anonymous, but that may hinder the investigation. The new tipping program is in addition to the current complaint procedure already in place for investors to lodge complaints pertaining to their investments.

**Arbitration**

It is often in the best interests of all the parties (firm, individual registrant and client) to resolve any such disputes as early, quickly, and fairly as possible.

For many clients, and firms as well, resolving disputes in the court system can be costly and time consuming. Moreover, the SROs cannot require member firms to make monetary restitution to a client. The IDA has therefore introduced a program for the use of arbitration as an alternative method of dispute resolution. The program is now offered in all provinces.

Arbitration is a method of resolving disputes where an independent arbitrator:
- listens to the facts and arguments of the parties to a dispute;
Section II: Communications with Clients

Eligibility

To be eligible for arbitration (on the grounds that a firm must participate if the client chooses this course of action), the dispute must meet the following criteria:

- Attempts must have been made to resolve the dispute with the investment dealer;
- The claim cannot exceed $100,000,
- The events in dispute must have originated after:
  - January 1, 1992 in British Columbia;
  - July 1, 1999 in Alberta, Saskatchewan, and Manitoba;
  - June 30, 1998 in Ontario;
  - January 1, 1996 in Quebec.
  - June 30, 1999 in New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland and Labrador

There is some flexibility on the dollar amount criteria because claims that are greater than the maximum amount ($100,000) may still go to arbitration if both parties agree.

The Arbitration Process

Before proceeding to arbitration, a claimant must first attempt to resolve the dispute directly with the member firm. In order to have a claim accepted for the arbitration process, the claimant must be able to demonstrate that the dispute was discussed, or that reasonable efforts had been made to discuss the dispute with the firm, but that no resolution was achieved. Once a claim has been accepted for arbitration, supporting documentation of failed attempts to resolve the issue along with a written summary and opening file fee must be forwarded to the applicable arbitration agency.

The agency will ensure that the supplied documentation is complete and determine whether the claim is eligible for arbitration. If there is a basis for an arbitration hearing, the case will be heard before an independent arbitrator who is knowledgeable about securities industry issues. The arbitrator then hears the facts
and arguments in the case either in person or by conference call, or by reviewing written submissions of each claimant. At the conclusion of the hearing, the arbitrator is responsible for making a decision in the dispute and for providing his or her reasons for that decision in writing. Once the decision has been made, all of the parties involved are bound by it. That is the reason why at the beginning of the arbitration process, parties to a dispute are required to sign an agreement stating that they give up their rights to pursue the matters further in the courts.

On average, “standard cases” take approximately 90 working days from start to finish, which includes the review of the documentation, the hearing itself and the decision. Usually the actual hearing only lasts about half a day and the arbitration award is issued no more than 30 days after the arbitrator has reached the decision in the matter.

The cost of arbitration includes fees for the arbitrators themselves and for the use of whatever facilities were used. The cost of a typical arbitration hearing varies by province (e.g. in Ontario it is estimated to be approximately $1,550 if the arbitration is completed within three hours, in Quebec it is estimated to be approximately $1,200 if the arbitration is completed within four hours). The parties are also responsible the fees pertaining to their own legal counsel.

**The Financial Services OmbudsNetwork (the OmbudsNetwork)**

As part of its commitment to enhance consumer access to complaint resolution mechanisms, the financial services industry created a national ombudservice. The OmbudsNetwork builds on existing industry consumer redress mechanisms, including the IDA’s arbitration program. The OmbudsNetwork provides Canadian financial services consumers with access to independent, impartial and effective complaint resolution services in the banking, life and health insurance, general insurance, securities and mutual funds industries.

Effective December 2, 2002, revised IDA By-law 37 requires that members must participate in the OmbudsNetwork. The OmbudsNetwork is comprised of two parts: the Centre for the Financial Services OmbudsNetwork and the ombudsmen for the various financial services.

The newly created Centre for the Financial Services OmbudsNetwork (the Centre) provides a single entry point consumer assistance. The Centre does not resolve concerns, but provides client referrals through its 1-800 number to the appropriate organization or service, be that the financial institution, the industry’s ombudsman or to a further level of dispute resolution, where it is available.

The participating securities industry groups (the IDA, MFDA and IFIC) in combination with the Canadian Bankers Association, established the Ombudsman for Banking Services and Investments (OBSI) as a single ombudsman service for their member firms. As is the case with arbitration, it is the client’s decision to go
Section II: Communications with Clients

to the Ombudsman and the firm’s participation is mandatory. Customers are required to take their complaint first to the member firm, before they initiate either the arbitration or ombudsman options.

In 2004, the Centre handled 1,832 complaints and 732 enquiries. During the same time period, the Centre’s website was accessed by nearly 70,000 consumers, which represents a 60% increase in traffic and indicates that more and more investors are using this resource to find the information they need.

There are a number of significant differences between arbitration and the ombudsman:

• OBSI’s recommendations are non-binding on clients and members. Except where a member firm does not comply with OBSI’s recommendations, OBSI, like the arbitration process, is confidential for both clients and members.
• There is no charge to customers for the OBSI service.
• Client disputes submitted to OBSI can involve a claim of up to $350,000.
• OBSI does not stipulate a date before which it will not investigate a matter. However, there may be limitations on OBSI’s ability to investigate a matter, due to statutes of limitation or to the availability of documents, etc.

Client Communication

Member firms are required to provide all new clients, and clients who submit a written complaint to the member, with a brochure entitled “Investor Protection for Clients of IDA Member Firms (the Revised Brochure)” that describes the IDA’s arbitration program, and that includes information on the Centre and OBSI.

Pursuant to the IDA being granted SRO recognition in Quebec, the IDA is promoting the AMF’s complaints examination and dispute settlement process in the Revised Brochure. The brochure now outlines the services offered by the AMF in Québec, as well as the obligations incumbent on member firms who receive a complaint from a client residing in Québec.

Regardless of whether the client was provided a copy of the brochure on account opening, where a client submits a written complaint to a member, that member must provide the client with a copy of the brochure. It should be noted that written complaints are considered to include e-mails.

The MFDA requires member firms to provide all new clients, and clients who submit a written complaint to the firm, a copy of the disclosure notice contained in the MFDA form “Client Complaint Information”. In addition, the MFDA requires each firm to provide material which describes the OBSI, the approved ombudsman of the MFDA.
MFDA members can comply with this obligation: by printing the form and providing it as a stand-alone document to the client; or by copying the form, in its entirety exactly as it appears on the MFDA website including font size, and including or inserting it into documentation provided by the member to its clients.

VII. Summary

Provincial securities legislation and SRO regulations provide requirements and guidelines for various types of communication with clients. Full and continuous disclosure is a fundamental concept underlying these provisions. Registrants should ensure that all client communications with which they are involved are consistent with the requirements of their jurisdiction(s) and their firm. Any communication regarding a client account is considered to be from the firm as well as the individual registrant and may be legally binding for the firm and employee.

Client complaints must be routed through the branch manager and registrants must never attempt to settle disputes with clients without the branch manager’s knowledge. Disputes between member firms where the client is seeking restitution, may be settled through the courts, through arbitration or through OBSI. Disputes regarding regulatory breaches may be reviewed through the SRO’s disciplinary process.
SECTION III: SPECIAL TRANSACTIONS AND PRODUCTS

Chapter 1

Bringing New Issues to Market

Introduction

There are a number of securities transactions that have more complex characteristics than the simple purchase or sale of a stock or a bond. An IA must understand these transactions and products in order to determine whether they are suitable for a client.

There are two chapters in this section. The first chapter covers the issuance of securities, whether the issuer is entering the market for the first time or bringing new securities of a previously trading class to the market. This includes disclosure requirements prior to and during a new issue, the rules concerning continuous disclosure while the security trades in the public marketplace and the rules for proxy solicitation.

The second chapter deals with transactions that affect all holders of a particular class of securities. These transactions include takeover bids, insider bids and issuer bids where a purchase offer is made to a group of security holders.

Learning Objectives

After reading this module, you should understand the regulatory process and requirements concerning:

• bringing securities to market
• continuous disclosure
I. Bringing Securities to the Market

Securities Distributions

Securities administrators have long been concerned that funds should not be raised from the public through the issue of securities without a number of safeguards and disclosure requirements being satisfied. These concerns have led to the development of various procedures and disclosure rules pertaining to the preparation of detailed prospectuses and the subsequent sales of previously issued securities.

When a Prospectus is Required

Unless an exemption has been granted, all provincial Acts require that a prospectus be filed and delivered if the offering or sale of securities is deemed to be a distribution, or in the case of the Manitoba, New Brunswick and Prince Edward Island Acts, a primary distribution to the public. This prospectus requirement generally applies to three types of trades in securities:

• trades in securities by or on behalf of an issuer (e.g., a new issue from treasury); and
• except in Quebec, trades from a control position unless the trade is made pursuant to a prospectus exemption; and
• trades in securities previously acquired by way of a prospectus exemption, unless the subsequent trade is made pursuant to a further prospectus exemption.

New Issues

When a company raises equity capital in the marketplace, it issues securities from its own treasury. These new securities are then sold to the public and the proceeds are received by the company issuing the securities. If the company is issuing securities for the first time, this is called an initial public offering (IPO) and a prospectus must first be filed with the regulators. If the company is issuing additional securities into the market place, it would be referred to as a reporting issuer and a prospectus is normally still required, unless a prospectus exemption is available. The prospectus of a reporting issuer may be less detailed than that associated with an initial public offering because there is already publicly available information about the reporting issuer.
Sale from a Control Position

Most provinces, other than Quebec, treat a sale of previously issued securities from a control position as a distribution of securities. A control person is a person, company, or combination of persons or companies owning sufficient shares to materially affect control of an issuer.

In all provinces except Manitoba, New Brunswick and Quebec, a 20% holding is deemed to represent control. In these provinces, a 10% holding represents control. Typically, the filing and delivery of a prospectus is necessary to effect a sale from control position. In Quebec, when a secondary distribution of securities held by a person or corporation holding more than 10% of a class of securities is made, the Administrator sometimes requires that a notice be given, and in other circumstances that an information circular be provided.

Most provinces, and the TSX, allow a controlling shareholder to distribute securities of a reporting issuer without a prospectus upon compliance with special hold period rules and declaration and filing requirements. The stock exchanges also impose restrictions on the methods used to sell securities on their exchanges in these circumstances.

Care must be taken in handling accounts of controlling shareholders, to avoid violating regulations when executing sell orders for such accounts. Where the accountholder is executing transactions in the securities of a company in which he or she controls, the rules for the sale from control position might apply. The IA should ensure that the proper steps have been taken before executing any transactions in securities of a company that his or her client controls.

Preliminary or Red Herring Prospectus

Most provinces require both a preliminary prospectus and a final prospectus to be filed. The preliminary prospectus is required to have, in red ink on its front cover, a statement to the effect that its preliminary prospectus has been filed, is not in final form, and is subject to completion or amendment. This prominent warning will state that the securities may not be sold, nor may offers to buy be accepted, until a receipt for the final prospectus has been obtained from the Administrator.

New Brunswick and Quebec do not require a preliminary prospectus to be filed, although when an offering is made in more than one province or where it is intended to solicit expressions of interest, a preliminary prospectus is normally filed in all provinces where the securities are offered.

One purpose of the preliminary prospectus is to allow the distributor of a new issue to determine the extent of possible public interest in the issue while it is being reviewed by the Administrator and prior to its actual pricing and distribution.
The form and content of a preliminary prospectus must comply substantially with the requirements of the Acts covering the form and content of a final prospectus, but may exclude information on the price to the underwriter and the price at which the securities are offered to investors. As well, the auditor’s report need not be included in the preliminary prospectus.

The underwriter or agent person or company distributing securities to the public must maintain a record of all persons and companies to whom a preliminary prospectus has been sent. If a preliminary prospectus is determined by the Administrator to be defective, a revised preliminary prospectus must be sent as soon as it is available to each recipient of the first preliminary prospectus.

Permitted Activities During the Waiting Period

During the period between the issuance of a receipt for a preliminary prospectus and receipt for a final prospectus (the “waiting period”), the underwriters may solicit expressions of interest from potential purchasers of the security. A copy of the preliminary prospectus must be provided to anyone who expresses interest, whether solicited or unsolicited.

Most other activities considered to be in furtherance of an issuance of securities (for example, the entering into of agreements of purchase and sale for the new issue securities) are prohibited. It is permissible during the waiting period, in a circular or advertisement, to identify the security proposed to be issued, state the price (if determined), and the name and address of the member firm or registrant from whom purchases of the security may be made, to alert the public as to the availability of the preliminary prospectus. No other material may be distributed to interested investors during the waiting period.

Final Prospectus

A final prospectus must contain complete details of the securities being offered for sale, so as to provide the required full, true and plain disclosure of all material facts relating to the securities to be distributed. A material fact means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities. As well, the offering price to the public, the proceeds to the issuer (and/or selling security holders), the underwriting discount and any other required information that may have been omitted in the preliminary prospectus are also included. The final prospectus must be accompanied by the written consents of experts such as appraisers, auditors and lawyers whose reports or opinions are referred to in the prospectus and other documents evidencing compliance with regulatory requirements.
A copy of the final prospectus must be mailed or delivered to all purchasers of securities that are offered in a distribution. This mailing or delivery must be made to the purchaser or his or her agent by not later than midnight on the second business day after an agreement of purchase and sale resulting from an order has been entered into.

Prospectuses contain a great amount of important and valuable information. The following are examples of some of the more important items required for a final prospectus of an industrial company under the Acts. The information must be presented in narrative, or in certain cases tabular, form to make it useful to prospective investors.

**Details of the Offering**

- the name, quantity, class and material attributes and characteristics of the securities being offered;
- the price to the public, the underwriting discounts or commissions, and the net proceeds to the issuer or selling security holder; and
- the plan of distribution, the name of the underwriters, their obligation, if any, to take up and pay for the securities, and the date by which the underwriters are to purchase the securities.

**Information on the Business and Affairs of the Issuer**

- the issuer’s name, head office and principal office addresses, details of its incorporation, history and subsidiaries, its present and intended operations (including principal products or services), its recent material acquisitions and its principal properties;
- names and addresses of directors and officers with five-year histories of principal occupations, and disclosure of specified information with respect to executive compensation and indebtedness of directors and senior officers to the issuer or its subsidiaries;
- details of any outstanding options, rights or warrants to purchase securities of the issuer, of shares held in escrow, and of any prior sales of the securities being offered; and
- particulars of every material contract entered into within the preceding two years by the issuer or any of its subsidiaries, and a statement as to the time and place where a copy of such contracts can be inspected during the distribution of the securities being offered.
Factors Affecting an Investment Decision

- a summary of the information which, in the opinion of the issuer or selling
  security holder, would be most likely to influence the investor’s decision to
  purchase the security;
- a statement of how the issuer intends to use the proceeds of the issue;
- a statement of the share and loan capital structure of the issuer and each of its
  subsidiaries both before the proposed new financing and on a pro forma basis
  after giving effect to the new financing;
- information concerning the risk factors of the securities offered; and
- an explanation of substantial variations in the issuer’s operating results for the
  three preceding years.

Information on Promoters, Principal Security Holders and Interest of
Management in Material Transactions

- details of any promoters of the issuer or any of its subsidiaries within the five
  preceding years and sales by them of property to the issuer or any of its
  subsidiaries within the two preceding years;
- disclosure of the principal holders of securities owning as of record or
  beneficially, directly or indirectly, more than 10% of any class of securities of
  the issuer; and
- a description of any material interest of management and principal security
  holders and their associates or affiliates in any material transactions which have
  occurred within the past three years, or any proposed material transaction which
  has materially affected or will materially affect the issuer or any of its
  subsidiaries.

