AUTORITÉ DES MARCHÉS FINANCIERS

REFERENCE GUIDE

PROTECTION MECHANISMS

CONSULTATION ON COMPENSATION OF QUÉBEC CONSUMERS OF FINANCIAL PRODUCTS AND SERVICES

November 2011

The Québec government has mandated the Autorité des marchés financiers ("AMF") to hold a broad public consultation on compensation for victims of financial crime.

A unique compensation system

Because of its specific features, Québec's compensation system for victims of financial crime is unique:

- *The system is based on the Fonds d'indemnisation des services financiers (the "Financial Services Compensation Fund" or the "Compensation Fund" or the "Fund"), which is administered by the AMF.*
- *Victims can claim compensation without having filed legal proceedings against the perpetrators of the fraud and without having exhausted other available remedies. Therefore, the Compensation Fund is not a last-resort system, as exists in other jurisdictions.*
- *Claims are made under an administrative process, not a judicial one.*
- *Funding is derived from dues paid by the firms of the market intermediaries covered by the Fund, amounts recovered through subrogatory recourses initiated by the AMF, and interest income. There is no cost to the claimant.*

Partial coverage

The Compensation Fund does not apply to all situations in which victims of financial crime could find themselves. Consequently, the Fund does not cover misconduct by individuals who are not registered with the AMF or fraud committed by fund managers or investment dealers.

Comments have previously been put forth regarding the scope and type of protection currently available, as well as the funding and administration of the Compensation Fund. This consultation therefore is intended to elicit comments and suggestions regarding possible changes and to analyze their impact.

Reference Guide and Notice and Request for Comment

To ensure optimal conduct of the consultation, it is important to fully understand the rules and approach underpinning the protection available to Québec consumers of financial products and services.

This Reference Guide examines all protection mechanisms in the Québec financial services industry. Compensation for financial crimes is only one component of the protection available to consumers. This protection encompasses a set of measures consisting of the framework governing financial industry players, prevention and education strategies, as well as an extensive range of recourses.

A Notice and Request for Comment regarding compensation of financial products and services, published concurrently with this Reference Guide outlines the different questions raised and highlights the issues to bring to the discussion.

Crucial protection

It is essential to protect financial consumers.

Protection is achieved through various measures: enhancing consumer awareness, regulating the industry upstream, stringently applying existing rules and, of course, providing compensation measures for victims, when justified.

Consumer protection fosters confidence in financial services and is indispensable to the efficiency of one of the strategic cogs of our economy.

In clearly explaining the existing mechanisms that protect consumers of financial products and services, the AMF is laying the groundwork for future discussions.

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SUMMARY

The AMF is undertaking a consultation on compensation of consumers of financial products and services. The purpose of this Reference Guide is to help interested parties prepare their comments and interventions.

Protection against financial institution and market intermediary insolvency

The first protection mechanisms set up in the financial industry applied to deposit institutions — essentially banks and financial services cooperatives ("caisses," also known as "credit unions") — as well as insurers and investment dealers.

These mechanisms have achieved their purpose.

- Along with oversight measures in Québec and in the rest of Canada, these mechanisms contribute directly to maintaining the confidence of financial consumers — depositors, investors, policyholders and insureds.
- Under the different mechanisms, major interventions have not been necessary for several years.
- Protection mechanisms in Québec are essentially similar to those in the rest of Canada, except that mutual fund dealers in Québec do not pay into the Mutual Fund Dealers Association of Canada's Investor Protection Corporation in respect of their assets under management in Québec and are therefore not covered by the Corporation for insolvency. However, their clients are protected against fraud through the Financial Services Compensation Fund.

Current insolvency protection does not raise any particular issues.

Protection against misconduct

A second set of mechanisms was established to protect consumers against misconduct by financial industry participants, including fault, errors and omissions.

Québec consumers can seek redress through three types of mechanisms:

- Complaint examination mechanisms are intended to settle problems amicably. They apply to financial institutions and market intermediaries.
- Consumers who are victims of misconduct can file an individual or a class civil action against the financial system participant, be it a financial institution, a fund manager or a market intermediary. Financial system participants named in an individual or class action can invoke their professional liability insurance, provided, of course, that they carry such insurance. In reality, the consumer must argue the merits of his legal action with the financial system participant's insurer. Recourse against professional liability insurance is not possible in cases of fraud.
- Under the Québec Securities Act, the AMF may launch a civil action on behalf of investors. This mechanism applies only to market intermediaries subject to the Act.

In Québec, remedies for misconduct encompass a wide range of misconduct by market intermediaries.

- These remedies cover fraud. However, because a market intermediary's professional liability insurance does not cover fraud, the protection available to consumers is reduced.

- Remedies under Québec's civil law system are, in practice, similar to the common law concept of "fiduciary duty" in the rest of Canada and in the United States.
- It is difficult to compare remedies for misconduct in Québec with those in the rest of Canada because of the differences in the design of their legal systems. Actions in damages in the rest of Canada are similar to those in Québec, except that they are based in common law. Regulators rely on insolvency funds and bonding insurance rather than on the requirement to maintain professional liability insurance.

Protection against misconduct is limited due to the nature of the remedies available to consumers.

- Civil suits and claims filed against professional liability insurance are protracted and often costly.
- A civil action may be ineffective if the intermediary is insolvent or its assets have disappeared.

Protection against fraud

Fraud is the ultimate form of misconduct. Various protection mechanisms exist in cases of fraud. However, because a financial sector participant cannot invoke professional liability insurance against fraud, this has an indirect bearing on consumers.

Québec is the only jurisdiction in North America to have set up a compensation system for fraud victims. The Financial Services Compensation Fund is an administrative process, not a judicial one.

Claims must essentially meet the following three conditions.

- The representative or firm involved must have been duly certified by the AMF in a sector covered by the Compensation Fund.
- Claimants must have demonstrated that they were victims of fraud and that the fraud was committed by the representative or firm.
- The fraud must concern financial products that the representative or firm was authorized to offer within the limits of the certificate issued by the AMF.

The maximum compensation payable by the AMF is $200,000 per claim.

From October 1, 1999 to March 31, 2011, the AMF received 1,399 eligible claims. Amounts claimed totalled close to $79 million. The Compensation Fund paid out nearly $49 million in compensation, or 62% of total amounts claimed. The difference between amounts claimed and compensation paid stems primarily from the type of amounts claimed (claims that exceeded the $200,000 cap, claims that included moral damages, etc.).

The Compensation Fund takes steps to recover at least a portion of compensation paid out. From October 1, 1999 to March 31, 2011, a total of $3 million was recovered through subrogatory recourses. This amount is relatively small, representing only slightly more than 6% of claims paid and less than 4% of amounts claimed.

The cost of operating the Compensation Fund is not directly borne by consumers. Funding is derived from three sources:

- dues paid by the firms of market intermediaries covered by the Fund,
- amounts recovered through subrogatory recourses initiated by the AMF,
- interest income.

From October 1, 1999 to March 31, 2011, dues generated 92% of funding, while subrogatory recourses and interest income accounted for 5% and 3% respectively of Fund revenues.

Until the 2003-2004 fiscal year, Compensation Fund revenues exceeded expenses. In fiscal 2003-2004, 2005-2006 and 2006-2007, sharp increases in compensation payments resulted in significant Fund deficiencies. The readjustment of dues gradually re-established the Fund's financial position: Between fiscal 2007-2008 and fiscal 2010-2011, the cumulative deficiency fell from $34.5 million to $20.1 million.

