CHAPTER 2:
THE CANADIAN SECURITIES INDUSTRY

Topic One: Industry Overview

1. **Self-regulatory Organizations (SROs).**
   A. The SROs set rules that govern the operations of investment dealers and market activity. Provincial regulators oversee the SROs.

   B. There are five SROs:
      (1) The Investment Industry Regulatory Organization of Canada (IIROC).
      (2) The Mutual Fund Dealers Association (MFDA).
      (3) Bourse de Montréal (also known as the Montreal Exchange).
      (4) The Toronto Stock Exchange (TSX).
      (5) The TSX Venture Exchange.

Topic Two: The Role of Financial Intermediaries

1. **Overview.**
   A. A financial intermediary moves capital between suppliers and users.
      (1) A chartered bank or a trust company is a financial intermediary that acquires capital via customer savings and investments and transfers that capital to users through mortgages and other forms of lending.
         (a) The chartered banks are, by asset, the largest of all financial institutions, and enjoy a high rate of growth due to:
            i. Activity in foreign markets.
            ii. Legislation that has improved bank competition with other financial institutions.
            iii. An increased number of banks, especially Schedule II and Schedule III banks.
            iv. Their acquisition of trust companies.
      (2) An insurance company acquires capital via premiums, and transfers capital to policy owners in the form of death benefits, disability income payments, and annuities.

(3) An investment dealer acquires capital by underwriting and distributing new securities and by trading in the secondary markets.
   (a) Underwriting is the process in which the investment dealer buys an issue of stocks or bonds from its issuing company on a given date and at a given price.

B. There are three types of firms in the Canadian securities industry.
   (1) Integrated firms that:
      (a) Offer all products and services, including research, portfolio evaluations, advice on mergers and acquisitions, and loans for margin accounts.
      (b) Participate in institutional and retail markets.
      (c) Underwrite debt and equity issues.
      (d) Trade on secondary markets and stock exchanges.
   (2) Institutional firms that serve only institutional clients.
   (3) Retail firms.
      (a) Full-service retail firms offer products and services to retail investors.
      (b) Discount brokerages provide retail investors with trading services at a lower price than full-service firms, but do not provide research and advice.

C. Firms are organized by:
   (1) Management, which includes senior officers of the company, such as the chairman, president, and executive vice-presidents.
   (2) The sales department, which is typically divided into institutional and retail divisions.
      (a) The institutional division sells issues of new securities to institutional investors.
      (b) The retail division is comprised of investment advisors (IAs) who:
         i. Sign up new clients and determine their investment objectives.
         ii. Sell to retail investors.
         iii. Provide advice.
         iv. Process trading orders.

   (3) The underwriting/financing department, which works with potential new issuers and helps to design the issue to enhance its marketability through proper pricing, special features, and dividend rate.

(4) The trading department, which is segmented by whether it sells:
   (a) Bonds: traded from the firm's inventory or from another firm that specializes in an issue.
   (b) Stocks: traders receive buy and sell orders from institutional and retail salespeople and market-makers.
   (c) Specialized instruments: trading specialists for mutual funds, exchange-traded options, or futures.

(5) The research department, which studies conditions, operations, and trends for an industry, the market, and the economy.
   (a) The institutional division makes proposals for institutional accounts.
   (b) The retail division fields client questions and makes proposals for client portfolios.

(6) Administration, which provides:
   (a) Operational support, ensuring trades are recorded, clients are credited with interest and dividends, and securities are registered and delivered.
   (b) Credit and compliance, by monitoring client cash and margin accounts.
   (c) Financial support, including payroll.

D. Securities firms are for the most part publicly traded corporations in their own right or operating units within a publicly traded corporation. For instance, Dundee Securities—a well-known Canadian investment firm—trades on the TSX under the symbol DW-T. TD Waterhouse, another large investment firm, is part of Toronto-Dominion Bank, and the bank shares trade under the symbol TD. The securities firms are financed by:

   (1) Capital invested by owners/shareowners.

   (2) Retained earnings (profit retained after dividends are paid to their shareowners).

   (3) Borrowing.

      (a) The entire securities industry is a major borrower. It needs capital to support the inventories of securities held by firms, underwriting, trading, and margin accounts, and is thus highly leveraged.

   (4) Revenues created by the firm, primarily from commissions and earnings generated by trading, in addition to fees charged on accounts, underwriting fees, and interest charges to customers.

      (a) Revenues and returns correspond to the markets: a bull market sees high returns; a bear market less. Thus, the industry itself is subject to cyclical business swings.

E. Dealers act as principals and agents in buying and selling securities.

   (1) A principal owns securities.

      (a) When there is a new issue of a security, a dealer can buy the whole issue and hold the security in its inventory. In doing so, the dealer becomes the underwriter of the issue. A primary distribution occurs when this issue is sold to investors.

      (b) Principals profit from the spread between the price at which the issue was bought and the price at which it is sold in the primary distribution.

      (c) Dealers also hold an inventory of securities to trade on the secondary market.

         i. Their inventories provide liquidity to the market.

      (d) Trading by principals also occurs on the over-the-counter market.

(2) An agent transfers securities between sellers and buyers, and has no ownership position in the securities.

(a) Such trading of already-owned securities occurs in the secondary market.

(b) Agents profit from commissions charged on trades.

(c) Agents who trade on the secondary markets are known as brokers.

F. CDS Clearing and Depository Services Inc. (CDS) operates a clearing and settlement system known as CDSX.

(1) Exchanges and ATS report all trades to the CDSX.

(2) All OTC trades are also reported to CDSX.

(3) CDS ensures that trades and cash that changes hands during the course of a trading day is the net amount of cash owed, instead of the amount owed as a result of the numerous trades that occur in a day.