Financial Information

- statements of asset coverage and earnings coverage where the securities offered
  are debt securities with a term to maturity of more than one year or are
  preferred shares;
- the issuer’s dividend record over the past five years;
- specified financial statements of the issuer which are normally:
  (i) an audited income statement, statement of retained earnings and statement
      of changes in financial position for each of the past five financial years of
      the issuer and an audited balance sheet as at the end of the past two
      financial years of the issuer; and
  (ii) unaudited financial statements for, or as at the end of, the period since the
       end of the last financial year to a date within 90 days of the date of the
preliminary prospectus, if the preliminary prospectus was dated more than 120 days after the financial year-end of the issuer;

• a report on the audited financial statements appearing in the prospectus signed by the issuer’s auditor.

**Representations, Declarations and Certificates**

• a statement to the effect that no securities commission or similar authority in Canada has in any way passed upon the merits of the securities offered under the prospectus and that any representation to the contrary is an offence (the “disclaimer clause”);

• a prescribed statement of the purchaser’s statutory rights of withdrawal and statutory rights for damages or rescission. (For an explanation, see Purchaser’s Statutory Rights, below);

• a certificate signed by the issuer’s Chief Executive Officer and Chief Financial Officer, two directors on behalf of the board and any promoters, stating that the information in the prospectus constitutes full, true and plain disclosure of all material facts relating to the securities offered; and

• a certificate signed by the underwriters that to the best of their knowledge, information and belief, the information in the prospectus constitutes full, true and plain disclosure of all material facts relating to the securities offered by the prospectus.

Although much of the information required is the same, different prospectus formats are prescribed by the Administrator for industrial companies, finance companies, mutual fund companies and mining or natural resource companies. For example, a mining or natural resource company must present information about its past production and expert opinions as to its future production and reserves.

The distribution of a security for which a prospectus is required may not continue longer than 12 months from the date of the issuance of the receipt for the preliminary prospectus (in some provinces the final prospectus). The date the last renewal prospectus is filed may be used if a renewal prospectus has been filed and a receipt is obtained from the Administrator within the time period set forth in the Acts. This rule is applicable for continuous offerings such as most mutual funds.

The Acts of most of the provinces provide that purchases of securities distributed after the expiration date of a prospectus may be cancelled at the option of the purchaser within a specified time after his or her first knowledge of the failure to comply with the conditions of continuation of the offering.
Market Out Clauses

Full disclosure is required in a prospectus of any or all market out clauses on the part of the underwriter that might result in a no offering or a cessation of offering of securities described in a prospectus. A market out clause permits the underwriter to cancel the offering without penalty under certain conditions, for example if the issue becomes unsaleable due to changes in market conditions or the affairs of the issuer. A reference to the conditional aspects of the underwriting is required on the cover page of the prospectus with a cross-reference to the location of further details under the Plan for Distribution in the prospectus.

Simplified or Short Form Prospectus and Shelf Prospectus

All of the provinces have adopted compatible legislation, policies or practices allowing certain securities issuers quicker access to capital markets by using a short form preliminary and final prospectus. National Instrument 44-101 Short Form Prospectus Distribution (SFPD), came into force on December 31, 2000, replacing the Prompt Offering Qualification System (POP System). The SFPD may be used only by reporting issuers on the theory that much of the information concerning them that would be included in a prospectus is already available and widely distributed. Reporting issuers are issuers who have previously made public distributions or have listed their securities on a stock exchange and are subject to continuous disclosure requirements, and who meet certain size and financial requirements. The SFPD system shortens the time period and streamlines the procedures by which qualified issuers can access Canadian securities markets through prospectus offerings.

In most provinces, access to the SFPD system is restricted to issuers who:
(i) have filed an annual information form (AIF);
(ii) have been reporting issues for 12 months prior to the date of the filing of its AIF; and
(iii) have a public float (i.e., an aggregate market value of listed equity shares, excluding preferred shares and equity shares held by its principal shareholders) of $75 million or more during the last calendar month of the issuer’s most recently completed financial year.

A reporting issuer meeting the relevant eligibility criteria may use a short form prospectus in the distribution of its securities. A short form prospectus omits a large portion of the information found in a long-form prospectus on the basis that the information can be found in the issuer’s AIF and other continuous disclosure documents. Accordingly, the short form prospectus focuses on matters relating primarily to the securities being distributed, such as price, distribution spread, use of proceeds and the securities’ attributes. The short form prospectus incorporates by reference the information contained, in the most recent AIF and continuous
Section II: Communications with Clients

disclosure documents of the issuer and describes how copies of such documents may be obtained.

National Instrument 44-102 *Shelf Distributions*, permits SFPD issuers to:

- distribute securities off the shelf, i.e., to distribute securities where the disclosure documents required to be approved by regulatory authorities have been cleared in advance of the proposed distribution and a prospectus supplement containing among other things, a description of the securities being offered is filed with the Administrators; and
- distribute securities pursuant to a prospectus which provides for a non-fixed price basis, i.e., where only the method of determining the price is disclosed, such as by reference to the prevailing price of a specified security in a specified market (for example, government bonds), at the market price prevailing at the time of sale or at prices to be negotiated with purchasers.

**The Bought Deal**

The “bought” deal is a refinement of a conventional underwriting. In contrast to the conventional short form prospectus system or other offering in which an underwriter agrees to make its best efforts to sell securities of an issuer to the public, a bought deal underwriter commits to buy a specified number of securities at a set price. The underwriter will then resell those securities to the public. In a conventional underwriting, if the securities do not sell, the issuer will not receive the proceeds of the sale of the securities. In a bought deal, the underwriter pays the full proceeds to the issuer regardless of whether the underwriter has been able to resell the securities to the public.

Under existing securities regulations, the underwriter can solicit investor interest in these newly offered securities for up to two days before the filing of the preliminary prospectus, as long as a firm commitment to purchase the securities has been made by the underwriter. The issuer must file the preliminary prospectus within two days of the commitment.

The unique characteristic of the bought deal is that the underwriting syndicate is at risk for a longer period than in a conventional short form prospectus offering, reflecting the earlier timing of commitment to the offered securities. The bought deal can be initiated by the issuing corporation or, alternatively, by the investment dealer syndicate.

**Use of U.S. Prospectuses**

National Instrument 71-101 sets out the requirement for a multijurisdictional disclosure system which permits public offerings of securities of U.S. issuers that
meet specified eligibility requirements to be made in Canada. Disclosure documents prepared in accordance with the laws of the U.S., with certain additional Canadian disclosure, may be used. The NI is intended to reduce duplicative regulation in cross-border offerings, takeover bids, issuer bids, business combinations, and continuous disclosure and other filings.

The Securities and Exchange Commission (SEC) of the U.S. has adopted rules, forms and schedules for the implementation of a similar multi-jurisdictional disclosure system in the U.S. These reciprocal measures remove impediments to certain offerings of securities of Canadian issuers in the U.S. and vice versa.

**Securities Distributions through the Exchanges**

A different form of prospectus or similar document may be used when shares are distributed through the facilities of Canadian stock exchanges. The exchange, rather than the Administrator, reviews the prospectus and approves or disapproves it. The prospectus must meet all requirements of both the exchange and the provincial Act.

**Distributions through the TSX**

The Toronto Stock Exchange (TSX) no longer maintains an Exchange Offering Prospectus (EOP) system.

**Distributions through Bourse de Montréal**

Since the Quebec small cap companies ceased trading on Bourse de Montréal and were moved to CDNX, Bourse also no longer supports distribution of equity securities through the facilities of the exchange.

**Distributions through the TSX Venture Exchange**

The *British Columbia Securities Act* permits the distribution of conditionally listed or fully listed securities through the facilities of the TSX Venture Exchange (TSX V). These offerings must be made, in accordance with the rules of the TSX V and the Act, to B.C. residents only, as follows:

(i) **Initial Distributions:** Conditionally-listed securities of an issuer effecting its initial distribution of securities to the public are offered on the TSX V through the use of a full prospectus reviewed by the Vancouver office of the exchange.

(ii) **Subsequent Primary Distributions:** Additional securities for fully-listed issues are offered on the TSX V through the use of an Exchange Offering
Prospectus accepted for filing and review by the TSX V. For underwritten distributions, in which a member of the TSX V and resells the securities, the member is free to negotiate its offering price with the issuer.

Financing by way of an Alberta EOP is available to Alberta issuers and qualifying issuers provided that the gross proceeds from the distribution are not greater than $5,000,000 and the distribution is completed by a member of the TSX V. The review of Alberta EOPs by Alberta Qualifying Issuers is carried out by the Alberta Securities Commission. Financing through an Alberta EOP is not available to certain Capital Pool Companies or Junior Capital Pool Companies.

The various provincial Acts and regulations and the rules and by-laws of the stock exchanges contain detailed requirements concerning stock exchange distributions, which should be reviewed.

**Exempt Issues**

Each of the Acts specifies a number of circumstances in which securities may be distributed without a prospectus. IAs should familiarize themselves with the particular prospectus exemptions available under the Acts of their province.

Generally there are three types of exemptions from the requirement of filing a prospectus to effect a distribution of securities:

(i) exemptions due to the nature of the securities;
(ii) exemptions due to the nature of the trade; and
(iii) exemptions in respect of a resale of securities purchased under other exemptions or first trade exemptions.
Exemptions Due to the Nature of the Securities

The following are examples of those securities the distribution of which in most provinces are exempted from the prospectus requirements of the Act:

- debt securities issued or guaranteed by the federal, a provincial or a foreign government, a Canadian municipal corporation, a Canadian chartered bank, a trust or loan company or an insurance company;
- guaranteed investment certificates issued by a trust company;
- negotiable promissory notes maturing within one year provided that if the purchaser is an individual, each note must have a principal amount of at least $50,000 ($150,000 in Saskatchewan);
- shares or units of certain investment clubs having 50 members or fewer;
- securities issued by non-profit organizations, cooperatives and credit unions; and
- securities in a private company which are not offered for sale to the public.

Exemptions Due to the Nature of the Trade

The following are examples of distributions that are exempted from the prospectus requirement of the Acts of most provinces:

- a distribution where the purchaser is a Canadian chartered bank, the Business Development Bank of Canada, a loan or trust company registered in the province, an insurance company licensed in the province, the federal or any Canadian provincial, territorial or municipal government, or a public board or commission in Canada, which purchases as principal;
- an isolated trade in a specific security by an issuer for its own account;
- a distribution where the purchaser of the securities purchases as principal and is recognized by the Administrator as an exempt purchaser (or sophisticated purchaser in Quebec). Exempt purchaser status is granted to sophisticated and knowledgeable investors (other than individuals) with substantial funds to invest, such as professionally-managed pension funds and mutual funds. The Administrator maintains a list of those entities recognized as exempt purchasers and an application must be submitted annually to maintain the status;
Section II: Communications with Clients

- a trade in a security having an aggregate cost of at least a specified amount, where the purchaser purchases as principal (this amount is $150,000 in Nova Scotia, Ontario, Quebec and Saskatchewan, and $97,000 in all other provinces);
- certain stock dividends, distributions to existing security holders as part of a reorganization or winding-up, and the transfer or issue of securities through the exercise of a right to purchase, convert or exchange previously granted by the issuer; provided that no commission or other remuneration is paid or given to others in respect of such distribution except for ministerial or professional services or for services performed by a registered dealer;
- issuance or exercise of rights usually after a rights offering circular has been filed with the Administrator who does not object;
- issuance of securities to employees of the issuer or its affiliates;

a trade by an issuer of its own securities, where solicitations are made to not more than 50 prospective purchasers, resulting in sales to not more than 25 purchasers, each of whom purchases as principal, has access to the type of information normally found in a prospectus and is either a sophisticated investor with appropriate net worth and investment experience, or a senior officer or director of the issuer or one of his or her immediate family. Such a distribution must be made without advertisement and must be completed within six months. No issuer may avail itself more than once of this exemption and the promoter of the distribution (other than a registered dealer) cannot have taken part in a distribution under this exemption within the previous 12 months. The particular conditions of this seed capital exemption vary from province to province; and

- a trade between registrants where the purchaser purchases as principal.
Resale or First Trade Exemptions

In all provinces except Manitoba, New Brunswick and Prince Edward Island, a prospectus will generally be required to be filed on a subsequent disposition of securities originally acquired under a prospectus exemption, unless the securities are traded under an available prospectus exemption or the subsequent disposition is made under one of the first trade exemptions (called final exemptions in Quebec). The relevant Act should be consulted with respect to the particular requirements of each proposed trade.

These requirements can be summarized as follows:

- The issuer must be a reporting issuer not in default of the applicable disclosure requirements of the relevant Act or regulations.
- No unusual efforts may be made to prepare the market or to create a demand for the security and no extraordinary commission or consideration may be paid.
- Where the securities were originally acquired under the exemptions that depend upon the sophisticated nature of the purchaser or the limited nature of the offering, they are subject to a hold period of 4 or 12 months. The 4-month hold period applies to exempt securities of reporting issuers, while the one-year hold period applies to exempt securities of non-reporting issuers. The one-year hold period can be reduced to four months for securities issued to employees, directors, consultants and executives of an issuer. These new hold periods came into force on November 30, 2001, and with the exception of Quebec, they are triggered automatically in one Canadian jurisdiction by an exempt market transaction in another.
- In the case of securities acquired under other specified exemptions, no prospectus is required for their resale and no hold period will apply, if the reporting issuer (or in the case of a merger or amalgamation, one of the parties thereto) has complied with the disclosure requirements of the relevant Act for a period of at least 12 months, or 4 months for issuers in B.C. and Alberta who have filed an AIF.

Effective November 31, 2001, the Ontario Securities Commission (OSC) has introduced significant amendments to exempt market regulation that governs the raising of capital by small and medium-sized business in Ontario. These changes originated from the OSC’s Task Force on Small Business Financing concept paper, which endorsed recommendations for easier access to capital for start-up issuers and simplified resale rules following the private placement. For more information,
refer to OSC Rule 45-501 *Exempt Distributions*, which may be accessed through the Ontario Securities Commission’s website [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

Note that similar provisions impacting exempt market regulation in British Columbia and Alberta came into force on April 3, 2002. The new exemptions represented a joint initiative of the British Columbia Securities Commission (BCSC) and Alberta Securities Commission (ASC), and are intended to increase access to capital and investment opportunities while providing appropriate investor protection. For more information, refer to Multilateral Instrument 45-103 *Capital Raising Exemptions*, which may be accessed through the BCSC Website [www.bcsc.bc.ca](http://www.bcsc.bc.ca).

The circumstances in which a prospectus need not be filed with respect to a distribution have been described in general terms only. Registrants intending to rely on an exemption should consult their supervisors, the Act of their province, and counsel, to ensure that the relevant exemption is available and to ascertain all conditions that must be satisfied.

In addition to many of the above exemptions, the Acts generally confer on the Administrators broad authority to exempt other distributions from the prospectus requirements where it is not prejudicial to the public interest to do so.

**Purchasers' Statutory Rights**

The CSA have adopted a statement of withdrawal and rescission rights to be included in all prospectuses (National Instrument 41-101 *Prospectus Disclosure Requirements*). NI 41-101 summarizes the following statutory rights of purchasers:

**Right of Withdrawal**

Securities legislation in all of the provinces except New Brunswick provides purchasers with the right to withdraw from an agreement to purchase securities within two business days after receipt or deemed receipt of a prospectus or any amendment to the prospectus. The purchaser must give notice to the vendor or its agent. Where a distribution requiring a prospectus is effected without a prospectus, most provinces permit a purchaser who still owns the security to revoke the transaction, subject to applicable time limits. In Quebec, the purchaser has the option of applying for an adjustment of the purchase price.

**Right of Rescission**

Most of the Acts give purchasers the right to rescind a contract for the purchase of securities while still the owner thereof, if the prospectus or amended prospectus offering the security contains a misrepresentation (that is, an untrue statement of a material fact or an omission to state a material fact) provided that the action to
enforce such right is brought within the applicable time limits. In most of the
provinces, a purchaser alleging misrepresentation must choose between the remedy
of rescission and the alternative of damages.

In Manitoba, New Brunswick, Quebec and Saskatchewan, rescission (and in
Quebec, revision of the price) may be sought without prejudice to a claim for
damages.