The Compensation Fund is managed by the AMF, which issues compensation decisions. Therefore, the Fund is a non-legal remedy for consumers. The mechanism is straightforward. Consumers need not have exhausted other available remedies in order to submit a claim. This integrated regulator system in Québec minimizes claim processing times.

General comments regarding financial fraud cases fall into two categories:

- The scope of current coverage under the Compensation Fund is complex and misunderstood, since it varies depending on the intermediary's registration category and the product offered. Norbourg illustrates this complexity and the limitations of the Fund's scope. Under the current system, fraud by fund managers and investment dealers is not covered.
- In addition, representatives offer similar products. Investors see them as being the same product, yet they are not and their status differs under the Compensation Fund. Investors must understand the type of product they are buying and if the product is covered. This is certainly an issue.

These comments prompt discussion on possible changes and an analysis of the impact of their implementation.

INTRODUCTION

The AMF is undertaking a consultation on compensation of consumers of financial products and services. The purpose of this Reference Guide is intended to help interested parties prepare their comments and interventions.

Québec consumers have numerous avenues to obtain redress for financial losses. Compensation for financial crimes is merely one component of protection that is available.

To help interested parties understand all current protection mechanisms, this Reference Guide outlines the different mechanisms in Québec that protect consumers – most of whom are investors – against misconduct by the financial system participants with whom they are dealing.

For purposes of this Reference Guide, "financial system participants" means financial institutions, fund managers and market intermediaries[1] that offer services directly or indirectly to clients.

Reference Guide outline

In this Reference Guide, protection mechanisms for consumers of financial products and services have been grouped under three sections based on their purpose:

– Historically, mechanisms to protect investors were intended to address insolvency by deposit institutions, essentially those in the banking and insurance sectors. Similar protection exists in certain specific cases in the event of market intermediary insolvency.
  The first section of this Reference Guide will therefore focus on **protection against financial institution and market intermediary insolvency**.
– Systems were subsequently established to protect investors against misconduct; i.e., fault, errors and omissions. Depending on the case, these systems apply to all or some financial system participants — financial institutions, fund managers and market intermediaries.
  Therefore, the second section will address **protection against misconduct**.
– Additional mechanisms exist to protect against fraud, the ultimate form of misconduct.

  The third section will therefore cover **protection against fraud**.

[1] For a more detailed description of financial system participants, refer to Appendix 1, page 67

This Reference Guide also includes <u>five appendices.</u>

- Appendix 1 provides a brief description of **financial services market participants** and a list of the categories, sectors and sector classes under AMF jurisdiction.
- Appendix 2 outlines the **rules in Québec governing professional orders, professional liability insurance and compensation funds**.
- Appendix 3 describes **initiatives undertaken to prevent misconduct and fraud**.
- Appendix 4 presents the **mechanisms in place in provinces other than Québec** to protect consumers of financial products and services.
- Appendix 5 provides an overview of **consumer protection mechanisms in certain developed countries**.

1. PROTECTION AGAINST FINANCIAL INSTITUTION AND MARKET INTERMEDIARY INSOLVENCY

The initial protection mechanisms introduced in the financial industry pertained to deposit institutions — essentially banks and financial services cooperatives ("caisses" also known as "credit unions") — as well as insurers and investment dealers.

This comes as no surprise, since the deposit institution and insurance industries could only grow if consumers were confident in the ability of banks and insurers to assume their obligations. It was therefore crucial to protect consumers in the event a financial institution were unable to meet its obligations, which would most likely occur at bankruptcy.

For this reason, existing insolvency protection mechanisms apply irrespective of the cause of the insolvency, including fraud.

This broad protection covers only two types of financial institutions:

– **Deposit institutions** — essentially, banks, credit unions, trust companies and insurers authorized to receive deposits of money;

– **Insurers** as part of their insurance activities.

Protection measures also exist in the event of insolvency of certain market intermediaries, such as investment dealers (also known as "securities dealers") and mutual fund dealers; however, the scope of application is more restrictive.

1.1 DEPOSIT INSURANCE: PROTECTION AGAINST DEPOSIT INSTITUTION INSOLVENCY

Deposit insurance offers protection against insolvency by deposit institutions. This protection extends to all financial institutions authorized to receive deposits from individuals or businesses, such as banks, credit and savings unions, trust companies, savings companies and certain insurers.

Purpose

Mechanisms to protect against deposit institution insolvency are intended to maintain depositor confidence in deposit institutions, thereby helping to ensure the stability of the industry.

Deposit institutions are particularly vulnerable to a loss of public confidence. Failing public confidence could trigger a deposit run and lead to liquidity problems. As a result, the affected deposit institutions might not be able to meet their obligations.

Depositor confidence lies at the very core of an efficient economic system.

– Deposits at a bank or credit union are the most basic form of financial investment.

– Deposit institutions play a strategic role at all levels of the economy. Deposits are mass financial products. Most consumers have at least one account at a deposit institution.
– A deposit is a popular savings vehicle with consumers who have a low tolerance to risk. Consequently, protection for these consumers must be both credible and effective.

Depositors cannot manage the risk that a deposit institution would become insolvent. It is difficult for them to assess insolvency risk and they are often reluctant to spread their deposits among several institutions.

Mechanism

Two equivalent regimes protect consumers against deposit institution insolvency depending on whether the institution is registered with the AMF or the Canada Deposit Insurance Corporation ("CDIC").

– Depositors who deal with deposit institutions registered with the AMF[2] are protected by the AMF under the Deposit Insurance Act.[3]
– CDIC[4] offers the same type of protection to depositors who deal with deposit institutions registered with CDIC. These institutions are federally regulated.

In both cases, the consumer, namely, the depositor, is insured against the insolvency of the deposit institution regardless of the cause of the insolvency.[5]

– Both regimes cover the service purchased by the consumer, namely, a deposit of money.
– The protection mechanism is funded by institutions authorized to receive deposits.

Coverage

The Québec deposit insurance fund and CDIC deposit insurance provide similar protection. All deposit institutions — depending on whether they are under Québec or federal jurisdiction — are covered by either the deposit insurance fund or CDIC.

Both funds cover eligible deposits up to a maximum of $100,000 per deposit institution, per depositor.

Eligible deposits are mainly:

– deposits to a chequing or savings account;
– term deposits;
– guaranteed investment certificates (GICs).

2 Institutions registered with the AMF are mainly financial services cooperatives and some trust companies authorized to receive deposits.

3 Deposit Insurance Act, R.S.Q., c. A-26.

4 Canada Deposit Insurance Corporation Act, R.S.Q., 1985, c. C-3.

5 Therefore, insolvency protection also covers fraud.

Funding

Funding of both regimes is the responsibility of the deposit institutions concerned.

- The AMF deposit insurance fund is funded through premiums collected from deposit institutions registered under the Deposit Insurance Act.

- CDIC coverage is funded by member deposit institutions.

Collected premiums are used to make up cash reserves for the payment of future claims. Should these reserves be insufficient, the regimes can borrow from their respective governments — the Québec Government for the deposit insurance fund and the federal government for CDIC.

Since 1967, interventions involving the deposit insurance fund have totalled $288.1 million, of which $171.0 million has been recovered.

- Interventions were in the form of repayments of guaranteed deposits ($49.6 million), cash advances ($93.3 million), debt payment guarantees ($124 million), asset acquisitions ($0.3 million) and financial assistance agreements ($20.9 million).

- The last major intervention was in 1994 with respect to First City Trust Company for $14.7 million. The most recent intervention was in 1996, when the fund paid out $2.3 million in financial assistance to North American Trust Company.

CDIC was created in 1967. Since that date, 43 member institutions have failed. The last CDIC member to fail was Security Home Mortgage Corporation in 1996. CDIC's total claims and loans amounted to $42.0 million.