Topic Three: Banks as Financial Intermediaries

1. Self-regulatory Organizations (SROs).

A. Banks are categorized according to their ownership as either:

(1) Schedule I banks.

(a) The amount of shareowner equity dictates ownership restrictions.

i. When shareowner equity is greater than $5 billion, voting shares must be widely held, with no person or entity owning more than 20% of the shares.

ii. When shareowner equity is less than $5 billion and more than $1 billion, a person or entity may own up to 65% of the voting shares, if the balance is widely held.

iii. When shareowner equity is less than $1 billion, all shares can be owned by a single person or entity.

(b) Schedule I banks provide a wide range of lending, savings, and investment products.

i. Loaning money at a rate higher than the bank's cost provides revenue to cover operating costs and increase profitability.

(c) Subsidiaries of the banks provide products and services the banks themselves are prevented from providing.

i. Sharing information between parent and subsidiary or between subsidiaries is prevented by the erection of Chinese Walls.
ii. Chinese Walls are imaginary separations between business units of a financial firm. For instance, a Chinese Wall prevents an investment banker who may be privy to information that could influence the price of securities from sharing that information with traders within the same firm.

(2) Schedule II banks.

(a) Schedule II banks are foreign bank subsidiaries.
(b) They are federally regulated and pursue the same types of business as a Schedule I banks, but most revenue is generated by retail banking and electronic services.
(c) Deposits may be covered by the Canada Deposit and Insurance Corporation (CDIC).
(d) AMEX Bank of Canada and Citibank Canada are Schedule II banks.

(3) Schedule III Banks

(a) Schedule III banks are owned by foreign banks.
(b) Their revenues are generated by corporate and institutional clients.
(c) Schedule III banks facilitate foreign investment in Canada.
(d) HSBC Bank, USA, and Mellon Bank, NA, are Schedule III banks.

COMPARISON OF FINANCIAL INSTITUTIONS

	Regulation	**Services**
Schedule I Banks	*Bank Act*	-deposit taking; short-term lending; medium and long-term corporate lending; mortgages, project financing, foreign lending, venture capital lending, credit card lending, equipment leasing
Schedule II Banks	*Bank Act*	-all Schedule I services but ability to lend is limited by the capital base of the Canadian Schedule II bank (not the parent bank)
Schedule III Banks	*Bank Act*	-all Schedule I services with certain restrictions
Credit unions and caisses populaires	*Cooperative Credit Association Act*	-deposit taking; lending; mortgages; mutual funds; trust services; mutual funds; investment dealer services; insurance; credit cards
Trust and loan companies	*Trust and Loan Companies Act*	-deposit taking; mortgages; registered plans; term deposits; trustees in charge of corporate or individual assets; estate planning; asset management
Life Insurers	*Insurance Companies Act*	-mortgages; life insurance policies; segregated funds; annuities; registered plans; accident and sickness policies

Topic Four: Trust Companies, Credit Unions, and Life Insurers

1. **Trust and Loan Companies.**
   A. Trust and loan companies provide the same products and services as banks, EXCEPT trust companies are the only financial institutions authorized to act as trustees in charge of corporate or individual assets, such as property, stocks, or bonds.

2. **Credit Unions and Caisses Populaires.**
   A. Credit unions are member-owned and located outside Quebec; caisses populaires are located in Quebec.

   B. They transact with businesses and consumers to take deposits and provide loans, mortgages, mutual funds, insurance, trust services, investments, and credit cards.

   C. Their investments in other firms are limited by the prudent portfolio approach, which is designed to limit risk. Substantial investments are permitted in authorized financial and near-financial entities only.

   D. Deposits are not CDIC-insured.

3. Insurers.

A. Insurance products are categorized as life insurance or property and casualty insurance.
   (1) Life insurance products include term and permanent insurance (whole life and universal life), disability income insurance, health insurance, segregated funds, and annuities.
      (a) Life insurers are concerned with long-term investment performance, since they must plan many years in advance (the lifetimes of their policy owners). Thus, they align their need with long-term investments, such as mortgages or long-term bonds.
   (2) Property and casualty insurance include auto, home, and liability insurance.
   (3) These insurers are more concerned with investment liquidity, because claims will tend more towards the short-term.

B. Policy-owner premiums are the primary source of revenue for insurers. Premiums are invested following the prudent portfolio approach.

C. Despite ownership of insurers by banks, insurance cannot yet be sold through bank branches.

D. Protection against the insolvency of life insurers is provided by Assuris, to specified limits.

Topic Five: Investment Funds, Savings Banks, Pension Plans, Sales Finance, and Consumer Loan Companies

1. Overview.

A. Investment funds are categorized, according to their structure, as either closed-end funds or open-end funds.

(1) Closed-end funds (also called CEFs).

(a) These funds are corporations that issue shares to their investors. The number of shares is fixed at the time of their initial public offering after which they trade on a stock exchange.

(b) CEFs are more fully invested than open-end funds because money does not need to be held in reserve for redemptions.

(c) Their share value is a result of their net asset value and share value.

(2) Open-end funds or mutual funds.

(a) These funds are created when investor money is pooled, and units of the fund are issued on an ongoing basis to investors at their net asset value.

(b) Units are also continually redeemed at the net asset value.

B. Savings Banks

(1) Alberta Treasury branches are the only savings banks in Canada.

(a) Deposits are fully guaranteed by the Government of Alberta.

C. Pension Plans

(1) Both the Canada Pension Plan and its Quebec equivalent, the Quebec Pension Plan, provide disability, retirement, and death benefits to their contributors.

(2) All Canadian employees and employers contribute.

D. Sales finance and consumer loan companies.

(1) These companies provide loans to consumers, who repay in instalments.

(2) They also purchase instalment-payment-plan sales contracts from retailers.