Right of Action for Damages

The right of action for damages as granted by most of the Acts provides that an
issuer and its directors and anyone who signs a prospectus may be liable for
damages if the prospectus contains a misrepresentation. The same applies to an
expert (such as an auditor, lawyer, geologist or appraiser) whose report or opinion,
or a summary thereof, appears with his or her consent in a prospectus, but only if
the misrepresentation is with respect to the report or opinion.

Amendments to The Ontario Securities Act in December 2002 granted a right of
action for damages for the purchase or sale of an issuer’s security during a period
when the issuer fails to make a timely disclosure of a material change. The period
ends when the issuer makes the required disclosure.

The Acts provide a number of defenses to an action for rescission or damages
based upon a misrepresentation. For example, liability will not arise against an
underwriter or the directors if they act with due diligence by conducting an
investigation sufficient to provide reasonable grounds for a belief that there has
been no misrepresentation. A defense is also available if the person or company
can prove that the purchaser purchased the securities with knowledge of the
misrepresentation. The Acts also provide certain limitations with respect to
maximum liability that may be imposed and time limits during which an action
may be brought.

Restrictions on Trading

Generally speaking, during the period commencing two business days prior to the
determination of the offering price of the securities to be offered by a prospectus
and throughout the period of distribution under the prospectus, issuers,
underwriters and dealers, among others, are restricted in their ability to trade in the
securities being distributed. These restrictions apply to any previously issued
securities of the same type as those being underwritten and any convertible
securities or any underlying securities of the securities being underwritten. These
rules prevent underwriters and others from attempting to influence the price of
securities that are the subject of the distribution. Securities dealers typically
maintain lists of these securities, which are distributed to traders, IAs and other
staff affected by the limitations.
There are a number of exceptions from these trading restrictions with respect to trades which would arise in the normal course, such as a bid or purchase where the client’s order was not solicited or, if the order was solicited, such solicitation occurred prior to the restricted period. The policies of the Administrators and the rules and by-laws of the stock exchanges should be consulted in each circumstance in order to determine what restrictions apply.

**Hot Issues**

“Hot” issues are those which are in great demand. SRO by-laws require that, during the period of distribution of securities to the public (the length of this period is defined in provincial securities legislation), members make a bona fide offering of the member’s total participation in the issue to public investors. The term “public investors” is defined to exclude employees of the member firm and employees of institutional investors who are regularly engaged in the purchase or sale of securities for such institutions. Therefore, those not considered to be public investors may not purchase an issue for which there is great public demand.

**Conflict of Interest Rules**

In the interest of fairness to the public, SRO rules require that member firms observe certain rules for private placements. These requirements are based on the calculation of aggregate holdings of a “pro group”, broadly defined as including, both individually and as a group, the member firm, employees of the member and partners, directors and officers of the member and their associates and affiliates. The purpose of these rules is to address the situation where member firms are selling private placement securities and the firm and/or the employees have significant holdings in the issuer of the securities.

The Committee that considered the issues of conflict of interest made four major recommendations for changes to SRO rules. Two recommendations are now rules; the two other recommendations were approved at the June 2000 IDA Board and the IDA staff are awaiting securities commissions’ approval.

The recommendations are as follows:

- disclosure of the combined securities holdings of the member firm and its employees (the “pro group”) on trade confirmations, in research reports and in monthly reports of the stock exchange;
- client priority rules for private placements which require members to make clients aware of private placements and give priority to client orders, subject to suitability requirements;
• uniform hold periods across stock exchanges and provincial securities commissions and restrictions on abridging these hold periods when pro group holdings exceed 20% of the securities outstanding; and
• tighter conflict of interest rules which require a member firm with a pro group holding exceeding 20% to include an independent dealer in any underwriting of these securities.

With respect to private placements, the member firm must now:

• give clients priority over Pro Group members with respect to purchases of private placements where the member is acting as an advisor, agent, underwriter or member of the selling group. If the member has a pro group holding of over 20% of the issued and outstanding securities of the issuer, clients must also be given priority. Members must have procedures to ensure that pros do not take up any portion of the securities unless the private placement has first been offered to clients.
• not allow pros to abridge any hold periods on securities they own. If pros hold 20% or more of a class of voting or equity securities, exchanges will not allow the hold period to be shortened by a subsequent prospectus. Some limited exceptions to this rule apply.

A position of influence has previously been narrowly defined as a situation wherein the Pro Group holds 20% or more of an issuer’s securities. The concept of “influence” has now been extended to include criteria such as control over 20% of the board of directors, exercise of influence over the Pro Group by the management of the issuer and exercise of influence by a third person over both the Pro Group and the issuer.

II. Maintaining Publicly Trading Status

In addition to requiring full, true and plain disclosure in a prospectus at the time a new securities issue is being distributed, provincial securities legislation requires securities issuers to report financial and other material information about themselves on a regular, year-round basis. This process is called continuous disclosure. These rules apply to reporting issuers, those who have issued securities under a prospectus or a securities exchange offering or have securities listed on a stock exchange.

Financial Disclosure

Most Acts require reporting issuers to provide shareholders with adequate and continuing disclosure of their financial affairs. Such companies are required to file annual and interim financial statements with the Administrators and with the applicable SRO(s). These statements must meet prescribed standards of disclosure.
and are open to public inspection through the Internet-based System for Electronic Document Analysis and Retrieval (SEDAR). (See Section II, Chapter Five for further information on SEDAR.)

Prior to March 30, 2004, issuers had 140 days from the end of the reporting period to file annual financial statements and management discussion and analysis, and 60 days to file interim reports and discussion. However, regulations that came into force in March 2004 reduced that time, most substantially for senior issuers. Companies listed on the TSX Venture Exchange, for example, will now have 120 days to make annual filings and 60 days to make interim filings. Senior issuers, such as those listed on the Toronto Stock Exchange, will have their deadline for annual statements reduced to 90 days and the interim to 45 days. Also, companies are no longer required to send annual financial statements and management discussion documents to shareholders. Instead, they are now only required to ask investors each year if they would like a copy.

The financial disclosure provisions of the Acts require that statements be filed with the Administrator as follows:

- within 90 days for senior issuers and 120 days for junior issuers of the financial year-end, comparative audited annual financial statements including an income statement, a statement of retained earnings, a balance sheet and usually a statement of change in financial position; and
- within 45 days for senior issuers and 60 days for junior issuers of the end of each of the first three quarters of the financial year, unaudited quarterly interim financial statements including an income statement and usually a statement of change in financial position.

Some Administrators require additional financial disclosure and analysis beyond the financial statements in order to provide an adequate basis for assessment of the issuer’s recent history and outlook for the future. The management of all reporting issuers other than mutual funds and certain smaller issuers are required to analyze the issuer’s annual financial statements in what is called Management’s Discussion and Analysis (MD&A). Such analysis must be sent to shareholders who have requested to receive the annual report. The MD&A is meant to be an explanation of the current financial situation and future prospects of the issuer. The MD&A must accompany the annual audited financial statements of the issuer (either as a separate document or in the annual report) and filed with the Administrators within the same time periods as the annual report.

In addition, certain reporting issuers must file an Annual Information Form (AIF) each year containing relevant background information about the nature of the issuer, its operations and prospects for the future. (Note that smaller issuers may be exempt from this requirement). The purpose of the AIF and MD&A is to enhance investor understanding of the issuer’s business by providing supplemental analysis.
and background material concerning the issuer, its operations and prospects for the future.

The issuer must file the AIF with the Administrators within the same time periods as the annual report and must make it available to security holders of the issuer upon request. Also, the issuer must provide the AIF to any other person upon request, upon payment of a reasonable charge.

Press Releases and Material Change Filings

Most Acts provide that a reporting issuer must, immediately upon the information becoming known to management, issue to the public and file with the Administrator a press release as soon as a material change occurs in its affairs. A material change is generally defined as a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of its securities. Required disclosure includes a decision to implement such a change made by the board of directors or by senior management who believe that confirmation of such a decision by the board is probable. The reporting issuer must also file a report of a material change with the Administrator as soon as practicable after such a change occurs, and, in any event, within ten days. Where disclosure would be prejudicial to the interests of the reporting issuer, a material change can be kept confidential under certain conditions.

In addition, an insider would not be liable if it could be proven that he or she reasonably believed that the material information had been generally disclosed. The information must have been disseminated to the trading public and enough time must have passed to allow the public to assess and react to the news. In Ontario, the Securities Commission has suggested that for large public corporations, a safe working rule would be to allow a minimum of one full trading day after the release of a news item to a news service. For smaller corporations that rely on local publication or the dissemination of information by mail to shareholders, a period of more than 24 hours may be required and a delay of one week may be more appropriate.

Market Regulation Services Inc. (RS) has identified three newswire services that they feel adequately fulfills their disclosure requirements: CNW (Canada Newswire), CCN Mathews and Infolink Technologies. The OSC also recognizes CNW (Canada Newswire) and CCN Mathews, as well as E-News as newswire services that fulfill their disclosure and dissemination requirements.

National Policy 51-201 Disclosure Standards

The CSA have become increasingly concerned about the selective disclosure of issuers’ material information to analysts, institutional investors and other privileged
market participants. Selective disclosure occurs when an issuer discloses material, non-public information to a select few individuals or companies, but not broadly to the investing public, thus posing a threat to investor confidence in the fairness and integrity of capital markets. As a result, National Policy 51-201 was adopted in the summer of 2002.

The purpose of NP 51-201 is to:

- describe the timely disclosure requirements and the confidential filing mechanisms available under securities legislation;
- define legislative prohibitions against selective disclosure and insider trading;
- provide examples of the types of information likely to be material under securities legislation;
- describe high risk disclosure practices, including conducting private briefings with analysts or entering into confidentiality agreements with analysts; and
- provide a list of best disclosure practices that issuers should adopt to help ensure good disclosure practices and compliance with securities legislation.

**SEDAR**

SEDAR (System for Electronic Document Analysis and Retrieval) is an Internet-based system developed by the CSA to facilitate:

(i) electronic filing of securities information and the electronic payment of filing fees;
(ii) public dissemination of securities information collected through the filing process; and
(iii) electronic communication between filers, filing agents and the regulatory authorities.

Filing with SEDAR is now mandatory for most reporting issuers in Canada. National Instrument 13-101 sets out general rules regarding electronic filing that have been implemented in each Canadian jurisdiction. Documents required to be filed electronically include, but are not limited to, the following (refer to NI 13-101 for a complete listing):

- Prospectuses
- Annual Information Forms
- Financial Statements
- Annual Reports
- Reports of Material Changes
- Press Releases
- Circulars
The System for Electronic Disclosure by Insiders (SEDI)

As discussed in Section II, Chapter Two, certain issuers, their insiders, and their representatives or authorized agents are required to electronically file insider reports about their securities transactions over SEDI, a secure Internet-based system via SEDI. A SEDI issuer is any reporting issuer, other than a mutual fund, that files disclosure documents electronically through SEDAR, the System for Electronic Document Analysis and Retrieval.

Proxies and Proxy Solicitation

Reporting issuers are required to have periodic shareholders’ meetings, no less frequently than annually. Shareholders vote on various matters coming before these meetings, either in person or by proxy. Management or others will often solicit shareholder proxies to ensure adequate representation of the shareholders for these votes. Another aspect of the full, true and plain disclosure required by provincial securities legislation is seen in the various requirements imposed on reporting issuers with respect to proxy solicitation.

Mandatory Proxy Solicitation

Most Acts require the management of a reporting issuer to solicit proxies from holders of its voting securities whenever it calls a shareholders’ meeting and at the same time to supply such holders with an information circular. The purpose of these requirements is to ensure that shareholders have sufficient information to make reasoned decisions regarding the exercise of their voting rights.

Information circulars must state whether or not the solicitation is made on behalf of management. They must contain, among other items, information on directors to be elected, remuneration of management, matters to come before the meeting and any interest of management in such matters. The issuer must give details on how to complete the proxy, including how to instruct a nominee to vote for or against a specific matter referred to in the proxy and whether or not the security holder from whom the proxy is sought has the power to revoke it. The form of proxy may confer discretionary authority on the proxy holder in certain circumstances, provided a specific statement to this effect is made in the information circular.

Shareholder Communication Procedures

On July 1, 2002, the CSA adopted NI 54-101 that replaced NP 41 Shareholder Communication. The purpose of the new regulations was to ensure that beneficial security owners continue to receive proxy-related materials and that they have ample opportunity to vote the securities that they own.

NI 54-101 amends NP 41 procedures by:
Section II: Communications with Clients

- allowing direct communication between reporting issuers and beneficial owners of the issuer’s securities if the beneficial owners do not object to the release of their names and other information (so-called non-objecting beneficial owners or NOBOs);

- permitting that materials be sent to beneficial owners by any means, including electronic delivery, provided that consent is first obtained. In the past these materials were only allowed to be sent by prepaid first class mail;

- deregulating fees and changing the time periods for sending the materials – previously shareholders had to be notified of standard annual meetings approximately 60 days prior but now that period has been reduced to approximately 55 days. In addition, reporting issuers are responsible to pay fees to member firms to obtain beneficial ownership information, as well as to reimburse member firms for the costs of sending such materials to security holders.

The new regulations also give reporting issuers the right to obtain from intermediaries updated NOBO lists that contain the names, addresses, email addresses and securities holdings. However, NOBO lists may only be used in connection with the sending of shareholder materials, efforts to influence voting, information regarding takeover bids or any other matter relating to the affairs of a reporting issuer.

Reporting issuers are still required to send annual and special meeting materials to beneficial owners and if a reporting issuer elects to send proxy-related materials directly to NOBOs, it will also have to assume the same responsibilities imposed on intermediaries with respect to sending such materials. For example, reporting issuers must ensure that the materials sent to NOBOs include a request for voting instructions, instead of the traditional form of proxy, as well as properly tabulate and execute the voting instructions received from NOBOs.

As with the old regulations, the new regulations permit, but do not mandate, reporting issuers to use the new procedures to send materials that are not proxy-related, such as voluntary corporate communications. Reporting issuers will continue to directly send interim financial statements and related interim MD&A based on mailing lists that they maintain.

Those contesting a proxy vote or proposing a takeover bid now have the ability to identify NOBOs and communicate with them directly – something that the previous securities registration system makes very difficult, if not impossible.

Under NI 54-101, member firms must send a mandated set of instructions and a client response form to new clients asking them if they wish to be classified as non-objecting beneficial owners (NOBOs) or objecting beneficial owners (OBOs), along with what documents they wish to receive. Until these instructions are received back from the client (in written or oral form), member firms are prohibited from holding securities on the client’s behalf. As far as existing clients are
concerned, intermediaries can either seek new instructions from clients or rely on the choices that the client made previously.

NI 54-101 requires material to be sent by the issuer directly to NOBOs at least 21 calendar days before the date fixed for the meeting, if the material is sent directly. If a reporting issuer is sending the material to an intermediary (e.g., a member firms), it must generally be sent three or four business days before the 21st day before the meeting, depending on the nature of the mailing (if by first class or courier three days and if by regular mail four days). The intermediary is then required to mail or courier within that same number of business days to beneficial owners and to other intermediaries. Where there is more than one level of intermediary, the next level of intermediary has one business day to forward material on to their beneficial holders. There are some exceptions, restrictions and additional requirements depending on a number of factors, but the timeframes noted above are the basic mailing deadlines.

Clients may decline to receive proxy-related materials relating solely to routine business, such as the election of directors, but they will be sent, for example, special meeting materials whether they wish to or not.

Member firms are now required to obtain client email addresses if the client has one, and to ask for the client’s consent to the electronic delivery of documents. Electronic delivery rules state that clients’ consent must be obtained prior to emailing shareholder communication and any sales materials, so if a reporting issuer wishes to send materials directly to a NOBO by email, the NOBO’s consent to electronic delivery must first be obtained.