Administration

The deposit insurance fund is administered by the AMF.

CDIC deposit insurance is administered by CDIC, a federal Crown corporation created by Parliament.

1.2 PROTECTION AGAINST INSURER INSOLVENCY

The second component of insolvency protection concerns insurers with respect to their insurance operations.

Purpose

The mechanisms are intended to protect eligible insurance contractholders against financial losses by an insolvent insurer.

The rationale is the same as for deposit institutions:

- The growth of insurance business is driven by sustained consumer confidence.
- Therefore, insureds, contractholders and beneficiaries alike must be covered against insurer insolvency regardless of the cause of the insolvency, including fraud.

Mechanism

Insolvency protection is assured by two organizations based on area of insurance:

- Assuris for life insurance.
- The Property and Casualty Insurance Compensation Corporation (PACICC) for damage (P&C) insurance.

This system of protection is equivalent to the deposit coverage system.

- Consumers who purchase a service, like the insureds and beneficiaries, are covered against the insolvency of the manufacturer of the service — the insurer.
- This protection is in force regardless of the cause of the insolvency. As such, it covers fraud.
- Both mechanisms are funded by insurers.

Assuris and PACICC are not-for-profit entities that protect policyholders Canada-wide.

- Membership in Assuris is mandatory. A life insurer may not write business unless it is a member.[6]
- Similarly, membership in PACICC is mandatory for damage (P&C) insurers.[7]

The last insolvencies in which Assuris was required to intervene occurred in the early 1990s: *Les Coopérants* (1992, $180 million), Sovereign Life (1992, $20 million) and Confederation Life (1994, $5 million).

For its part, PACICC has paid out nearly $106 million in compensation since 1998.

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[6] For details of the mechanism, consult the Assuris website at http://www.assuris.ca/.

[7] For details of the mechanism, consult the PACICC website at http://www.pacicc.com/.

Coverage

Assuris guarantees at least 85% of benefits promised under a contract, to a maximum of $100,000. This protection applies to life insurance contracts and investment products such as accumulation annuities and pension plans. In the event of insurer insolvency, Assuris also ensures that in-force insurance contracts are transferred to a solvent insurer.

PACICC compensates damage insurance claims to a maximum of $250,000. PACICC protection covers all unpaid claims for losses arising from a single occurrence at the time the insurer is placed in liquidation.

PACICC also reimburses 70% of the unexpired portion of the premium, to a maximum of $700 per policy.

Funding

Assuris and PACICC are funded through premiums paid by insurers (member assessments).

Members' assessments are based on the premium income of insurers operating in Canada.

Administration

Assuris and PACICC are not-for-profit entities.

- Each has a board composed of nine directors who do not have any ties to insurers.
- Directors are elected at the general meeting of members. Board members are chosen for their knowledge and experience in insurance and technical areas important to insurance and in insolvency management.

1.3 PROTECTION AGAINST INVESTMENT DEALER INSOLVENCY

The third type of insolvency protection pertains to investment dealers (also known as “securities dealers”).

The scope of this protection is very specific.

Purpose

Investment dealers who are members of the Investment Industry Regulatory Organization of Canada (IIROC) are members of the Canadian Investor Protection Fund (CIPF).

CIPF protects investment dealers’ customers who have suffered or may suffer financial loss solely as a result of the insolvency of a CIPF member. The loss must be in respect of a claim for the failure of the member to return or account for securities, cash balances, or other property, received, acquired or held by, or in the control of, the member for the customer. In practice, CIPF covers only funds in transit with the dealer pending conclusion of a transaction on behalf of the customer.

Mechanism

CIPF protection applies in Québec and elsewhere in Canada.

A customer eligible for CIPF protection is any customer having a securities, or commodity or futures contracts account with a member used solely for the purpose of transacting securities or commodity and futures contracts business (dealing as principal or agent).

Coverage

CIPF offers consumers protection that is specific and, as mentioned, relatively restrictive.

- The maximum coverage is $1 million per account, as defined in the CIPF Coverage Policy.
- Losses that result from changing market values of securities, unsuitable investments, or the default of a securities issuer are not covered.

Funding

CIPF is funded by its member investment dealers, who are required by regulation to contribute to the Fund.

Past CIPF interventions have been few. Since 1969, insolvencies have numbered 17, in respect of which CIPF paid out $36 million. The last time CIPF was required to make a payment was in 2002 (Thomson Kernaghan & Co. Limited, nearly $1 million).

Administration

CIPF is administered privately. It is a not-for-profit organization administered by a board of directors composed of at least eight but not more than 12 members.

Under a memorandum of understanding between the Canadian Securities Administrators (CSA) and CIPF, the CSA has oversight responsibility for CIPF.

1.4 PROTECTION AGAINST INSOLVENCY OF MUTUAL FUND DEALERS OUTSIDE QUÉBEC

Protection is available if a mutual fund dealer outside Québec becomes insolvent. Mutual fund dealers offer units in mutual funds. This protection is similar to protection against investment dealer insolvency.

Québec dealers who do business in the rest of Canada are required to take out this coverage.

Purpose

The Investor Protection Corporation (IPC) covers funds entrusted to mutual fund dealers for investment in mutual funds.

Mechanism

IPC provides coverage to customers of members of the Mutual Fund Dealers Association of Canada (MFDA) for losses of property in customer accounts caused by the insolvency of a member. Losses eligible for coverage by IPC must arise from the failure of the member to return or account for property of the customer held by or in the control of the insolvent member. Losses which do not result from the insolvency of a member such as losses from changing market values of securities, unsuitable investments or the default of an issuer of securities are not covered.

The property in a customer's account for which IPC coverage is available is restricted to securities, cash, segregated funds or other property in which an MFDA member is entitled to deal pursuant to its registration, and are in the custody or control of the dealer. Property that is not held by the mutual fund dealer, such as mutual fund units registered directly in the name of the client, even though it was sold to the customer through the dealer, is not eligible for coverage.

Coverage

As with CIPF, the maximum coverage under IPC is $1 million per customer account, as defined in the IPC Coverage Policy.

Funding

IPC is funded by MFDA members.

Québec does not recognize the MFDA as a self-regulatory organization. Therefore, dealers in Québec do not pay into IPC and do not benefit from IPC coverage. However, as discussed later, customers of these dealers benefit indirectly from the dealers' professional liability insurance[8] as well as from fraud protection under the Financial Services Compensation Fund.[9]

Administration

IPC is administered privately and subject to regulator oversight. Currently, seven Canadian provinces have recognized the MFDA as a self-regulatory organization.

[8] See page 36

[9] See page 43

CONCLUSION

Mechanisms set up to protect consumers against financial institution and insurer insolvency have achieved their purpose.

- These protection mechanisms have achieved their purpose. Along with Canada-wide oversight measures, they contribute directly to maintaining the confidence of financial consumers – depositors, investors, policyholders and insureds.
- Major interventions under these mechanisms have not been necessary the past few years.
- Protection mechanisms in Québec are essentially similar to those in the rest of Canada, except that mutual fund dealers in Québec do not pay into the Mutual Fund Dealers Association of Canada's Investor Protection Corporation in respect of their assets under management in Québec and are therefore not covered by the Corporation for insolvency. However, as discussed later, their clients are protected against fraud through the Financial Services Compensation Fund.

Consequently, insolvency protection does not raise any particular issues. However, it was important to outline the rationale behind this protection and the related mechanisms, given that it was the first type of protection arrangement set up in the financial industry. In order to fully understand all mechanisms protecting consumers in the financial industry, it was necessary to provide an overview of the precursors to current protection schemes.

Framework to reduce insolvency risk

In Québec, numerous requirements and controls are in place to reduce insolvency risk.

Capital adequacy requirement for financial institutions to meet obligations

Financial institutions are required to maintain sufficient capital to meet their obligations towards consumers and comply with sound and prudent management practices. This requirement applies to insurers, financial services cooperatives and trust companies. The AMF is tasked with issuing detailed guidelines setting out minimum capital requirements.

Several international observers noted the strong performance of Canada's financial institutions in the wake of the 2008 financial crisis. This was attributable in large part to these capital adequacy requirements.

Bonding insurance (Financial Institution Bond)

Securities fund managers and market intermediaries are required to take out a financial institution bond as protection against insolvency as a result of employee dishonesty.(1)

Control and supervision of financial resources of fund managers and market intermediaries to ensure business continuity

Market intermediaries are required to maintain minimum capital of $25,000 to $250,000, depending on their registration category and whether or not they are members of a self-regulatory organization. This requirement applies to securities fund managers and market intermediaries. It is intended to ensure business continuity in the event of an interruption in operations due to superior force.

Rules governing reliable, complete and true disclosure by firms and requirement to obtain audited financial statements

Market intermediaries are required to disclose information that validates a firm's financial resources and to deliver such information in the form of reports. This requirement applies to market intermediaries practising in the securities industry.

Conservatory measures

Various measures can be taken under industry-based laws governing financial institutions, in particular where the institution has insufficient assets to effectively ensure the protection of depositors or policyholders. These measures can be written instructions or orders, restructuring plans, or management agreements.

Under the Deposit Insurance Act, the AMF may take measures to reduce the risk of insolvency of an institution in difficulty and thus prevent the repayment of depositors.

The AMF may:

– make advances of money;

– acquire the assets or securities issued by the institution;

– guarantee an institution against any loss it may incur following an amalgamation or acquisition;

– apply to the Court for an order to force the sale or amalgamation of an institution.

In addition, under their insolvency protection regimes, Assuris and PACICC may intervene when a member insurer is in financial distress before the member becomes insolvent. Assuris and PACICC may take such steps as assisting in the sale, transfer or reinsurance of a book of business written, and issuing guarantees or otherwise providing financial support with respect to these policies.

(1) Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations, c. V-1.1, r. 10, sections 12.3 to 12.7. Also refer to the text box on page 39 Bonding insurance to cover losses from employee dishonesty.

2. PROTECTION AGAINST MISCONDUCT

The protection measures outlined in the first section of this Guide pertain to the insolvency of financial institutions and, in specific cases, certain market intermediaries. In all cases, the cause of the insolvency is irrelevant. Insolvency protection therefore covers fraud.

The risk of financial institution insolvency prompted the implementation of an initial series of protection mechanisms.

A second series was established to protect consumers against misconduct, namely, certain acts by financial industry participants, including fault, errors and omissions.

Protection related to specific causes

Protection against misconduct refers to protection mechanisms related to specific conduct by financial system participants.

- Protection against misconduct is intended to cover losses incurred by consumers due to the conduct of a financial institution or a market intermediary.
- Misconduct may be poor advice, failure to act diligently or in a client's best interests, fault or error.
- Depending on the case, these protection mechanisms apply to all or only some financial system participants (financial institutions, fund managers, market intermediaries).
- These mechanisms stem from rules of civil liability, which are universally applicable.
- When a client seeks acknowledgement of liability from a financial system participant, the participant may invoke its professional liability insurance.[10] Although professional liability insurance covers facts and actions pertaining to the financial system participants concerned,[11] under a general insurance principle, professional liability insurance does not cover fraud.

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[10] Some financial system participants are required by regulation to carry professional liability insurance, namely, representatives governed by the Distribution Act (insurance of persons, damage insurance (agents and brokers), and group insurance representatives, claims adjusters and financial planners), scholarship plan dealers and mutual fund dealers. Moreover, as indicated in the text box on page 39, some financial system participants are required to take out bonding insurance, such as a financial institution bond, as protection against loss incurred as the result of employee fraud or dishonesty. This requirement is, to some extent, an alternative to professional liability insurance.

[11] The system of professional liability insurance also exists for all professions. See Appendix 2, page 71.

Prevention against misconduct and fraud

In the financial services industry, as in many other industries, misconduct and fraud can be reduced through prevention.

It is therefore possible to prevent misconduct, such as fraud, by:

- investing in consumer education,
- relying on self-regulatory organizations,
- providing a regulatory framework incorporating components such as registration requirements, rules of conduct and inspections.

Appendix 3[(1)] presents an overview of the AMF's main prevention initiatives.

Consumer education

To enable consumers of financial products and services to better deal with the potential perils of investing, the AMF has been focusing its efforts on educating consumers by:

- designing user-friendly tools to help consumers make informed decisions;
- partnering with various organizations to disseminate advice and training to target client groups;
- setting up a team of conference speakers to provide information sessions on identifying and avoiding fraud.

(1) **See page 73.**

Three types of protection mechanisms

Québec consumers are protected through three mechanisms.

- **Complaint examination** mechanisms designed to settle problems amicably. These mechanisms apply to financial institutions and market intermediaries.
- Consumers who are victims of misconduct can file an **individual or a class civil action** against a financial system participant (financial institution, fund manager or market intermediary).
- Under the Québec Securities Act,[12] the AMF may pursue a civil action **on behalf of investors**. This mechanism applies only to market intermediaries subject to the Act.

12 R.S.Q., c. V-1.1.

2.1 COMPLAINT EXAMINATION SYSTEM

The complaint examination system is the first step in settling a dispute between a consumer and the financial institution or market intermediary with which the consumer was dealing.

The purpose of the complaint examination system is to help the consumer (complainant) and the financial institution or market intermediary reach an amicable settlement. Given its voluntary nature and purpose, this system is similar to mediation.

Three systems

Consumers of financial products and services have three complaint examination systems at their disposal:

- the internal systems of financial institutions and market intermediaries;
- the AMF's mediation and conciliation service;
- an industry ombudsmen system set up by financial institutions under federal jurisdiction.

- **Internal complaint examination systems of financial institutions and market intermediaries**

Financial institutions and market intermediaries in Québec were the first to develop internal complaint examination systems. In Québec, all financial institutions and most market intermediaries are required to have an internal complaint examination system. Consumers must use these internal systems first when they have a complaint.

- A complaint examination system is mandatory for all financial system participants, other than fund managers. In Québec, financial institutions and market intermediaries are required to have a complaint examination and dispute resolution mechanism. They must adopt a complaint examination policy to ensure that each consumer is treated fairly.
- Financial institutions and market intermediaries manage their systems internally. However, they are required to disclose client complaints to the AMF using a web-based complaint reporting system.

- **AMF mediation and conciliation service**

Consumers who are not satisfied with the resolution of their complaint through this internal system may draw on the AMF's mediation and conciliation service.

A dispute resolution process was set up by the Québec government in December 2002. It has been offered by the AMF since 2004, providing consumers with assistance and dispute resolution services for financial matters free of charge.

If not satisfied with the decision by the market intermediary or the manner in which the complaint was handled, the complainant may request to have the file transferred to the AMF.

The AMF will examine the file, and may recommend mediation or conciliation if the parties are in agreement.

Conciliation and mediation are therefore dispute resolution mechanisms available to investors on a voluntary basis. It is this aspect which distinguishes these mechanisms from arbitration.

- Conciliation is a personalized process during which AMF analysts work with the parties involved to seek a solution.
- Mediation is far more formal. It consists of a three-hour session offered at no charge by the AMF, conducted by an outside mediator who helps the parties resolve the issue.