**Voting by Dealers**

For shareholders classified as objecting beneficial owners (OBOs), a registrant must deliver, no later than 25 days before the meeting date, proxy-related materials to each person entitled to receive notice of a shareholder meeting or to vote, unless that person has waived the right to receive proxy-related materials and to vote by executing instructions in Form C or by other written authorization in accordance with the Policy. Proxy-related materials generally include the notice of meeting, information circular, financial statements (in the case of an annual meeting) and form of proxy where the holders of securities are entitled to vote. A registrant may either forward a signed proxy to the shareholder or request voting instructions from them. If the former, the security holder may forward the completed proxy to the issuer; if the latter, the registrant will deliver those proxies for which it has received voting instructions to the issuer not later than two days before the meeting date.

Dealers often hold securities on behalf of clients. A dealer must vote a security of which it is not the owner in accordance with specific written voting instructions received from the objecting beneficial owner (the client) on whose behalf it holds the security. Except as provided in the policy or a legally valid written agreement,
a dealer cannot exercise any voting rights in respect of the security of which it is not the beneficial owner.

An objecting beneficial owner may revoke voting instructions or waive the right to receive materials at any time by written notice and the registrant shall use its best efforts to carry out such instructions. The registrant, however, is not required to act on revocation of voting instructions in respect of a meeting that is not received at least seven days before such meeting.

III. Summary

Although most registrants may not be involved in the corporate finance-related activities presented in this chapter, it is important that all registrants have a basic understanding of how securities are first brought to market and how publicly trading status can be maintained. This will help to clarify any restrictions or regulations that may apply to trading activities.
Chapter 2

Takeover Bids, Insider Bids, and Issuer Bids

Introduction

This chapter deals with transactions that affect all holders of a particular class of securities. Takeover bids, insider bids and issuer bids are types of transactions where an offer to purchase is made to a group of security holders. Rules concerning procedures and fairness to all holders of the securities subject to a bid apply to these transactions and are described below.

Learning Objectives

After reading this chapter, you should understand:

• the takeover process and takeover legislation
• insider bids
• issuer bid regulations

I. Formal Takeover Bids

For the most part, the Acts of the provinces, other than New Brunswick and Prince Edward Island, contain provisions regulating takeover bids. Takeover bid legislation is designed to safeguard the position of shareholders of a company that is the target of a takeover (often called a “target company”) by ensuring that each shareholder has an equal opportunity and adequate information to make an informed decision.

What Is a Formal Takeover Bid?

A formal takeover bid is an offer to acquire 20% or more of the outstanding voting or equity securities of a target company. The definition includes not only an offer
to purchase but also an acceptance of an offer to sell and a combination of the two. Under the Acts, the 20% threshold must include all current holdings of voting, equity or unissued shares owned by the offeror and its joint actors. As well, the offeror and its joint actors are deemed to own all securities that could be obtained by the exercise of any rights, warrants or convertible securities held.

Persons acting jointly, or in concert with an offeror, are presumed to include associates, affiliates, as well as any person or company who, as a result of a formal or informal agreement, committed to act jointly or in concert with an offeror. In addition, persons or companies intending to exercise any voting rights attached to any securities of the target company as a result of a formal or informal agreement, commitment or understanding, are also deemed to be acting jointly or in concert with an offeror.

Early Warning Rules

The Acts provide for an initial threshold, prior to a takeover bid, known as the “early warning”. The early warning rules were designed to raise red flags and prevent unsuspected takeover bids. Therefore, any person or company accumulating beneficial ownership or control in aggregate of 10% or more over voting or equity class of target securities of a federally incorporated company must immediately issue a press release disclosing such accumulation. The release must be filed with the applicable provincial Administrator and a more detailed report must follow within two business days. This requirement also applies to securities that are convertible or exchangeable into the target securities, as well as the securities that carry the obligation or right to acquire the target securities.

The acquisition of each additional 2% or more of the target securities raises the obligation to issue and file a further press release and a requisite report with the applicable Administrator. The press release must contain the following information:

- the offeror’s name;
- the total number of securities acquired and held;
- ownership of the offeror and any person or company acting jointly with the offeror;
- the names of those acting jointly or in concert with the offeror;
- the market on which the securities were acquired;
- any change in a material fact disclosed in a previous report; and
- a statement of the purpose of the acquisition and any future intentions to increase ownership or control.
Following the filing of a requisite report, no additional purchases may be made for one business day. This process may be repeated until the aggregate holdings reach the 20% threshold.

**Takeover Bid Rules**

A takeover bid that is not exempted under the Acts must comply with a number of requirements, including disclosure, timing and equal treatment of all shareholders of the issuer.

**Takeover Bid Circular**

Such requirements include the preparation and distribution of a “takeover bid circular” to all holders of the target securities, as well as the holders of securities convertible into or carrying the right to purchase securities of that class. The takeover bid circular must provide disclosure about the bid, the information about the offeror’s holdings in a target company, and the offeror’s relationship with the management of the target company.

**Directors’ Circular**

Within 15 days from the date of the offer, the directors of the target company must send a “directors’ circular” to all security holders subject to the takeover bid. The directors’ circular must provide a recommendation to accept or reject the bid and the reasons for such recommendations, or indicate that no recommendations are given and the reasons for not making any recommendations.

**Timing**

A takeover bid must allow at least 35 days from the date of the offer for securities to be deposited and the offeror can not take up any of the deposited securities until after the expiry of the 35 day time period. The offeror is obligated to take up, and pay for, all securities deposited under the takeover bid within 10 business days following the expiry of the bid and these securities are normally deposited with a selected depository such as the issuer’s transfer agent or legal counsel.

During the takeover bid, the offeror cannot purchase securities subject to the bid through normal open market transactions, unless:

- the intention to make such purchases is stated in the takeover bid circular;
- the aggregate number of securities so acquired does not exceed 5% of the outstanding securities subject to the bid;
• the offeror issues and files a press release disclosing the details of the purchase; and
• the transactions are conducted through the facilities of a recognized stock exchange.

**Withdrawal Rights**

Any security holder that deposits shares in response to a takeover bid may withdraw those securities at any time before the bid expires (within 35 days), or after 45 days from the date of the bid if the securities have not been purchased by the offeror. If the terms of the takeover bid change before the bid expires, subject to certain exceptions, the shareholder has 10 days from the date of the notice of the varied offer to withdraw any securities deposited. If the security holder decides to withdraw the shares deposited in response to the takeover bid, a “notice of withdrawal” must be provided to the designated depository. Under the instructions of the notice of withdrawal, the offeror is obligated to return the deposited securities to the depositing shareholder.

**Fairness Rules**

The Securities Acts also contain provisions designed to ensure fairness of the offer to security holders. The onus of the securities legislation is to offer identical consideration to all security holders subject to the takeover bid. For example, where a takeover bid was made for less than all of the outstanding securities of the same class and the number of securities deposited exceeded the number of shares specified in the takeover bid, the offeror is obligated to take up the shares on a pro-rata basis.

In a friendly takeover (where management is amenable to the takeover), a “lock-up agreement” may be formed between the offeror and larger shareholders, in which the shareholders agree to sell their shares at a certain price to the offeror.

Often shares that are not fully voting are given the right to participate in takeover bids made for the fully voting shares of a target company. Such rights awarded to securities without full voting rights are called “coat-tail provisions”. In these circumstances reference should be made to the share attributes themselves.

**Other Acquirers**

During the course of a takeover bid, a shareholder other than the offeror may acquire beneficial ownership or control over target securities which, when added to any other securities of that class already owned by the shareholder, constitute 5% or more of securities of the class subject to the bid. In that case, the shareholder must issue a press release by the opening of trading on the next business day and
file it with the Administrator. On each additional acquisition of 2% or more, a further press release must be issued and filed. The content of the press release must be similar to that issued as an early warning on the acquisition of 10% or more as described under Early Warning Rules.

II. Insider Bids

An insider bid is a formal takeover bid made by an insider of a target company (see Who are Insiders, Section II, Chapter One). The insider bid is subject to additional requirements, over and above those in effect for a takeover bid, which include the following:

• preparation of a valuation report by an independent and qualified valuer that must be filed with the Administrator and summarized in a takeover bid circular;

• disclosure in the insider bid circular must include information similar to that contained in the circulars for an issuer bid, but in particular:
  (i) reasons for the transaction;
  (ii) previous purchase and sales for the preceding 12 months;
  (iii) previous distributions;
  (iv) dividend policy; and
  (v) tax consequences.

• disclosure of prior valuations made in the 24 months preceding the date of the bid, if any; and

• reference to judicial developments, if appropriate.

The Administrator may exempt any person or company from any of the above rules or requirements on a public interest basis.

III. Statutory Rights of Shareholders

Where a takeover circular or notice of change contains a misrepresentation, a security holder deemed to have relied on such a misrepresentation has two alternatives available. He or she can elect between a right to rescind the transaction or a right of action for damages against the offeror and its joint actors. Similarly, if a directors circular or notice of change contains a misrepresentation, a security holder has a right of action for damages against every director or officer who had signed the circular or notice.

The civil remedies available under The Quebec Securities Act for misrepresentations in takeover bid documents are slightly different. The Quebec Securities Act provides an offeree with an alternate right to rescind the purchase or to apply to a court for an adjustment in the purchase price paid for his or her securities where a takeover bid circular contains a misrepresentation.
Defenses to Unfriendly Takeover Bids

Responses to hostile takeover bids by the management of target companies have historically raised concerns with the regulators. Unilateral actions often deprived their shareholders from the opportunity to assess the true merits of the bid. Such responses could be extreme, including: selling major assets, purchasing target company’s own securities in open market transactions, soliciting offers to other bidders, attempting takeovers of the offeror, issuing target securities to friendly parties, implementing shareholders’ rights plans (“poison pills”), etc. In order to regulate such actions, the Canadian Securities Administrators have enacted National Policy 62-202, which permits the management of a target company to attempt persuading its shareholders (within clearly stated parameters) to reject the offer. The management is also permitted to take action to maximize the returns to shareholders, to solicit a higher offer from a third party, or to take other defensive actions provided that they are not detrimental to the shareholders’ interests and the company itself.

IV. Exempted Takeover Bids

Generally, a takeover bid is exempt from the takeover bid requirements when:

• it is effected through the facilities of a recognized exchange (see Stock Exchange Takeover Bids);
• the bid is made for not more than 5% of a class of security over a period of 12 consecutive months and the consideration paid does not exceed the current market price at the date of the acquisition;
• the bid is made for the securities of a reporting issuer (where the published market exists), and the following conditions must apply:
  (i) purchases must be made from not more than five persons or companies in aggregate;
  (ii) the bid must not be made to all holders of a class of securities subject to the bid;
  (iii) consideration paid for the bid, including fees and commissions, must not exceed 115% of the market price of the securities at the date of the bid.
• it is an offer to purchase securities of a company that is not a reporting issuer, there can be no more than 50 holders of the securities excluding employees and affiliates of a target company, and there is no published market for the securities (the private company exemption);

It should be noted that there has been great misuse of some of these exemptions. For example, to avoid exceeding the limited number of holders, clients may be inappropriately pooled together, wherein several people have an interest but only one person is registered as the holder. Also, the definition of “close friends” or “business associates” may be applied to those who do not truly fit the definition.
For these reasons, the SROs are now paying more attention to exemptions and applying stricter criteria for them.

**Stock Exchange Takeover Bids**

As mentioned above, an exemption from the takeover bid requirements of the various Acts is available when the bid is done through the facilities of an exchange. Both the exchanges’ rules and the rules contained in the Acts define a takeover bid as an offer to acquire (together with present holdings of the offeror) 20% or more of the outstanding voting or equity shares of a target company. Note that a takeover bid circular may be filed even if the issuer is exempt, so that the issuer may become a reporting issuer. The exchanges have also adopted virtually uniform rules and regulations governing such takeover bids. These rules are as follows:

**Normal Course Issuer Bid**

A Normal Course Issuer Bid, as defined by the TSX, is an issuer bid to purchase not more than 5% of the outstanding listed voting or equity securities of a class of securities subject to the bid over a 12 month period. An offeror making a Normal Course Issuer Bid on these exchanges is not obligated to issue a notice of intention.

Under TSX Venture Exchange Corporate Finance policies, a Normal Course Issuer Bid applies only to voting securities. A notice of intention does not need to be filed with the TSX Venture Exchange (TSX V) where, during the 12-month period preceding the offer, the purchases made did not exceed either 5% of the outstanding securities subject to a bid or 10% of the public float.

Since the TSX Venture Exchange Corporate Finance Rules define a Normal Course Issuer Bid as a takeover bid, filing of a notice of intention applies only if the takeover bid threshold of 20% is exceeded. Companies listed on this exchange are classified in three Tiers, each with its own minimum listing requirements based on financial performance, stage of developments and financial resources. The exchange will not accept the notice of intention if it is suspected that the issuer would not be able to sustain its listing on the applicable Tier after executing all the purchases specified in the notice. An issuer can make purchases beginning three or four trading days after the date the exchange receives all documents in the final form.

A stock exchange takeover bid is generally more appropriate where the offeror already holds a minority position in the target company and is interested in consolidating its ownership. For this type of bid an offeror may only specify the maximum number of target securities that may be deposited in response to the bid and the minimum number of securities that must be deposited before any securities can be taken up and paid for cannot be specified as a condition of the bid. The reason for this rule is that a stock exchange takeover bid is considered a market
transaction, and once a security holder elects to deposit the shares in response to the
bid, he or she must be certain that his shares will be purchased. The stock
exchange takeover bid is also less expensive overall because the disclosure
requirements are not as onerous and no directors’ circular is required.

Regulations on Substantial Takeover Bids Made on a Stock Exchange

Prior to making a takeover bid on an exchange, other than a Normal Course
Purchase, a notice of intention must be given to, and accepted by, the exchange(s)
where the bid is to be effected. The notice must contain detailed information about
the bid, the offeror’s holdings in the target company, evidence of the offeror’s
satisfactory financial arrangements for the company, the business plans for the
company and its relation to management of the company. Upon acceptance of the
notice, the offeror must immediately issue a press release announcing the terms of
the offer. The notice must then be sent to all holders of the securities subject to the
bid. The board of directors of the company must also issue a press release within
seven business days providing detailed information and recommending acceptance
or rejection of the bid, or giving no recommendation and in each case explain their
position.

Allotment Procedure and Competing Bids

In order to keep record of all tenders submitted in response to a bid, the exchange
keeps open a book for the receipt of tenders on the trading floor. The book will be
opened no sooner than 21 calendar days after the day on which notice of the bid
was accepted by the exchange. As soon as possible after closing the book, the
exchange will announce the total number of shares acquired by the offeror. If more
shares are tendered than sought, allocation will be executed on a pro rata basis.
Normal trading in the outstanding listed voting shares of the target company will
commence immediately after the exchange announces the allotments.

If there is a competing stock exchange bid, the original bid may be withdrawn
provided that the average bid value of the competing bid is higher. If the first bid is
not withdrawn, the two bids may be adjusted to close on the same day. A stock
exchange bid may not be made for a class of securities where there has been an
offer already made in compliance with the rules specified in the Securities Acts.

Conduct of Members in Tendering Shares and Short Tendering

To safeguard against members tendering more shares than they actually hold, either
in the street name or in their clients’ names (“short tendering”), the following
provisions must apply:
• no member may knowingly assist or participate in tendering more shares than
  are owned by the tendering party; and
• tendering, trading and settlement will be executed according to rules of the exchange governing each bid.

V. Issuer Bids

As with takeover bids, the Acts of all the provinces (other than New Brunswick and PEI) contain specific provisions regulating issuer bids. Issuer bids are defined to include offers by issuers to acquire their own securities, other than debt securities that are not convertible into non-debt securities. Issuer bids are subject to rules similar to those applicable to takeover bids.

A circular must be sent to the security holders receiving the bid describing things such as the reasons for the bid, benefits to insiders, any distributions of the securities in the last five years, the issuer’s dividend policy and prior valuations made in the 24 months preceding the bid. This disclosure is similar to that required in a takeover bid, although it is somewhat more extensive.