- **Industry ombudsmen**

Consumers who are not satisfied with the resolution of their complaint may, in certain cases, consult an industry ombudsman. Such an industry-sponsored system was put in place by federally regulated financial institutions.

Some industry-based organizations, such as the Ombudsman for Banking Services and Investments, the OmbudService for Life & Health Insurance, and the General Insurance OmbudService, offer mediation services to their members.

The approach is similar to the AMF's complaint examination and dispute resolution service.

- Industry ombudsmen offer independent dispute resolution services to consumers.
- These services cover complaints about member companies.

The approach results in a non-mandatory recommendation. The ombudsman has no power to impose either the recommendation or compensation.

Coverage, funding and administration of complaint examination systems

Complaint examination systems are in response to the following types of complaints:

- A complaint that is a reproach, a real or potential harm or a request for corrective redress against a market intermediary with whom the consumer was dealing.
- A complaint stemming from poor advice, fault and other misconduct.
- A complaint in relation to claims and agreements negotiated between the consumer and the financial institution or market intermediary.

Consumers do not pay for these services.

- The AMF assumes the cost of its conciliation and mediation service.
- Industry ombudsmen services are free of charge for consumers.

Complaint examination systems offer administrative advantages:

- Processing times are shorter than with legal proceedings.
- The mechanism is straightforward. However, both parties must be willing to participate.

2.2 INDIVIDUAL OR CLASS CIVIL ACTION

When problems between a consumer and a financial institution or market intermediary cannot be resolved amicably, the consumer who is the victim of misconduct may file an individual civil action or be part of a class civil action. These remedies can be initiated against any financial system participant — financial institutions, fund managers and market intermediaries.

This common law remedy may cause the financial institution, fund manager or market intermediary to invoke its professional liability insurance.

Recourse through individual or class action

In an individual action, the consumer initiates legal action against the financial system participant for losses incurred as a result of error, omission or fault. This is called a civil liability action.

Consumers who believe that they are the victims of misconduct may also launch a class action. This type of suit is filed by a group of individuals seeking to exercise similar rights.

- The provisions of common law apply to class actions, just as they do to individual actions. A class action must be authorized by judicial process; it must meet specific conditions.
- A class action can be filed against a financial institution, a fund manager or a market intermediary.

Purpose of professional liability insurance

A financial system participant named in an individual or class action can invoke its professional liability insurance provided, of course, that the participant carries such insurance.

- The financial system participant contacts the insurer that issued the policy.
- This insurance is mandatory for representatives governed by the Distribution Act, mutual fund dealers and scholarship plan dealers.[13]
- In reality, the consumer must argue the merits of the action with the financial system participant's insurer.
- Professional liability insurance does not cover fraud. Under a general insurance principle, an insured cannot to invoke its insurance contract to cover fraud.

Professional liability insurance therefore protects consumers indirectly.

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13 R.S.Q., c. D-9.2, section 83; Securities Regulation, c. V-1.1, r. 50. section 193.

In fact, this type of insurance provides the insured — the financial institution, fund manager or market intermediary — with minimum protection against the financial consequences of its civil liability in the event of error, fault, negligence or omissions committed in the course of its professional activities.

This insurance therefore is intended to guarantee payment by the financial system participant found guilty of misconduct. Professional liability insurance coverage is however limited and does contain exclusions.

Civil remedies for insurance matters

When a consumer seeks compensation, the steps in the process are generally as follows:

- The consumer contacts the financial institution, fund manager or market intermediary.
- The financial institution, fund manager or market intermediary forwards the claim to its insurer. Generally, the consumer does not contact the insurer directly.
- The financial institution, fund manager or market intermediary may acknowledge the claim and award compensation to the consumer.
- If the consumer's claim is rejected by the financial institution, fund manager or market intermediary, or by the insurer, the consumer may take the matter to court. As a general rule, the consumer must file legal proceedings and obtain a judgment in order to obtain compensation.
- The financial institution, fund manager or market intermediary invokes its professional liability insurance and asks its insurer to defend it against the consumer's suit.
- In this case, the consumer must deal with the insurer of the financial institution, fund manager or market intermediary.

Professional liability insurance coverage

Professional liability insurance covers the liability of the financial system participant in the event of error, fault, negligence or omissions committed in the course of the participant's activities. There are, however, limitations and exclusions with this insurance.

- Professional liability insurance does not cover fraud.
- For market intermediaries governed by the Distribution Act, mutual fund dealers and scholarship plan dealers, an insurance contract must provide minimum coverage of $500,000 per claim and $1 million per year. Coverage is valid for five years after the market intermediary ceases activities.

An alternative to professional liability insurance exists. Certain securities dealers, securities advisers and fund managers must take out bonding insurance, such as a financial institution bond, as protection against losses incurred as the result of employee fraud or dishonesty.[14]

Funding of professional liability insurance and civil remedies

Professional liability insurance premiums are payable by the insured, namely, the financial institution, fund manager or market intermediary. They are not assumed directly by consumers.

Consumers are however required to pay the costs of any civil court proceedings necessary to obtain redress.

[14] See text box on page 39

Administration of civil remedies

As with any civil suit, the process can be lengthy and costly. Whether or not a client obtains redress is at the judge's discretion. Recovery of funds is uncertain and any related costs are the responsibility of the consumer.

Doctrine of "fiduciary duty"
In Québec, fraud cases such as Norbourg brought calls from citizen groups for the introduction of the concept of "**fiduciary duty**." – Fiduciary duty is a common law doctrine. It takes into account the fact that in a contractual relationship, the contracting parties are not equal. – Fiduciary obligation and fiduciary duty are concepts used in common law jurisdictions in Canada (i.e., outside Québec) and in the United States. Fiduciary duty means that the trustee has an enhanced advisory duty. He must act diligently and place the customer's interests before his own. The fiduciary relationship goes beyond a simple business relationship. Theoretically, the concept of fiduciary duty appears to be very broad and therefore offer extensive protection to investors. In practice, however, the Supreme Court of Canada has set out the **essential characteristics** of a fiduciary relationship: – The trustee — in this case, a market intermediary — holds a certain discretionary power. – The trustee may unilaterally exercise this discretionary power in order to influence the legal or practical interests of a beneficiary — the consumer. – The beneficiary is especially vulnerable to or dependent on the trustee holding discretionary power. The 1994 reform of the Civil Code of Québec led to the introduction of **standards of civil rights** similar to fiduciary duty. – Contractual rules of mandate impose obligations on financial system participants that are similar to fiduciary duty. The main obligations are good faith, loyalty and honesty. – The nature and scope of these obligations vary depending on the legal context of the relationship between the market intermediary and the consumer. The extent of the obligation is proportionate to the relationship between the parties: the more unequal the trustee-beneficiary relationship, the greater the trustee's obligation. The concept of fiduciary duty is therefore part of the Québec legal context. – Under the Civil Code of Québec, failure to act in good faith and with loyalty and honesty gives rise to professional liability, unless such failure is intentional or fraudulent. – Therefore, failure to act in good faith and with loyalty and honesty is usually covered by professional liability insurance, except in the case of fraud.

An alternative to liability insurance: Bonding insurance to cover losses from employee dishonesty

Securities dealers,[1] securities advisers and fund managers are required to maintain **bonding insurance** such as a **financial institution bond** against losses arising from employee dishonesty and fraud.

- Such coverage protects consumers indirectly against this type of loss.
- It also protects them against insolvency arising from this type of event.

It is a regulatory requirement for the intermediaries concerned.

The purpose of bonding is **two-fold**.

- Bonding covers losses incurred as a result of fraud or dishonesty by an employee of a securities dealer, securities adviser or fund manager.
- The bonding indirectly protects the consumer's assets, since the dealer, adviser or fund manager harmed by an act of employee fraud or theft can recover the assets in question, including those belonging to the consumer.

The **mechanism** operates as follows.

- As with professional liability insurance, bonding protects securities dealers, securities advisers and fund managers.
- A consumer may not bring a claim directly against the bonding.

Coverage is in accordance with the following rules.

- The bonding required by regulation covers primarily a loss amounting to 1% of the consumer's total assets held by the dealer or to which the dealer has access, to a maximum of $25 million, for fraud committed by one of its employees.
- There is no coverage for error or omission by a dealer or adviser or their representatives, or by a fund manager.
- Coverage extends to the dealer, adviser or manager. Consumers may not file claims.

Funding of the cost of the bonding contract is born by the insured (i.e., the dealer, adviser or fund manager), not by the consumer.

Administration is relatively straightforward.

- The dealer, adviser or fund manager will generally file a claim directly against the bond.
- The consumer is covered indirectly. The dealer who has been the victim of employee fraud or theft recovers the assets concerned, including those belonging to the consumer.

[1] Except mutual fund dealers and scholarship plan dealers.

2.3 CIVIL ACTION ON BEHALF OF INVESTORS

In addition to the complaint examination system and individual or class civil actions, in Québec, the AMF may bring a civil action on behalf of investors.

This remedy is similar to a class action. Under the Québec Securities Act,[15] the AMF has the power to bring an action on behalf of defrauded investors, where it considers it to be in the public interest to do so.

- This remedy is brought solely in respect of market intermediaries governed under the Securities Act.
- As in the case of class actions, this mechanism can only be triggered when specific conditions are met.

Purpose

The AMF may take legal recourse against an individual or a firm who has failed to comply with securities regulation and file a civil action on behalf of investors.

In addition, the AMF may require the individual or firm to pay damages to compensate investors.

Mechanism

Civil action on behalf of investors can only be initiated where justified by the public interest. The AMF will only bring an action if the severity of the misconduct is such that:

- financial market integrity is compromised,
- the action is necessary to maintain investor confidence,
- the action will help discourage certain illegal conduct.

Coverage

An action initiated by the AMF on behalf of investors is an acknowledgement of a market intermediary's misconduct and the intermediary's responsibility to compensate investors for the damage caused to them.

In addition, the court may order the intermediary to repay the profits derived from such misconduct or may impose punitive damages.

Funding

The AMF assumes the cost of the civil actions it initiates. There is no cost to consumers.

15 R.S.Q., V-1.1, section 269.2.

Administration

As with the other types of civil remedies, an action filed by the AMF on behalf of investors pursues a legal process.

– Compensation of the consumer is at the discretion of the judge.
– As with any legal recourse, the process is lengthy.

Difficulty invoking protection against misconduct

Several recent cases have highlighted the difficulties consumers of financial products and services face when bringing an action for misconduct.

- Legal actions are burdensome and costly.
- Ultimately, consumers recover only a small portion of their funds. Amounts recovered are limited by the solvency of the intermediaries prosecuted.
- For example, between October 1, 1999 and March 31, 2011, the Financial Services Compensation Fund paid out nearly $49 million in compensation. During this same period, subrogatory recourses initiated by the Fund recovered $3 million, or approximately 6% of total compensation paid.(1)

(1) See page 57.

Protection against misconduct in other jurisdictions in Canada

Québec's legal system is based on the Civil Code, whereas the systems in the rest of Canada are based on the principle of common law. Individual or class actions in damages are permitted under both systems.

Outside Québec

In general, securities regulators in the rest of Canada rely on insolvency funds and bonding insurance rather than on the requirement for financial system participants to maintain professional liability insurance.

- All securities dealers and advisers must, based on their registration category, be members of a self-regulatory organization and participate in a complaint examination mechanism.
- The securities commissions of Manitoba, Saskatchewan and New Brunswick have the power to order, at the investor's request, compensation for losses incurred.(1)
- Other jurisdictions have compensation powers through the courts.

(1) See Appendix 4, page 77 Protection mechanisms in other Canadian jurisdictions.

CONCLUSION

In Québec, remedies for misconduct encompass a wide range of misconduct by market intermediaries.

- These remedies cover fraud. However, because a market intermediary's professional liability insurance does not cover a fraud, the protection available to consumers is reduced.
- Remedies under Québec's civil law system are, in practice, similar to the common law concept of "fiduciary duty" in the rest of Canada and in the United States.
- It is difficult to compare remedies for misconduct in Québec with those in the rest of Canada because of the differences in the design of the two legal systems. Actions in damages in the rest of Canada are similar to those in Québec, except that they are based in common law. Regulators rely on insolvency funds, such as the Canadian Investor Protection Fund (CIPF) and the Investor Protection Corporation (IPC), and bonding insurance rather than on the requirement to maintain professional liability insurance.

Protection against misconduct is limited due to the nature of the remedies available to consumers.

- Civil suits and claims filed against professional liability insurance are often costly and protracted.
- A civil action may be ineffectual if the intermediary is insolvent or its assets have disappeared.

3. FRAUD PROTECTION

The previous sections have examined protection against insolvency, regardless of the cause of the insolvency, and protection against misconduct.

As discussed, in some cases, consumers are protected against misconduct by financial system participants, be they financial institutions, fund managers or market intermediaries. This protection covers specific conduct by the financial system participant and generally invokes the participant's professional liability insurance.

Ultimate form of misconduct

Fraud is the ultimate form of misconduct.

- Protection mechanisms against misconduct can be invoked when fraud is involved. These include the individual or class civil actions discussed above.
- However, the fact that a fraud was committed prevents the financial system participants concerned from invoking their professional liability insurance. Because fraud is a deliberate act, it is excluded from professional liability insurance coverage. Financial institutions, fund managers and market intermediaries accused of fraud cannot invoke their insurance. This has an indirect bearing on consumers.
- Additional measures under Québec legislation protect consumers against fraud, but only fraud committed by market intermediaries in certain categories, i.e., market intermediaries who contribute to the Financial Services Compensation Fund.

Unique protection

In Québec, under certain conditions, victims of financial fraud are compensated through the Financial Services Compensation Fund.

The Financial Services Compensation Fund is unique. Québec consumers have benefitted from protection since 1989.[16]

- The first compensation funds were created in 1989 under An Act respecting market intermediaries.[17] The Act created three funds covering the insurance of persons (life and health insurance), damage (P&C) insurance and financial planning sectors.
- The funds were administered by the Québec regulatory bodies existing at that time. In 1999, the three funds were merged under the Distribution Act.
- That same year, the mutual fund, scholarship plan and investment contract brokerage sectors were added to those covered by the Financial Services Compensation Fund.

The scope of the Compensation Fund has remained relatively unchanged since 1999. Each year, the Fund covers approximately 45,000 market intermediaries.

16 In force in 1991.

17 R.S.Q., c. I-15.1.

3.1 PURPOSE OF THE FINANCIAL SERVICES COMPENSATION FUND

The Financial Services Compensation Fund is based on the compensation systems set up by professional orders in Québec.[18]

– The creation of a compensation fund is predicated on the willingness of a group of professionals to protect their clients against acts of fraud committed by one of the group's members.
– Under a civil law principle, persons cannot enter into a liability insurance contract covering them for acts of fraud they commit. An insurer is never held liable to repair the injury caused through the intentional fault of the insured.
– To mitigate the consequences of this principle, a compensation fund model was developed in Québec. This model applies in particular to professionals who hold cash in trust, such as lawyers, notaries and accountants.