The issuer must also provide a valuation report concerning the securities sought and prepared by an independent and qualified valuer. This valuation report must be filed with the Administrator and summarized in the issuer bid circular. The Acts provide exemptions from the issuer bid requirements if:

• the purchases and redemptions are made through the facilities of a recognized exchange;

• there is a published market for target securities, the following must apply:
  (i) consideration paid must not exceed the market price at the date of the acquisition; and
  (ii) the aggregate number of securities sought must not exceed 5% of the outstanding target securities over a 12 month period following the announcement of the bid;

• it is an offer to purchase securities of a company that is not a reporting issuer, there is no published market, and the offer is made to no more than 50 security holders (excluding employees and affiliates);

• the purchases or redemptions are required by the terms and conditions attached to the target securities, or if such transactions are required by the statute under which the issuer was incorporated;

• the purchases or redemptions are required to meet sinking fund or purchase fund requirements.
VI. Exchange Issuer Bids

As stated above, an issuer bid is exempt from the provisions of the Acts if it is made in accordance with rules and policies of a recognized exchange.

The TSX and TSX V have both indicated that an issuer will, subject to certain restrictions, be permitted to purchase through normal market purchases (other than by way of an exempt offer) up to 2% of its securities in any 30 day period. A purchase maximum that applies over any 12 month period must not exceed either 10% of the public float or 5% of the outstanding securities of a class subject to the bid (excluding any securities already owned by the offeror and its joint actors on the date of the offer).

To be eligible for the normal course issuer bid exemption, the company must prepare and submit a notice of intention to the applicable exchange for its approval. Upon acceptance of the notice by the exchange, a press release must be issued immediately. A summary of the notice must also be sent in the next scheduled mailing to the shareholders of the class of shares for which the issuer bid is being made.

In order to prevent an issuer from using a normal course issuer bid to influence the market price of its securities, all purchases must be made at a price not higher than the last independent board lot trade of the class of securities subject to the bid.

A substantial issuer bid is a bid made by an issuer who is interested in purchasing more than 5% of the issued target securities in a 12 month period. In that case, the bid is subject to the same rules applicable to the stock exchange takeover bids (see Stock Exchange Takeover Bids).

VII. Summary

Although most registrants are not normally involved in the details of corporate finance, it is important that all registrants have an understanding of how securities are brought to market. Furthermore, registrants should be aware of how events such as takeover bids may affect the value of securities, as well as what restrictions may apply to the sale and purchase of new or secondary offerings which are the subject of tender offers.
Case Studies

We now present three case studies and an analysis of each. These specific cases will not be tested on the CPH exam, but provide an opportunity for you to practice applying some of the information you have learned in this text.

While reading each case, keep in mind the Code of Ethics and Standards of Conduct in Section I, Chapter One, as well as other information in the text that may be applicable. You should be able to identify the ethical violations in each case and suggest a correct course of action.
Case Studies

Case #1 - Gemini Mutual Funds

Finishing up the copy for her latest client newsletter, Andrea Denton heaved a sigh of relief. The day before, she had corrected a mistake that could have had unfortunate consequences for some of her clients. Now she needed to let them know about it.

Andrea Denton

Andrea, 27, had been an Investment Advisor with Capricorn Securities Inc. for nearly two years, and had a growing and loyal clientele. Many of her clients were women, and she tried to expand this client base by including articles specific to women’s financial concerns in her quarterly client newsletter.

Over the past couple of months, Andrea had recommended purchases of Gemini Mutual Funds for many of her clients. This particular family of funds had been performing well over the last few years and charged a relatively low MER. Over two dozen of the clients to whom Andrea had made this recommendation ordered units of different funds in the Gemini family for their non-RRSP accounts. All of the orders had been processed.

Later that week, Andrea was in the office talking about Gemini funds with a fellow IA, Maude Anthony. “The Gemini funds have been outperforming all the benchmarks. They look like a really good investment,” Andrea mentioned. “Yes,” Maude agreed, “I’ve put several of my clients into both the Gemini Sector and regular funds. The Sector fund tax advantages are really useful outside of RRSPs.” Andrea returned to her desk and re-read her information on Gemini funds. Sure enough, there were two Gemini fund families. The regular funds would trigger a disposition in the hands of the seller even if exchanged for units in other funds in the Gemini group. In the Gemini Sector funds, no such disposition would occur if units in a Sector Fund were sold and replaced with units in another Sector Fund.

The various mutual funds and their related Sector Fund counterparts contained the same investment mix, since the only units purchased by a Sector Mutual Fund were units in its Mutual Fund counterpart. Therefore, there was no change in the risk between a person owning units in a Sector Fund over its Mutual Fund counterpart. Andrea decided that her clients would benefit more from owning the Sector funds because of the capital gains treatment on switches within the fund family.

Andrea decided to switch, unit for unit, all the regular Gemini funds in her clients’ non-registered accounts to Gemini Sector funds. Fund characteristics would remain exactly the same with respect to risk and performance. The transactions were executed on a dollar for dollar basis and Andrea charged no commission for the switches.
Knowing that clients might have questions about the switch, Andrea resolved to write about it in her newsletter, due out the next week. She included the following note, which was approved by her branch manager:

“All clients with Gemini funds outside of their RRSPs will see some ‘switches’ into the equivalent Gemini Sector funds over the next few weeks. Once you are inside the Gemini Sector family, all future switches within the Sector group will generate no capital gains. The only time a capital gain will be realized is if you sell out of the Gemini family completely. There may be some minor capital gains realized by making this switch into Sector. However, since we are all long-term investors, the sooner we get into this new Sector portion of the Gemini family, the better off the portfolios will be in the long run. So please do not worry when you see notices of the switches.”

Of all the clients involved, only one called to object to the exchange. Andrea then reinstated this client’s original Mutual Fund positions right away, without charging commission.

Did Andrea act correctly? If not, what would have been the correct course of action once the mistake had been discovered?
CASE ANALYSIS

Gemini Mutual Funds

Synopsis:
Andrea Denton, an IA, discovers that she has made a mistake by putting clients into regular funds, instead of the fund company’s Sector counterparts. A switch into the corresponding Sector funds would have no adverse risk/return consequences, but would be more advantageous for the clients’ tax situations. Andrea decides to make the switch for her clients, and mentions this in her next client newsletter.

Analysis:
This case is based on a real-life situation in which an IA acted exactly as Andrea did, except that the original mistake was made by the order processing department. The IA in that case was cleared of any wrongdoing by the IDA, after investigation showed that the clients’ orders were for Sector Funds, not regular funds. The IA’s actions were in the nature of a correction and therefore not characterized as discretionary trading; however, it was ruled that the IA did err in not obtaining clients’ permission for the substitution. It was due only to the unique nature of this case that the IA was not penalized.

In this fictional case, Andrea’s actions were based on her own mistake. She did not read the information on Gemini Mutual Funds carefully, and thus violated Standard A (ii), Due Diligence, by not thoroughly researching the investments she was recommending. She should have known that the Sector funds existed, and may have been more suitable for her clients’ non-RRSP accounts.

Andrea also violated Standard A (iii), Unsolicited Orders, since the unauthorized switching of funds would be considered unauthorized discretionary trading.

The correct course of action after the mistake had been made would have been to call her clients and explain what had happened, and seek their authorization to make the switches.
Case #2 - Luke Picard

Luke Picard, an IA in the Saskatoon, SK office of Capricorn Securities Inc. ("Capricorn") was working on several newspaper and radio advertisements that he wanted to place with the local media. Luke, 35, had worked in the investment industry for eleven years, two as a sales assistant and the rest as an IA. He was originally from Ontario but had recently married and resettled in Saskatoon. His wife’s family had helped him to feel welcome in the community but Luke still found it difficult to make business connections. He needed to bring in more clients and advertising seemed to be the best way to reach people.

Luke wrote the copy. His ads read, in part,

“With over 10 years' experience as an Investment Advisor, Luke Picard can help you to finance the retirement you’ve always dreamed of. Our track record proves that it is possible to be a millionaire, if you have the right team behind you. Luke Picard and Capricorn are the right team for you!”

Knowing that the firm must approve all advertisements, Luke wished he could run the ad past his branch manager, Mary Murphy, who was out of the office for a seminar. Luke faxed the ad to Capricorn’s National Marketing Department at the head office in Vancouver. A head office employee read through the ad, edited it slightly (for flow, not content) and faxed Luke back with the comment that it was "fine". Upon receiving this fax, Luke contacted various radio stations and newspapers and placed the ad. He received a good response and was able to open accounts for eighteen new clients in the first week after the ads began.

Two weeks later, Mary Murphy received a call from Capricorn’s Compliance Department in Vancouver. The IDA had received a complaint about Luke Picard’s ad, and had launched an investigation.

Have Mary or Luke anything to worry about?
CASE ANALYSIS

Luke Picard

Synopsis:

Luke Picard, an IA, writes his own advertisement and, in the absence of his branch manager, faxes it to head office for approval. The firm’s Marketing Department approves them and Luke places the ad on local radio and in newspapers. The ad generates a good response. Two weeks later, the branch manager receives a call from head office. The IDA is investigating Picard’s ads.

Analysis:

• Although the advertisements were reviewed and edited by an employee of the member’s National Marketing Dept, they were not approved by an officer, director, partner or branch manager prior to issuance, as required of member firms.

• The ads contained an untrue statement. Luke Picard had nine years’ experience as an IA (as opposed to IR), not “over ten” as the ads stated. The firm should have verified this.

• The mention of “it is possible to be a millionaire” in the ad contained an inferred promise that investors could achieve this through following the IA’s advice. This is misleading, as investors may be limited by resources or other factors. These limitations should be mentioned in a balanced presentation by the firm and/or IA.

This case is based on a real-life situation. In the real case, the firm was fined $5,000 for violation of IDA By-law 29.7 and required to pay the costs of investigation in the amount of $1,000.
Case #3 - The Cheng Accounts

Bryan Singh, a rookie IA with Vega Securities Inc. (“Vega”), was a bit confused. He was covering the accounts of a fellow IA, Nicole Sousa, who was in the Cayman Islands for a week. One of Sousa’s clients, Andrew Cheng, had called that day and placed an order to sell some speculative biotechnology shares. Upon reviewing the account file, Singh realized that Cheng had not yet paid for the shares. Singh put through the sell order but knew this wasn’t a recommended practice. When he looked in the Cheng account records, he wondered about some of the transactions he saw there. Should he say something to the branch manager?

Bryan Singh

Singh, 24, had just joined Vega, a small investment firm in Halifax, Nova Scotia, six months previously. It was his first job as an Investment Advisor, and he had previously worked as an Account Representative in a bank. Singh had completed all of the necessary courses and became fully registered soon after joining Vega.

Nicole Sousa

Sousa, 30, had been with Vega for one year. Before she joined Vega, she had worked for three years as an IA for a larger, bank-owned securities firm. There had been problems with certain of her accounts at her former employer, and the IDA was still investigating one complaint. Sousa was certain that the results of the investigation would show that she had done nothing wrong.

Roger Lecours

Lecours, 41, was Sousa’s and Singh’s branch manager. He was aware that Sousa was still under investigation by the IDA, but considered it a formality that would soon be sorted out. He knew that Sousa had a record as a good performer and, moreover, she had the kind of energy and “star quality” that Vega badly needed to bring in clients. After hearing her side of the story during Sousa’s interview for the job with Vega, Lecours decided that the original complaint had resulted from an ambiguous situation and he had been happy to hire Sousa. During her year at Vega, she had brought in many new clients (several from her former position) and he had heard no complaints. Lecours was happy to have at least one IA who didn’t need constant supervision and who could help train rookies like Bryan Singh.
The Chengs

Jenny, 29, a physical therapist, and Andrew Cheng, 31, a marketing assistant, had been married for two years. Both had held RRSP accounts with Sousa since she started at Vega. They listed their combined net worth as $100,000 to $200,000. Their NAAFs also listed investment objectives of 70% income and 30% long-term growth for both accounts.

The Chengs were both starting to earn more and had also recently inherited a fairly large sum from Andrew’s great-uncle. With talk about the future of the Canada Pension Plan and job insecurity, they felt they should start saving for their retirement. Neither knew much about investing, and relied heavily on Sousa’s recommendations. As initial deposits, the Chengs had each contributed $10,000 to their RRSPs, which Sousa invested in long-term bond funds.

Eight months after this initial contribution, Sousa was speaking to Jenny and recommended that she invest in the High Yield Bond Fund to increase the possibility of long-term gains. Jenny, acting on Sousa’s recommendation, purchased 700 units of the High Yield Bond Fund on January 3. A debit balance was created in the account, since the fund purchase cost more than was in Jenny’s account. Jenny did not deposit the necessary extra funds until January 22. Later, on Sousa’s recommendation, Jenny redeemed all of her fund units and purchased 2,450 common shares of Trust Co. These shares then represented 100% of her RRSP account. Andrew Cheng also purchased 100 common shares of the same company on Sousa’s recommendation. This represented 100% of his RRSP account. Andrew also opened a locked-in RRSP account to deposit a pension rollover from his employer. This account had objectives of 80% income and 20% long-term growth. Sousa recommended Andrew purchase an additional 400 shares of the Trust Co. for this account.

At the time Sousa recommended these purchases, Trust Co. had reported substantial losses in the fourth quarter of the previous year. She was aware of this but did not tell the Chengs, as she thought it might frighten them away from an investment that she considered good value.

Trust Co. did not perform well after all, and the Chengs eventually became concerned about net losses in their accounts. In September, Sousa recommended that they sell their shares in Trust Co. and invest in an unlisted company, New Co., whose stock traded over-the-counter. Sousa knew the founders and directors of New Co. quite well, and received shares in the company as compensation for promoting their stock to her clients. She would have promoted the company anyway, since she believed wholeheartedly in its prospects. Sousa told the Chengs that they could make up their losses from the previous trades because New Co. would become listed on the TSX in the near future and the price would go up. Sousa further assured the Chengs that New Co. was not a speculative investment and told them that the price of the shares would be $10 by the end of that year. To
further inform them, she sent the Chengs a copy of New Co.’s annual report, along with a letter printed on the firm’s letterhead and signed by herself, attesting that the firm’s prospects were good and that it expected to be listed on the TSX by the end of the year.

The New Co. shares then made up 80% of their combined RRSP accounts. On December 10, on Sousa’s recommendation, Mr. Cheng opened a cash account and purchased 10,000 shares of Canadian Biotechnology Inc. Sousa told Cheng that if the shares rose in value in the near future, which seemed likely, he could then sell them before settlement date without paying for the purchase. This quick profit could be used to offset the previous losses on Trust Co. Canadian Biotech shares did indeed rise in price before settlement date and Andrew Cheng called Bryan, who was covering Sousa’s accounts for the week, to order the sale. He made a considerable profit, which went towards covering the Cheng’s losses on the previous trades. The Chengs felt that they were lucky to more or less break even, as they had friends who had lost large amounts of money in the stock market. “I’m so glad Nicole showed us how to do this,” Andrew told Bryan after he ordered the sale. “It’s a good way to make money without having to put it up front.”

As Bryan tidied up for the day he wondered whether Sousa’s recommendations to the Chengs were entirely “above board.” He did not want to be party to any wrongdoing, but the clients seemed happy, and that was the important thing, wasn’t it? He resolved to dig out his Conduct and Practices Handbook when he got home, and perhaps speak to Roger Lecours the next day.
CASE ANALYSIS

The Cheng Accounts

Synopsis:
An IA, Nicole Sousa, recommends several securities for the accounts of her clients, the Chens. The securities drop in value, and Sousa suggests that the husband purchase a speculative security, which he can sell before the settlement date if the price goes up. This plan works out well, and the losses are recouped. A new IA has observed Sousa’s handling of the accounts and wonders whether it was ethical, and if he should tell the branch manager.

Analysis:

Ethical/compliance issues:

• Supervisory responsibility:

  Sousa was under investigation by the IDA regarding a complaint about an account at her previous employer. Lecours was aware of this, and had a duty to closely supervise Sousa. Whether or not he thought the complaint was justified was immaterial. Instead, he seems to have been so impressed by her that he actually supervised her less than he did other IAs.