The compensation fund model of professional orders was broadened to the financial industry in order to protect consumers against fraud by certain market intermediaries. As a result, Québec offers protection that is not available elsewhere in North America.[19]

Why compensate?

Before examining the very principle of compensation in the financial services industry, it is essential to consider the following question:

Is society responsible for compensating consumers of financial products and services, or does doing so make the compensated individual, namely, the consumer or the representative offering advice, unaccountable for his actions?

– Fundamentally, the existence of a compensation mechanism is related to services or activities of public interest, such as insurance covering health care and occupational diseases and injuries. Crop insurance was set up because farming was considered an essential activity for society.
– The essential character of savings and investment activities is not in doubt. In an efficient economy, consumers can invest safely and confidently. Consumers of financial products and services must be protected against certain risks that they cannot control and which are not related to market movements.
– In addition, compensation allows consumers to benefit from the advantages of dejudicialization — as with the Québec automobile insurance system. The costs and delays inherent in any legal system are avoided in a dejudicialized compensation system.

Moral hazard and accountability

18 Appendix 2 outlines the rules in Québec governing professional orders and their respective compensation funds.

19 Compensation systems exist in a number of European countries. See Appendix 5 for an overview of financial consumer protection in certain developed countries.

There must be a balance between what can rightfully be expected of consumers and what the market intermediary is expected to guarantee. Investors must be guided by prudence, whereas market intermediaries bear a professional responsibility.

This is what economists refer to as “moral hazard.”

– In a risk situation, the relation between two parties can produce an adverse effect. Insulated from risk — for example, by a compensation arrangement covering all foreseeable risks — a consumer may behave differently than if exposed to risk and may make irresponsible decisions as a result.
– Similarly, a market intermediary may believe that the compensation system exempts him from his professional obligations.

Moral hazard is not reason enough not to set up a protection mechanism. A compensation system and consumer accountability can be reconciled by introducing measures such as co-insurance or deductibles.

Restrictions

Certain restrictions apply to the compensation of consumers of financial products and services.

- **Comprehensive coverage**

Wrongful acts by non-registered market intermediaries are not covered. Any form of compensation is accompanied by a framework that implies, at the outset, the registration of the intermediaries concerned.

Therefore, before investing, consumers must at least verify that the intermediaries with whom they are dealing are registered. The same would be expected of any citizen who entrusts the care of his eyes or teeth to a professional.

The Earl Jones affair is an example of fraud that could not be covered by a compensation system, since the intermediary was not licensed to practise.[20]

- **Market vagaries and movements**

It is inconceivable to have a compensation mechanism that covers market vagaries and movements.

Risk is inherent in the purchase of a financial product, and the returns generated are directly tied to the risks assumed. Covering market movements would have a direct impact on the operation — even the existence — of markets. The balance between risk and reward are an integral part of financial markets.

[20] The Earl Jones affair highlighted the importance of dealing with market intermediaries who are licensed by the AMF. This case occurred in 2009. Some 100 individuals had given Earl Jones money to make investments on their behalf and manage their accounts. In total, approximately $50 million was invested. No compensation could be paid, since Earl Jones did not hold a licence issued by the AMF.

- **Personal activities**

Yet another restriction concerns the personal activities of market intermediaries. A compensation system such as the Financial Services Compensation Fund covers intermediaries' professional activities. It is inconceivable that compensation would cover non-professional activities.

– As part of their professional activities, market intermediaries offer insurance or investment products to consumers. If a market intermediary accepts a loan from a consumer so that he can purchase a building or start a business, he is acting beyond the scope of his profession.
– Protecting an intermediary's personal activities would in effect protect him against all of his actions, regardless of their scope. No professional benefits from such protection in today's society.

- **Issuer fraud**

"Issuers" refers to all companies and economic players that use the financial market to finance their investments and operations by offering shares or other securities to the public. Corporations listed on an exchange are an example.

A protection mechanism against issuer fraud would involve redefining all rules governing companies and business financing.

However, a compensation mechanism could be developed to cover misconduct by intermediaries involved in fraud committed by issuers. The intermediary's actions would have to be examined in relation to the fraud committed by the company that issued the product offered by the intermediary.

- **Illegal investment schemes, such as tax evasion**

The final restriction concerns illegal investments. Obviously, a fraud protection mechanism would not indirectly cover illegal transactions. A mechanism that protected investors who engaged in money laundering or tax evasion would in effect be protecting them against illegal transactions they have committed.

Civil remedies against issuer misrepresentation under the Securities Act

In addition to civil remedies that can trigger professional liability, a consumer can bring a civil remedy under the Québec Securities Act or under the Securities Act of another jurisdiction of Canada.

- This is known as a civil remedy for secondary market liability.[1]
- This remedy concerns issuers.
- It is based on the provisions concerning securities. In principle, it is more effective before the courts, since it lessens the consumer's burden of proof. However, it may be as lengthy and costly as a civil remedy brought under common law.
- This remedy will apply where the investment is made based on misrepresentation and, as a result, the investor has suffered a loss.

Purpose

A civil remedy brought under the Securities Act is an action for damages for misrepresentations contained in the issuer's documents or public statements. It can be brought against the company (i.e., the issuer), its officers, its directors or its employees with respect to the investment made based on the misrepresentations.

Mechanism

A civil remedy brought under the Securities Act is a legal remedy. The Act sets out a specific civil liability regime which, in principle, renders the remedy more effective before the courts. A cap is put on the amount of financial compensation that can be awarded. The Act determines the calculation of damages and the sharing of liability.

Coverage

Depending on the case, a civil remedy brought under the Securities Act covers financial compensation related to the termination of a contract, a disposal of securities or the revision of a price. A consumer may also claim for damages. The remedy may be brought against one party or several parties.

Funding

The consumer is responsible for court costs and legal fees.

Administration

A civil remedy brought under the Securities Act is a judicial mechanism. Compensation of the investor is at the judge's discretion. Although a civil remedy brought under the Securities Act is lengthy and costly, the chances of success are greater than with civil remedies brought under common law.

[1] Securities Act, R.S.Q., V-1.1, sections 225.2 and following.

3.2 FINANCIAL SERVICES COMPENSATION FUND

As indicated, claims filed with the Financial Services Compensation Fund are made according to an administrative process, not a judicial one. Consumers are not required to be represented by a lawyer.

The steps in filing a compensation claim are as follows:

- The consumer must have completed a complaint form, have the claim sworn by a commissioner for oaths and provide documentary evidence demonstrating that he satisfies the eligibility criteria under the Act and the applicable regulation.[21]
- The consumer must demonstrate that he has suffered a loss and that the loss is the result of misconduct by a representative covered by the Financial Services Compensation Fund.
- The claim must be filed within one year of the date on which the consumer became aware of the fraud so that the AMF can take legal action against the individuals responsible.[22]
- After assessing the claim, the AMF issues a decision.
- The decision is final and may not be appealed. There is no decision review mechanism.[23] Consumers who are dissatisfied may launch an appeal in civil court to have the decision overturned.

If consumers are entitled to compensation, they are asked to support the AMF's subrogatory recourses. As previously discussed, the AMF will bring an action against any persons considered liable, in order to recover funds that were paid out as compensation. This recourse must be launched prior to the prescribed time limit for legal action, namely, within three years of the date the victim became aware of the fraud.

3.3 COMPENSATION AMOUNT

The maximum compensation payable by the AMF from the Financial Services Compensation Fund is $200,000 per claim for a loss arising from fraud, fraudulent tactics or embezzlement related to the distribution of financial products.