• Duty of Care to Client:

  Suitability - Some of the investments that Sousa recommended for the Chens were not suitable, given their investment objectives and limited knowledge. The Cheng accounts also tended to be highly concentrated in certain funds/stocks, whereas diversification should have been considered to lessen risk.

  Fiduciary Duty - As the Chens had little knowledge of investing and relied heavily on Sousa’s recommendations, a court might find that the IA had a fiduciary duty to the clients.

• Unethical Sales Practices:

  – Balanced Presentation - Sousa did not present all the facts about Trust Co. to the Chens. No matter how good their prospects seemed, the fourth quarter losses were extremely important material information.
– **Making Guarantee**: Sousa virtually guaranteed that New Co. would be listed on the TSX soon, and that the price would rise to $10 by the end of the year. No such guarantees should be made, as these are not certain and will reflect badly on the IA and the firm.

**Duty of Care to Firm:**

– **Poor Credit Practices** - Sousa should have known that transactions that create debit balances were prohibited in RRSP accounts pursuant to provisions of the *Canada Income Tax Act*, which prohibits an RRSP account from borrowing money or pledging assets. Sousa also encouraged Andrew Cheng to free ride in his cash account, in order to recoup the Trust Co. losses. These actions left the firm in a vulnerable position.

– **Unauthorized Sales Literature**: Sousa sent out information about Trust Co. on Vega letterhead. This implicates Vega in the promotion of the securities and leaves them liable to any action concerning the promotion.

**Full Disclosure:**

Sousa should have disclosed her business relationship with New Co. to the Chengs and to her firm. Even if her business interest as a paid promoter of the company did *not* affect her judgement with respect to their securities (which is unlikely), there would be a public perception of bias.

**Whistle-blowing:**

At the end of the day, Singh is not sure whether there is any problem. If he decides that there is, he will then be faced with an ethical dilemma -- should he tell Roger Lecours or speak to Sousa when she returns? By assisting in the execution of these orders, Singh is aiding in any violation.
Glossary

Acts
The Securities Acts of the provinces or territories.

Advertisement
A sales communication that is published or designed for mass distribution through public media.

Affiliate
In the context of insider trading restrictions, this refers to a parent or subsidiary or a company with common ownership with the insider.

Agency Transaction
A transaction in which a firm buys or sells securities from or to a third party on behalf of a client.

All or None Order (AON)
An order that must be executed in its entirety — partial fills will not be accepted.

Annual Information Form (AIF)
A document in which an issuer is required to disclose information about presently known trends, commitments, events or uncertainties that are reasonably expected to have a material impact on the issuer’s business, financial condition or results of operations.

Arbitration
A method of dispute resolution in which an independent arbitrator is chosen to assist aggrieved parties recover damages. It is an alternative to costly and lengthy litigation.

Autorité des marchés financiers (Financial Services Authority) (AMF)
The body that administers the regulatory framework surrounding Québec's financial sector: securities sector, the distribution of financial products and services sector, the financial institutions sector and the compensation sector.

Associate
In the context of insider trading restrictions, this refers to a spouse, relative, relative of a spouse sharing the same house as an insider, a partner, trust or estate in which an insider acts as trustee or has a substantial beneficial interest and a company of which an insider controls more than 10% of the voting equity in a company.

Beneficial Owner
The real (underlying) owner of an account, securities or other assets. An investor may own shares which are registered in the name of an investment dealer, trustee or bank to facilitate transfer or to preserve anonymity, but the investor would be the beneficial owner.

Best Efforts Basis
The attempt by an investment dealer to fulfill a customer’s order or to sell an issue of securities, to the best of their abilities. The investment dealer is not held liable to fulfill the order or to sell all of the securities.
Board Lot
A regular trading unit which has uniformly been decided upon by the stock exchanges, in most cases it is 100 shares, but this can vary depending on the price of the stock.

Bought Deal
An offering in which an underwriter (or syndicate) buys all of the shares for resale to its clients, usually by way of a private placement or short form prospectus offering. In a bought deal the dealer risks its own capital.

Broker
Another term for a duly registered individual or an investment dealer that is registered to trade in securities in the capacity of an agent or principal and is a member of a Self-Regulatory Organization.

Bucketing
Confirming a transaction when no trade has actually been executed.

Canada Business Corporations Act (CBCA)
The federal Act that governs all aspects of business corporations, including incorporation and takeover bids.

Canadian Depository for Securities (CDS)
CDS provides customers with physical and electronic facilities to deposit and withdraw depository-eligible securities and manage their related ledger positions (securities accounts). CDS also provides electronic clearing services both domestically and internationally, allowing customers to report, confirm and settle securities trade transactions.

Canadian Derivatives Clearing Corporation (CDCC)
The CDCC is a service organization that clears, issues, settles, and guarantees options, futures, and futures options traded on the Bourse de Montreal (the Bourse). The CDCC also provides clearing, settlement, and administrative services to the Winnipeg Commodity Exchange (WCE) and the WCE Clearing Corporation.

Canadian Investor Protection Fund (CIPF)
A fund that protects investors against the insolvency of any member firm. It is financed by the IDA and the exchanges (except the WCE) who are collectively referred to as Sponsoring Self-Regulatory Organizations (SSROs).

Canadian Securities Administrators (CSA)
The CSA is a forum for the 13 securities regulators of Canada's provinces and territories to coordinate and harmonize regulation of the Canadian capital markets.
Carrying Broker
Securities firms that offer back office services and facilities to other member firms, which are known as introducing brokers.

Cash Account
A type of account where an investor is required to pay for purchases or deliver securities sold by the settlement date of the transaction.

Cash Account Rule
Rule governing settlement of securities transactions in cash accounts. It prescribes settlement dates, payment methods and restrictions on trading if accounts are overdue.

Cancel/Change Former Order (CFO)
An instruction to cancel or change a previously entered order.

Chinese Walls
Procedures and policies that ensure that a firm restricts access between departments to non-public, material information, in order to avoid the illegal use of inside information.

Churning
Excessive trading in a client’s account solely to generate commissions and resulting in no benefit to the client.

Coat tail Provision
A provision that allows shares that are not fully-voting the right to participate in takeover bids made for the fully-voting shares of a target company.

Code of Ethics
A guiding set of principles that establish norms geared towards compliance with “the letter of the law” as well as with the “spirit of the law.” These norms are based upon principles such as trust, integrity, justice, fairness and honesty.

Commission
The fee charged by an Investment Advisor for his/her services in facilitating a transaction, such as the buying or selling of securities.

Complaints and Settlement Database (ComSet)
A web-based system that allows member firms to relay information to the IDA on matters such as client complaints, securities-related civil claims and arbitration notices, internal disciplinary actions and criminal offences.

Confidential Account
An account for which the beneficial ownership is on record only at the firm’s head office.

Confidentiality
The ethical principle that a securities industry professional will hold secret all information relating to a client and a client’s account unless the client gives consent permitting disclosure or a formal request is made by the appropriate regulators.

Confirmation
A written statement acknowledging a securities transaction and confirming the details of the trade.
**Conflict of Interest**
A situation in which the personal or financial interests of a registrant conflict with the interests of a client or the registrant’s firm. In cases of potential or actual conflict of interest, a client’s interests must be given priority and the conflict should be disclosed.

**Constrained Share Companies**
Companies or institutions that are either culturally important or fundamentally important to the Canadian economy (e.g., Canadian banks, trust, insurance, broadcasting and communication companies) and therefore have foreign ownership restrictions.

**Contingent Order**
An order for the simultaneous buy of one security and the sale of another.

**Continuous Disclosure**
The requirement for issuers of securities that when a material change occurs a press release must be issued and filed immediately and a material change report must be filed with the commission(s) within 10 days through SEDAR. There is no requirement to file a press release for non-material changes.

**Control Position**
Ownership of sufficient voting stock in a company to materially affect its affairs. In all provinces except Manitoba, New Brunswick and Quebec, a 20% holding is deemed to represent control.

**Control Stock**
The voting stock owned by a shareholder in a control position.

**Day Order**
A buy or sell order that automatically expires if it is not executed on the day it is entered. All orders are day orders unless otherwise specified.

**Delayed Delivery Order**
A transaction that will not be settled within the normal settlement period.

**Delivery Against Payment (DAP)**
A transaction in which the buyer's payment for securities is due at the time of delivery (usually to a bank acting as agent for the buyer) upon receipt of the securities. The payment may be made by bank wire, cheque, or direct credit to an account.

**Directors’ Circular**
A document that must be sent to all shareholders by the directors of a company that is the target of a takeover bid. A recommendation to accept or reject the bid, and reasons for this recommendation, must be included.

**Disclosure**
one of the principles of securities regulation in Canada. This principle entails full, true and plain disclosure of all material facts necessary to make reasoned investment decisions.

**Discretionary Account**
A securities account where the client has given specific written authorization to an investment dealer to make decisions regarding the
security, price, quantity or timing of orders in the account.

**Distribution**
An offering of securities, generally by the issuer from its treasury, which requires the use of a prospectus or the availability of a prospectus exemption. In some provinces this is formally referred to as a primary distribution.

**Due Diligence**
Investigation into and verification of the details of a potential investment such as an examination of operations and management and the verification of material facts.

**Duty of Care**
The duty an IA has to a client to ensure that everything ‘reasonably practicable’ is done to protect the client’s assets. This involves devoting the necessary time and attention to be able to make informed decisions.

**Early Warning**
An initial threshold prior to a takeover bid. A person or company accumulating beneficial ownership or control over 10% or more of voting or equity securities of a class of securities must issue a press release and report to the Administrator immediately.

**Effective Delivery By Electronic Means**
The electronic distribution of information to the intended recipients that is equivalent to the information provided in paper form.

**Either/Or Order**
A simultaneous order for two different securities. As soon as one is executed, the other is cancelled.

**Enforcement**
One of the principles of securities regulation in Canada. Securities laws and administrative policies are enforced by the Administrators and the SROs.

**Equity Position**
The net credit in a client’s account.

**Excess Margin**
The client margin in an account exceeding what is required by the firm.

**Exempt Issue**
A securities issue for which a prospectus is not required. Exemptions may be due to the nature of the securities, the nature of the distribution or a resale of securities that were originally exempt.

**Fails**
Securities that are not delivered by settlement date.

**Fiduciary Duty**
A legal term that describes a high degree of duty of care. Criteria that may be used to determine whether a fiduciary duty is present in an IA-client relationship include a high degree of reliance by the client on the IA’s advice and the vulnerability of the client.
Final Prospectus
A document that contains complete details of securities being offered for sale. It provides full, true and plain disclosure of all material facts relating to the distribution. The final prospectus contains all of the information omitted in the preliminary prospectus (e.g., offering price, proceeds to the issuer, etc.). A copy must be mailed or delivered to all purchasers of the securities by no later than midnight on the second business day after an agreement of purchase or sale had been entered into.

Financial Action Task Force on Money Laundering (FATF)
An inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing.

Financial Institution
A banking or trust institution, pension fund, insurance company, credit union or other entity licensed to do business in the financial sector.

Financial Transactions Reports Analysis Centre of Canada (FINTRAC)
FINTRAC receives, analyzes, assesses and discloses financial intelligence on suspected money laundering, terrorist financing, and threats to the security of Canada.

Form C
The Shareholder Communication and Voting Instructions Form. This provides for written instructions from clients as to the receipt of proxy-related materials, disclosure to issuers of the client’s name, address and number of securities held and the voting of securities held by the client.

Free Credit Balance
Uninvested monies in client accounts that may be used by firms for their own purposes but are payable on demand to the clients.

Frontrunning
Entering an order with the prior knowledge of a pending trade that will likely affect the market price of the security.

Fully-Margined
A situation in which the client margin in a margin account is equal to or greater than the margin required.

Fully-Secured
A positive net equity position in an account. In other words, the value of holdings exceeds any debit balance.

Good Delivery By Electronic Means
Electronic delivery of information in which the recipients receive prior notice of delivery, have easy access to it, it is delivered unaltered and uncorrupted and the sender receives evidence of its successful delivery.

Grey Areas
Areas where compliance policies are not clear and ethics play a part in decision making. An ethical decision in a grey area depends on the details of the situation.
Hedge
An investment made to reduce the risk of adverse price movements in a security, by taking an offsetting position in a related security, (e.g., an option or a short sale).

Initial Public Offering (IPO)
A company's first sale of stock to the public.

Inside Information
Material non-public information about a company.

Insider
All directors and senior officers of a corporation and those who may also be presumed to have access to non-public or inside information concerning the company; also anyone owning more than 10% of the voting shares in a corporation.

Insider Report
Insiders are required to report their holdings upon becoming an insider and they must also report any change in those holdings within 10 days following such change. In Canada, insiders file these reports through the System for Electronic Disclosure by Insiders (SEDI) in electronic format via the Internet.

Insider Trading (Illegal)
Using material non-public information about a company to effect trades in that company’s securities or trading in securities as an insider without reporting the trades to the regulators.

Integrated Market Enforcement Teams (IMETs)
An initiative of the RCMP and the federal government to detect, investigate and deter capital markets fraud. The teams are composed of police, lawyers and other investigative experts through branches in Toronto, Vancouver, Montreal and Calgary. They are jointly managed by the RCMP and Justice Canada and work closely with securities regulators, such as the IDA, MFDA and RS, as well as other federal and provincial authorities.

Investment Advisor (IA)
An individual licensed to transact in the full range of securities. The term refers to employees of SRO member firms only. Also known as a Registrant or Registered Representative (RR).

Investment Dealer
A person or company that engages in the business of trading in securities in the capacity of an agent or principal and is a member of the IDA.

Investment Dealers Association (IDA)
The national Self-Regulatory Organization and representative of the securities industry. The IDA regulates the activities of investment dealers in terms of both their capital adequacy and conduct of business.

Investment Representative (IR)
Refers to an individual licensed as an order taker or sales assistant and strictly prohibited from providing investment advice to the public.
Issuer Bid
An offer by an issuer to security holders to buy back any of its own shares or other securities convertible into its shares.

Know Your Client (KYC) Rule
The cardinal rule in making investment recommendations. All relevant information about every client and every order must be known to ensure that all recommendations made by an IA to clients are suitable.

Limit Order
A client’s order to buy or sell securities at a specific price or better. The order will only be executed if the market reaches or betters that price.

Liquid Assets
Assets that can be readily converted into cash.

Loan Value
The dollar amount of credit that the firm will extend to a client for a purchase on margin.

Management’s Discussion and Analysis (MD&A)
A document that requires management of an issuer to discuss the dynamics of its business and to analyze its financial statements with the focus being on information about the issuer’s financial condition and operations with emphasis on liquidity and capital resources.

Manipulative Trading
Any attempt to affect or control the price of a security through trading.

Margin
Margin is the amount of money paid by a client when he or she uses credit to buy a security. It is the difference between the market value of a security and the amount loaned by an investment dealer.

Margin Account
An account that requires only partial payment from a client for certain purchases. The member firm loans the client the unpaid portion. Margin accounts can be long or short.

Margin Agreement
A contract that must be completed and signed by a client and approved by the firm in order to open a margin account. This sets out the terms and conditions of the account.

Margin Call
When an investor purchases securities, or sells securities short, on margin and share prices go against the investor, the investment dealer will demand the deposit of additional cash or marginable securities to the account to protect the broker’s loan.

Margin Deficiency
A situation in which a client’s margin in an account falls below the level required by the firm. This results in a margin call.

Margin Position
The amount of client margin and broker loan currently in an account.

Margin Rate
The percentage of a security’s value that a client must put up in order to
make a purchase or short sale on margin. The reciprocal of loan value.

**Market Order**
An order to buy or sell securities at the prevailing market price. All orders are market orders unless a price limit is specified.

**Market Out Clause**
A clause in an underwriting agreement allowing an underwriter to cancel the agreement without penalty for certain specified reasons, such as the issue becoming unsaleable due to changing market conditions or changes in the affairs of the issuer.

**Market Regulation Services Inc. (RS)**
The Self-Regulatory Organization that oversees trading on the Canadian equity markets, including the Toronto Stock Exchange (TSX), TSX Venture Exchange (TSX V), Bloomberg Tradebook Canada Company (Bloomberg) and Canadian Trading and Quotation System (CNQ). RS monitors every trade in real time to protect investors and ensure market integrity.

**Materiality**
This relates to the Cash Account Rule, and basically means that debits relating to such items as dividends, interest and fees (as opposed to trading activity) do not trigger account restrictions.

**Memorandum of Understanding**
A formal agreement between two or more regulatory bodies to co-operate in certain aspects of securities regulation.

**Minimum Quotation Spread**
The minimum acceptable range between bid and ask prices when quotations are given for securities. This range is determined by each individual exchange.

**Money Laundering**
The process in which the proceeds of crime are converted into legitimate funds using complex transactions, usually through financial institutions.

**Multi-jurisdictional Disclosure System (MJDS)**
This system permits public offerings of securities of U.S. issuers that meet specified eligibility requirements to be made in Canada on the basis of U.S. disclosure documents with additional Canadian disclosure.

**Mutual Fund Dealer**
A firm licensed exclusively for the purpose of trading in mutual fund securities.

**Mutual Fund Dealers Association (MFDA)**
The Self-Regulatory Organization that regulates the distribution (dealer) side of the mutual fund industry in Canada.

**Mutual Fund Sales Representative (MFSR)**
An individual licensed to transact in mutual fund securities only.
Mutual Reliance Review System (MRRS) for Applications for Exemptive Relief
During a securities distribution this system expedites the various review processes involving more than one jurisdiction. This allows the filer to deal with only one jurisdiction rather than all of the jurisdictions where the securities will be distributed.

National Association of Securities Dealers (NASD)
The largest securities-industry Self-Regulatory Organization in the U.S. It is responsible for the operation and regulation of NASDAQ and the over-the-counter securities markets, as well as the administration of U.S. securities licensing exams.

National Instruments
These are policies that apply in all Canadian jurisdictions and have the force of a binding rule.

National Policies
These are policies that apply in all Canadian jurisdictions but do not have the force of a binding rule. National Policies are more akin to a guideline as they inform market participants of the manner in which a securities commission may exercise its statutory discretionary authority.

National Registration Database (NRD)
A web-based system that permits dealers and advisers to file registration forms electronically, reduces the regulatory burden for industry participants and harmonizes securities regulations across jurisdictions.

Net Worth
Assets less liabilities. This must be included on the NAAF and taken into account by an IA when making investment recommendations to clients.

New Account Application Form (NAAF)
A form that is filled out by a client and an IA at the opening of an account. It provides personal information about the client, their financial position, risk tolerance, investment objectives, etc. which assists the IA in handling the account and (where applicable) making suitable investment recommendations. The NAAF must be completed and approved before (or promptly thereafter) any trades are executed in an account.

Nominee Account
An account that is in the name of an entity that is not the beneficial owner and in whose name securities are transferred.

Non-Client Order (N-C)
An order for the account of an employee of a member firm. Client orders are given priority over non-client orders for the same securities at the same price and terms.

Non-Objecting Beneficial Owners (NOBO)
The beneficial owners of securities who do not object to the release of their names and related information and permit issuers to communicate with them directly.
Non-Registered Holder
A security holder whose securities are held in the name of an investment firm of whom the holder is a client. This is also referred to as being held in “street name”.

Normal Course Issuer Bid
A takeover bid made by way of the purchase of not more than 5% of the outstanding listed voting or equity securities of a class of securities of a target company over a 12-month period.

North American Securities Administrators Association (NASAA)
An association of securities Administrators from the U.S., Canada, and Mexico.

Numbered Account
An account whose ownership is solely identified by an account number rather than by a name.

Objecting Beneficial Owners (OBO)
The beneficial owners of securities who object to the release of their names and related information and will not permit issuers to communicate with them directly.

Odd Lot
A number of shares that is less than a board lot. This usually refers to an equity trade for less than 100 shares, and is sometimes called a broken lot.

Partly-Secured
A negative net equity position in an account that occurs when the value of holdings is less than the debit balance.

Office of the Superintendent of Financial Institutions (OSFI)
The primary regulator of federally chartered financial institutions and federally administered pension plans. OSFI supervises and regulates all banks, and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and pension plans.

OmbudsNetwork
The OmbudsNetwork provides Canadian financial services consumers with access to independent, impartial and effective complaint resolution services in the banking, life and health insurance, general insurance, securities and mutual funds industries.

Open Order
An order that is valid until filled or cancelled. Sometimes called good till cancelled (GTC) order.

Personal Information Protection and Electronic Documents Act (PIPEDA)
The Act that governs each firm’s information gathering processes and regulates what firms can do with the personal information that is collected, used and disclosed in the course of doing business.
Politically Exposed Persons (PEPs)
Senior foreign government officials, their immediate family members and their close associates. These individuals pose a potential money laundering threat if their funds are the proceeds of embezzlement or foreign corruption.

Portfolio Manager
A person or company that manages the investment portfolios of clients through discretionary authority granted by the clients.

Portfolio Record
A document that shows each client’s current holdings. IAs should have this readily available at all times.

Power of Attorney
A legal document giving authority to an individual to direct the affairs of another (usually in the case of an absence).

Preliminary Prospectus
The initial document published by an underwriter of a new issue of securities that is given to prospective investors to ascertain the extent of public interest in the issue while it is being reviewed by a securities commission.

Primary Distribution
A distribution of securities, generally by the issuer from its treasury. All primary offerings are distributions which requires the use of a prospectus or the availability of a prospectus exemption.

Principal
The person for whom a broker executes an order, or a dealer buying or selling for its own account. The term may also refer to a person’s capital or to the face amount of a bond.

Principal Regulator
Under the MRRS, the Administrator with whom an applicant files. This is usually the Administrator of the jurisdiction in which an individual resides or where a firm’s head office is located.

Pro Group
Those considered “non-clients” with regard to the purchase of certain securities. This includes (both individually and as a group) the member firm, employees of the member and partners, directors and officers of the member and their associates and affiliates.

Provincial Contingency Fund
A fund established by provincial securities regulators to protect investors against insolvency of participating firms who are not members of another contingency fund.

Provincial Policies
Policies that reflect local differences in legislation, regulation and procedure between the provinces.

Proxy
A written or electronic authorization given by a shareholder for someone else, usually the company’s management, to cast his/her vote at a
shareholder meeting or at another time.

**Red Flags**
Warning signals and indicators of possible improper activities that may provide a basis for further actions.

**Red Herring Prospectus**
Another term for a preliminary prospectus so called because certain information is printed in red ink on the front page.

**Registered Holder**
A securityholder whose name is registered with the issuer.

**Registered Representative (RR)**
Another term for an Investment Advisor which is commonly used by regulators. In a broad sense it includes individuals licensed to do business in the securities industry.

**Registered Trader (RT)**
A trader who is registered with the TSX.

**Registrant**
This refers to individuals registered with the Securities Administrators or Self-Regulatory Organizations.

**Registration**
One of the principles of securities regulation in Canada. This principle requires registration of all securities dealers and advisors.

**Regular Delivery**
The date that a securities trade usually settles – i.e., the date that the seller must deliver the securities.

**Regulator**
A general term referring to the Securities Administrators and Self-Regulatory Organizations (SROs) collectively.

**Reporting Issuer**
A corporation that has issued securities to the public and is subject, among other things, to continuous disclosure requirements.

**Right of Action for Damages**
Most securities legislation provides that those who sign a prospectus may be liable for damages if the prospectus contains a misrepresentation. This right extends to experts (e.g., lawyers, auditors, geologists, etc.) who report or give opinions within the text of the document.

**Right of Rescission**
The right of a purchaser of a new issue to withdraw from the purchase agreement within the specific province's applicable time limits if the prospectus contains an untrue statement or omitted a material fact.

**Right of Withdrawal**
The right of a purchaser of a new issue to withdraw from the purchase agreement within two business days after receiving the prospectus.

**Safekeeping**
A safeguarding service provided by a securities firm for its clients’ fully paid-for securities registered in the clients’ own names. The practice entails the use of vault space to store securities certificates until they are withdrawn or sold.
Sales Assistant
An Investment Representative (IR) employed with a full-service Investment Dealer.

Sales Communication
Any type of oral or written communication used to induce the purchase of securities.

Secondary Offering
The resale by a holder of securities previously issued by the issuer. Under certain specific conditions a secondary offering could also be a “distribution”.

Securities Acts
Provincial Acts that are administered by the securities commission in each province, which set the rules under which securities may be issued and traded in that province.

Securities Administrator
A general term referring to the provincial regulatory authority (e.g., securities commission or provincial registrar) responsible for administering a provincial Securities Act.

Securities and Exchange Commission (SEC)
The federal securities regulatory agency in the United States.

Securities Eligible for Reduced Margin
Securities which demonstrate sufficiently high liquidity and low price volatility based on meeting specific price risk and liquidity risk measures.

Security Cross-Reference
An alphabetical listing of securities held by clients, with the clients’ names listed underneath each security.

Segregated Securities
Client-owned securities, fully paid for or representing excess collateral in margin accounts, that are locked away and cannot be used to conduct a securities firm’s business. Segregated securities may be registered in street name.

Self-Regulatory Organization (SRO)
An organization recognized by the Securities Administrators as having powers to establish and enforce industry regulations. Its main functions are to protect investors, maintain fair, equitable and ethical practices in the industry and ensure conformity with securities legislation. Canadian SROs include: the Investment Dealers Association, Market Regulation Services, the Mutual Fund Dealers Association, the Montreal Exchange, the Toronto Stock Exchange, the TSX Venture Exchange and the Winnipeg Commodity Exchange.

Selling Away
Dealing in securities outside of the normal business of the firm. These dealings are known as outside deals.

Settlement Date
The date on which a securities buyer must pay for a purchase or a seller must deliver the securities sold. For stock transactions, settlement must be
made on or before the third business day following the transaction date.

**Shelf Distribution**
A securities distribution where the required disclosure documents have been cleared by the regulators in advance of the proposed distribution and a prospectus supplement containing among other things, a description of the securities being offered is filed with the appropriate securities commission(s).

**Short Form Prospectus Distribution System (SFPD)**
This system allows reporting issuers quicker access to the capital markets via a short form prospectus that basically only provides details of the offering. The short form prospectus contains by reference the material filed in the issuer’s Annual Information Form.

**Short Sale**
The sale of a security which the seller does not own but which is loaned to the seller by the investment dealer. This is done when an investor believes that the price of a stock is going to fall and he or she intends to cover the sale by buying the stock back at a lower price. Short sales must be declared at the time the order is entered.

**Short Tendering**
The practice of tendering more shares in response to a tender offer than an investor owns.

**Soft Dollar Arrangements**
Non-cash payments received in exchange for services such as research and computer equipment used to assist in making investment decisions..

**Special Relationship**
Any relationship which gives an individual access to material, non-public information.

**Sponsoring Self-Regulatory Organization (SSRO)**
An SRO that sponsors the Canadian Investor Protection Fund. The SSROs are the Investment Dealers Association, the Montreal Exchange, the Toronto Stock Exchange and the TSX Venture Exchange.

**SRO Member Firm**
Any firm that is a current member of a Self-Regulatory Organization (SRO).

**Standard Performance Data**
A calculation of current and effective yield for money market funds and total return for other mutual funds.

**Standard Trading Unit**
The replacement term for a “board lot” under UMIR, which recognizes that different marketplaces may use different sizes for board lots.

**Stop Buy Order**
An order to buy a security only after it has reached a certain price. This may be used to protect a short position or to ensure that a stock is purchased while its price is rising. According to TSX rules these orders become limit orders when the stop price is reached.
Stop Loss Order
The opposite of a stop buy order. An order to sell a security after its price falls to a certain amount, thus limiting the loss or protecting a paper profit. According to TSX rules these orders become limit orders when the stop price is reached.

Street Name
Securities registered in the name of an investment dealer or its nominee, instead of the name of the real or beneficial owner, are said to be "in street name." Certificates so registered are known as street certificates.

Suitability
A registrant’s major concern in making investment recommendations. All information about a client and a security must be analyzed to determine if an investment is suitable for the client in accounts where a suitability exemption does not apply.

Switch Order
An order to sell one security and use the proceeds to purchase another security.

System for Electronic Disclosure by Insiders (SEDI)
SEDI facilitates the filing and public dissemination of "insider reports" in electronic format via the Internet.

System for Electronic Document Analysis and Retrieval (SEDAR)
SEDAR facilitates the electronic filing of securities information as required by the securities regulatory agencies in Canada and allows for the public dissemination of information collected in the filing process.

Takeover Bid
An offer made to the security holders of a company to purchase the voting securities of a company which, with the offeror’s already owned securities, will in total exceed 20% of the outstanding voting securities of the company. For federally incorporated companies, the equivalent requirement is more than 10% of the outstanding voting shares of the target company.

Tipping
When someone possessing inside information knowingly conveys that information, while also knowing that there is a risk that the recipient will use the information to buy or sell, directly or indirectly, a security to which the information relates or convey the information to someone else who may do so.

Trading Unit
The name given to each single, indivisible amount in a transaction. The unit of trading for stocks is a share while the unit of trading for options is a contract.

Transfer Agent
An agent employed by a corporation or mutual fund to maintain shareholder records, including purchases, sales, and account balances.

Undermargined
A margin account that has a margin deficiency (i.e., insufficient funds).
Uniform Act Policies
Policies that only apply in Ontario and the four Western Provinces.

Universal Market Integrity Rules (UMIR)
A common set of equities trading rules designed to ensure fairness and maintain investor confidence. These rules create the framework for the integrity of trading activity on marketplaces and allow for the competitive operation of exchanges, quotation and trade reporting systems (QTRSs) and alternative trading systems (ATSs) in Canada.

Unsolicited Order
An order entered by a client where there was no recommendation made by the client’s IA or his/her firm.

Uptick Rule
This applies to short sale orders. These orders can only be executed at a price that is higher than the preceding price.

Waiting Period
The period of time between the issuance of a receipt for a preliminary prospectus and receipt for a final prospectus from the securities administrators.

Wash Trade
A trade in which there is no change of beneficial ownership of a security. This may be done to give an impression of false trading activity in a security.
Appendix A – The CSA Numbering System for National Policies and National Instruments

CSA Numbering System

You should be aware that the method of numbering each instrument or policy is not arbitrary, however you are not expected to know the numbering system. The following is presented for your information only:

First Digit

Subject matter of the instrument or policy:
1 – Procedure and Related Matters
2 – Certain Capital Market Participants
3 – Registration Requirements and Related Matters
4 – Distribution Requirements
5 – Ongoing Requirements for Issuers and Insiders
6 – Takeover bids and Special Transactions
7 – Securities Transactions outside the Jurisdiction
8 – Mutual Funds
9 – Derivatives

Second Digit

Sub-category of the subject matter.

Third Digit

Type of instrument:
1 – National Instrument and any related Companion Policy of Form
2 – National Policy
3 – Denotes a CSA notice
4 – (Reserved for Future use by the CSA)
5 – Local rule, regulation or blanket order or ruling and any related Companion Policy or Form
6 – Local Policy
7 – Local Notice
8 – Implementing Instrument

The fourth and fifth digits are assigned consecutively to instruments within the sub-category.
Appendix B – TSX Electronic Communications Disclosure Guidelines

(The following is reproduced by permission of the Toronto Stock Exchange. Note that for the purposes of consistency throughout the text, all references to the TSE have been replaced with the new abbreviation, i.e. the TSX.)

For financial markets, the Internet may be the greatest leap forward in providing information and analysis since the advent of electronic communications. It is putting relevant information at investors’ fingertips – instantaneously and simultaneously. But the Internet also poses regulatory challenges. In a world in which information is more readily available than ever, it is more important than ever that it be accurate, timely and up-to-date.

With this in mind, the TSX has developed these electronic communications guidelines to assist listed companies to meet their investors’ informational needs. Part II reminds companies that the applicable disclosure rules apply to all corporate disclosure through electronic communications and must be followed by each company. Part III sets out the guidelines that apply directly to the Internet and other electronic media. The overall objective of the guidelines is to encourage the use of electronic media to make investor information accessible, accurate and timely. The challenge of regulating electronic media is to ensure that regulatory concerns are addressed without impeding innovation.

I. Introduction

These guidelines should be read with the TSX Policy Statement on Timely Disclosure and Related Guidelines.

Web sites, electronic mail ("email") and other channels available on the Internet are new media of communication available to listed companies for corporate disclosure. Each of these media provides opportunities for a company to disseminate broadly investor relations information. There are, however, a number of issues that a company must consider when it goes online. Investor relations information that is disclosed electronically using these new media should be viewed by the company as an extension of its formal corporate disclosure record. As such, these electronic communications are normally subject to securities laws and TSX rules and should not be viewed merely as a promotional tool.

The TSX strongly recommends that all listed companies maintain a corporate Web site to make investor relations information available electronically.

Current securities filings of listed companies such as financial statements, AIFs, annual reports and prospectuses are maintained on the SEDAR Web site operated
by CDS. In addition, the TSX maintains a profile page on each listed company on its Web site (www.tse.com). Further, many news wire services post listed company news releases on their Web sites. Since these various sites are not all connected, it may be difficult and time consuming for an investor to search the Internet and obtain all relevant investor relations information about a particular company. If a company creates its own Web site, it ensures that all of its investor relations information is available through one site and can provide more information than is currently available online. For example, SEDAR contains only mandatory filings, while a company’s site may carry a wealth of supplemental information, such as fact sheets, fact books, slides of investor presentations and transcripts of investor relations conferences.

**Disclosure by the Internet alone will not meet a company’s disclosure requirements and a company must continue to use traditional means of dissemination.**

Electronic communications do not reach all investors. While growing in popularity, only a minority of investors have access to the Internet. Even investors with access will be unaware that new information is available unless the company notifies them of an update.

**II. Applicable Disclosure Rules**

Distribution of information via a Web site, email or otherwise via the Internet is subject to the same laws as traditional forms of dissemination such as news releases. In establishing electronic communications, a company should have special regard to disclosure requirements under applicable securities law. Companies should refer to the TSX Policy Statement on Timely Disclosure and Related Guidelines and National Policy No. 40 Timely Disclosure. Companies must comply with the disclosure requirements in all jurisdictions in which they are reporting issuers.

These rules apply to all corporate disclosure through electronic communications and must be followed by each company.

**1. Electronic Communications Cannot Be Misleading**

A company must ensure that material information posted on its Web site is not misleading. Material information is misleading if it is incomplete, incorrect or omits a fact so as to make another statement misleading.
a. Duty to Correct and Update

A Web site should be a complete repository of current and accurate investor relations information. Viewers visiting a Web site expect that they are viewing all the relevant information about a company and that the information provided to them by the company is accurate in all material respects. A company is, therefore, obligated to correct any material information available on its Web site that is misleading. It is not sufficient that the information has been corrected or updated elsewhere.

It is possible for information to become inaccurate over time. A company must regularly review and update or correct the information on the site.

b. Incomplete Information or Material Omissions

Providing incomplete information or omitting a material fact is also misleading. A company must include all material disclosed information. It must include all news releases, not just favourable ones. Similarly, documents should be posted in their entirety. If this is impractical for a particular document, such as a technical report with graphs, charts or maps, care must be taken to ensure that an excerpt is not misleading when read on its own. In such circumstances, it may be sufficient to post the executive summary.

2. Electronic Communications Cannot Be Used to “Tip” or Leak Material Information

A company’s internal employee trading and confidentiality policies should cover the use of electronic forms of communication. Employees must not use the Internet to “tip” or discuss in any form undisclosed material information about the company.

A company must not post a material news release on a Web site or distribute it by email or otherwise on the Internet before it has been disseminated on a news wire service in accordance with the TSX Policy Statement on Timely Disclosure and Related Guidelines.

3. Electronic Communications Must Comply with Securities Laws

A company should have special regard to securities laws and, in particular, registration and filing requirements, which may be triggered if it posts any document offering securities to the general public on its Web site. If a listed company is considering a distribution of securities, it should carefully review its
Web site in consultation with the company’s legal advisors in advance of and during the offering. The Internet is increasingly becoming an important tool to communicate information about public offerings to shareholders and investors. Nevertheless, the release of information and promotional materials relating to a public offering before or during the offering is subject to restrictions under securities laws.

Documents related to a distribution of securities should only be posted on a Web site if they are filed with and receipted by the appropriate securities regulator. All promotional materials related to a distribution of securities should be reviewed before they are posted on a Web site to ensure that such materials are consistent with the disclosure made in the offering documents.

Anyone, anywhere in the world can access a Web site. Special regard should be made to foreign securities laws that may be stricter than Ontario laws. Foreign securities regulators may take the view that posting offering documents on a Web site that can be accessed by someone in their jurisdiction constitutes an offering in that jurisdiction unless appropriate disclaimers are included on the document or other measures are taken to restrict access.

Reference should be made to the guidelines issued by other jurisdictions such as those issued by the U.S. Securities and Exchange Commission for issuers who use Internet Web sites to solicit offshore securities transactions and clients without registering the securities in the United States.

### III. Electronic Communications Guidelines

The TSX recommends that listed companies follow these guidelines when designing a Web site, establishing an internal email policy or disseminating information over the Internet.

Unlike the disclosure rules which are applicable to all electronic communications, these guidelines are not hard and fast rules which must be followed. Aspects of these guidelines may not be appropriate for every company. A company should tailor these guidelines to create an internal policy that is suitable to its particular needs and resources.

Each listed company should establish a clear written policy on electronic communications as part of its existing policies governing corporate disclosure, confidentiality and employee trading. Please refer to the TSX Policy Statement on Timely Disclosure and Related Guidelines.

The TSX suggests that the policy describe how its electronic communications are to be structured, supervised and maintained. The policy should be reviewed regularly and updated as necessary. To ensure that the policy is followed, it should be communicated to all individuals in the company to whom it will apply.
1. **Who Should Monitor Electronic Communications?**

The TSX recommends that one or more of the officers appointed under the company’s disclosure policy be made responsible for the company’s policies on electronic communications. Reference should be made to page 13 of the TSX Policy Statement on Timely Disclosure and Related Guidelines. These officers should ensure that all investor relations information made available by the company on the Web site, broadcast via email or otherwise on the Internet complies with applicable securities laws and internal policies.

This responsibility includes ensuring the company Web site is properly reviewed and updated.

2. **What should be on the Web site?**

   a. **All Corporate “Timely Disclosure” Documents and Other Investor Relations Information**

   The TSX recommends that companies take advantage of Internet technologies and make available through a company Web site all corporate “timely disclosure” documents and other investor relations information that it deems appropriate to post on its Web site. A company may either post its own investor relations information or establish links to other Web sites that also maintain publicly disclosed documents on behalf of the company such as news wire services, SEDAR and stock quote services. “Investor relations information” includes all material public documents such as: the annual report; annual and interim financial statements; the Annual Information Form; news releases; material change reports; declarations of dividends; redemption notices; management proxy circulars; and any other communications to shareholders. The TSX recommends that a company post its investor relations information, particularly its news releases, as soon as possible following dissemination.

   If a company chooses to link to SEDAR or to a news wire Web site, it is recommended that the link be directly to the company’s page on that site. If a company merely links to the other site’s home page, the investor may find navigating the other site to find the information to be frustrating and time consuming. Links to other Web sites should be checked regularly to ensure they still work.

   b. **All supplemental information provided to analysts and other market observers but not otherwise distributed publicly**

   The TSX recommends that a company that distributes non-material investor relations information to analysts and institutional clients make such supplemental
information available to all investors. Supplemental information includes such materials as fact sheets, fact books, slides of investor presentations and transcripts of management investor relations speeches and other materials distributed at investor presentations. Posting supplemental information on a Web site is a very useful means of making it generally available.

This recommendation is consistent with the recommendations made in the Final Report of the Committee on Corporate Disclosure: Responsible Corporate Disclosure (March 1997) and the Canadian Investor Relations Institute: Standards and Guidance for Disclosure (February 1998). Each recommends that any supplementary information that is distributed on a selective basis be made available generally.

Keeping in mind that a company should design its Web site to meet its business needs, the TSX recommends the Internet as a useful medium to distribute supplemental information. The TSX suggests that a company should post all supplemental information on its Web site, unless the volume or format makes it impractical. If this is the case, the company should describe the information on the Web site and provide a contact for the information so that an investor may contact the company directly either to obtain a copy of the information or to view the information at the company’s offices.

In addition to any supplemental information provided by the company to analysts, the TSX suggests that a company also consider posting on its Web site or otherwise making available transcripts or recordings of all analyst conference calls.

c. Investor Relations Contact Information

The TSX suggests that a company provide an email link on its Web site for investors to communicate directly with an investor relations representative of the company. The company policy should specify who may respond to investor inquiries and should provide guidance as to the type of information that may be transmitted electronically.

To assure rapid distribution of material information to Internet users who follow the company, a company may consider establishing an email distribution list, permitting users who access its Web site to subscribe to receive electronic delivery of news directly from the company. Alternatively, a company may consider using software that notifies subscribers automatically when the company’s Web site is updated. Any electronic distribution of material information must be made after the information has been disseminated on a news wire service.
d. Online Conferences

A company may choose to participate on an online news or investor conference. The TSX suggests that participation by the company in such online conferences should be governed by the same policy that the company has established in respect of its participation in other conferences such as an analyst conference call.

3. What Should Not Be Distributed via Electronic Communications?

a. Employee Misuse of Electronic Communications

Access to email and the Internet can be valuable tools for employees to perform their jobs, however, the TSX suggests that clear guidelines should be established as to how employees may use these new media. These guidelines should be incorporated into the company’s disclosure, confidentiality and employee trading policy. Employees should be reminded that their corporate email address is a company address and that all correspondence received and sent via email is to be considered corporate correspondence. Appropriate guidelines should be established about the type of information that may be circulated by email. A company should prohibit its employees from participating in Internet chat rooms or newsgroups in discussions relating to the company or its securities. Moreover, communications over the Internet via email may not be secure unless the company has appropriate encryption technology. Employees should be warned of the danger of transmitting confidential information externally via unencrypted email.

b. Analyst Reports and Third Party Information

As a general practice, the TSX recommends that a company should not post any investor relations information on its Web site that is authored by a third party, unless the information was prepared on behalf of the company, or is general in nature and not specific to the company. For example, if a company posts an analyst report on its Web site, it may be seen to be endorsing the views and conclusions of the report. By posting such information on its site, a company may become “entangled” with the report and be legally responsible for the content even though it did not author it. This could also give rise to an obligation to correct the report if the company becomes aware that the content is or has become misleading (for example, if the earnings projection is too optimistic). While the TSX recommends that companies refrain from posting analyst reports on their Web sites, it recognizes that some companies take a different view. If a company chooses to post any analyst reports on its Web site, the TSX recommends that extreme caution be exercised. A company’s policy on posting analyst reports should address the following concerns:
Appendix B – TSX Electronic Communications Disclosure Guidelines

- permission to reprint a report should be obtained in advance from the analyst, since reports are subject to copyright protection;
- the information should clearly be identified as representing the views of the analyst and not necessarily those of the company;
- the entire analyst report should be reproduced so that it is not misleading;
- any updates, including changes in recommendations, should also be posted so the company’s Web site will not contain out-of-date and possibly misleading information;
- all analyst reports should be posted; if the company posts only some of the available reports, it should list all of the other reports that are available on the company and provide contact information so that such reports may be obtained directly from the analyst.

Instead of posting analyst reports on its Web site, an alternative approach is for a company to provide a list of all analysts who follow the company together with contact information so that investors may contact the analyst’s firm directly. If a company chooses to provide its investors a list of analysts, the list should be complete and include all analysts that the company knows to follow it, regardless of their recommendations. Since companies are not obligated to keep track of every analyst that follows them, it may be onerous to compile an accurate and complete list that is not misleading to investors.

c. Third Party Links

A company may establish hyperlinks between its Web site and third party sites. If a company creates a hyperlink to a third party site, there is a risk that a viewer will not realize that he or she has left the company’s Web site. The TSX suggests that the company include a disclaimer that the viewer is leaving the company Web site and the company is not responsible for the contents of the other site.

d. The Blurred Line between Investor and Promotional Information

The TSX recommends that a company clearly identify and separate its investor information from other information on its Web site. In particular, promotional, sales and marketing information should not be included on the same Web pages as investor relations information. A company’s Web site should clearly distinguish sections containing investor relations information from sections containing other information.

4. When Should Information Be Removed from A Web Site?

Care should be taken to make sure that information that is inaccurate or out-of-date no longer appears on the Web site. Companies may delete or remove inaccurate
information from the Web site, as long as a correction has been posted. In addition, companies may establish an archiving system to store and access information that is no longer current. To assist investors in determining the currency of the information on the site, the TSX suggests that a company date the first page of each document as they are posted on the Web site.

The TSX recommends that the company’s policy establish a minimum retention period for material corporate information that it posts on its Web site. Different types of information may be retained for a different period of time. For example, the company may decide to retain all news releases on the site for a period of one year from the date of issue. In contrast, the company may decide that investors would want to access its financials for a longer period (e.g. two years for quarterlies and five years for annuals).

5. Rumours on The Internet

Rumours about the company may appear on chat rooms and newsgroups. Rumours may spread more quickly and more widely on the Internet than by other media. Market Surveillance monitors chat rooms and newsgroups on the Internet to identify rumours about TSX listed companies that may influence the trading activity of their stocks. The TSX Policy Statement on Timely Disclosure and Related Guidelines addresses how a company should respond to rumours. A company is not expected to monitor chat rooms or newsgroups for rumours about itself. Nevertheless, the TSX recommends that the company’s standard policy for addressing rumours apply to those on the Internet. Whether a company should respond to a rumour depends on the circumstances. The TSX suggests that the company should consider the market impact of the rumour and the degree of accuracy and significance to the company. In general, the TSX recommends against a company participating on a chat room or newsgroup to dispel or clarify a rumour. Instead, it is preferable for the company to issue a news release to ensure widespread dissemination of its statement.

If a company becomes aware of a rumour on a chat room, newsgroup or any other source that may have a material impact on the price of its stock, it should immediately contact Market Surveillance. If the information is false and is materially influencing the trading activity of the company’s securities, it may consider issuing a clarifying news release. The company should contact Market Surveillance so that the TSX can monitor trading in the company’s securities. If Market Surveillance determines that trading is being affected by the rumour, it may require the company to issue a news release stating that there are no corporate developments to explain the market activity.
6. Legal Disclaimers

Corporate disclosure by electronic communications may give rise to many legal issues. It is in the best interests of a company to consult with its legal advisors to discuss the appropriateness of including legal disclaimers about the accuracy, timeliness and completeness of the information posted on its Web site.

IV. Maintaining Site Integrity

Electronic communications on the Internet are not always secure. The TSX recommends that a company establish procedures to assure maximum security of its Web site and email.

As electronic technologies evolve, security measures also evolve. To ensure the security of its electronic communication, the TSX suggests that a company:

• review and up-date its security systems regularly;
• be aware that it might be possible for unauthorized persons to alter the content of the site; and
• monitor the integrity of its Web site address to make sure that the site is accessible and has not been altered.

V. TSX Monitoring of The Internet

The TSX regularly monitors listed company Web sites as well as chat rooms and newsgroups on the Internet. The TSX has the capability to review alterations to listed company Web sites and to perform random searches of the Internet to identify active discussions relating to listed companies. However, such monitoring can never be exhaustive. Companies are responsible for maintaining their Web site and should continue to make Market Surveillance aware of significant rumours or problems relating to Internet discussions.