The main objective of the Compensation Fund is to limit victims' financial losses incurred as a result of market intermediary misconduct.

Compensation is based on:

- the amount of money embezzled,
- the value of direct damages,
- the value of the protection offered — in this case in particular, as regards insurance.

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21 *An Act respecting the distribution of financial products and services*, R.S.Q., c. D-9.2, sections 258, 274.1; Regulation respecting the eligibility of a claim submitted to the Fonds d'indemnisation des services financiers, D-9.2, r.1.

22 The legal prescription period regarding the AMF's right is three years following the date of awareness of the fraud.

23 Under section 6 of *An Act respecting administrative justice*, R.S.Q., chapter J-3, an administrative authority must inform a claimant that it is about to make an unfavourable decision. The claimant must have the opportunity to provide the pertinent information or documents to complete or support his claim. The *Direction de l'indemnisation* (AMF Compensation) complies with this obligation by sending a letter to the claimant and providing him with an extension of the time limit for adding evidence to his file.

The Compensation Fund compensates direct damages. The concept of “direct damage” excludes redemption fees, capital gains, expected or lost interest, losses due to market fluctuations, and any other similar fees or costs.

3.4 COMPENSATION FUND COVERAGE

The scope of the Compensation Fund is determined by three parameters:

- the market intermediary concerned,
- the intermediary’s conduct,
- the product concerned by the intermediary’s conduct.

Each of these eligibility conditions must be met separately. If one condition is not met, the claim cannot be accepted and therefore no compensation will be paid.

Specific categories of market intermediaries

The first condition of compensation eligibility relates to the market intermediary concerned: The fraud must have been committed by market intermediaries registered in specific sectors.

- **Intermediaries**

Market intermediaries must be duly registered with the AMF and pursue activities in the following sectors:

- insurance of persons,
- group insurance of persons,
- damage insurance,
- claims adjustment,
- financial planning,
- mutual fund brokerage,
- scholarship plan brokerage.

Consequently, conduct by individuals who are not registered with the AMF is not covered by the Compensation Fund. This was the case with Earl Jones.[24] Also excluded from the scope of the Compensation Fund is fraud committed by certain market intermediaries, namely, investment dealers and fund managers.

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[24] See page 45

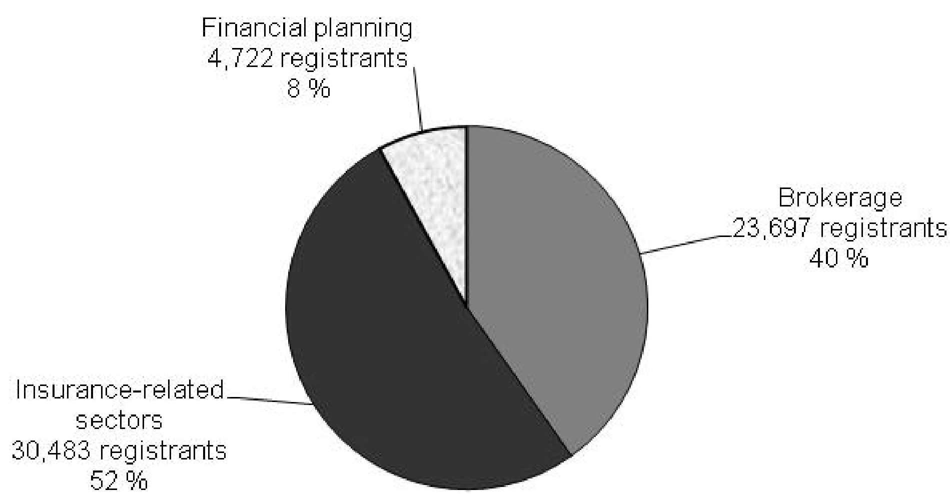
As at April 1, 2011, nearly 45,000 representatives as well as 3,500 firms were registered with the AMF.

However, since representatives can register in several sectors, in actual fact, more than 58,000 representatives were registered at that date:

- 52% in insurance-related sectors,
- 40% in brokerage,
- 8% in financial planning.

CHART 1

AMF registrants by sector as at April 1, 2011

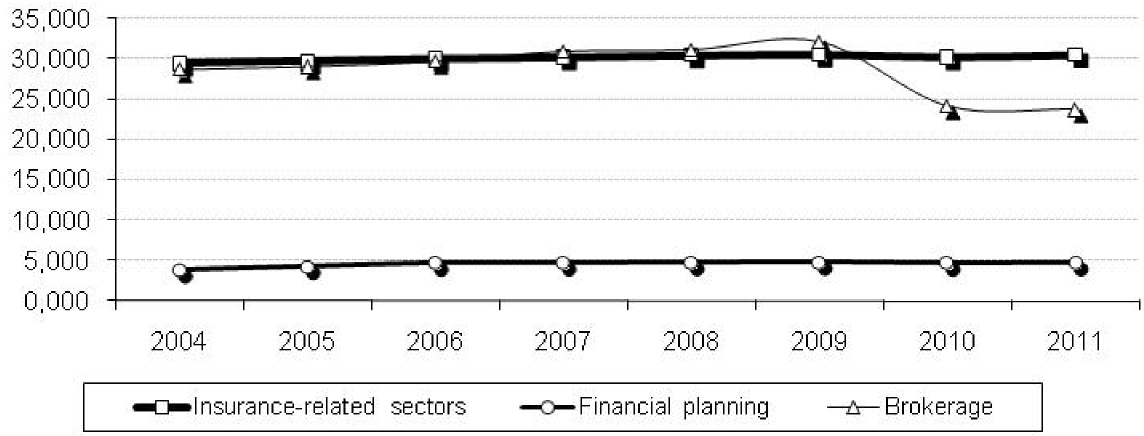


Source: AMF

Between 2004 and 2011, the number of registered representatives increased by nearly 14%. The number of brokerage representatives decreased compared with other sectors.

CHART 2

Changes in AMF registrations by sector – 2004-2011



Source: AMF

- **Reasons for rejected claims**

The exclusion of fraud by certain market intermediaries from the scope of the Financial Services Compensation Fund partly explains why compensation claims in some recent cases were rejected.

– In the Norbourg affair, several compensation claims were rejected because the fraud was committed by the fund manager. Investors purchased Norbourg or Evolution mutual funds through mutual fund or securities representatives.
– The fund manager was Norbourg Asset Management, which was registered as a securities adviser under the Securities Act. The financial fraud originated with the manager.

Fraudulent conduct

The second condition of compensation eligibility concerns conduct. The Financial Services Compensation Fund only covers fraudulent conduct. More specifically, the scope of the Fund is limited to fraud, fraudulent tactics or embezzlement.

The Compensation Fund does not cover other types of misconduct such as errors, poor advice, negligence or losses due to changes in market values.

- **What is fraud?**

Fraud is conduct stemming from voluntary, deliberate acts. Fraud is an act of bad faith intended to infringe another person’s rights and interests.

Fraud is made up of two elements: dishonesty by the person committing the act and harm suffered by the victim.

Fraud can include embezzlement and what is known as “fraudulent tactics.”

- Embezzlement is the use of funds given for a specific purpose other than that for which they are used. Misappropriation is a form of embezzlement. For there to be a misappropriation, it must be proven that the individual received the embezzled funds for his benefit.
- Fraudulent tactics are an aggravated form of fraud. There is plan to deceive and a carefully executed strategy.

Examples of fraud and its variants

Fraud

An insurance representative solicits a client to invest in a new Québec insurance company. However, the representative fails to tell his client that he has a personal interest in the transaction. Convinced that an insurer could never go bankrupt, the client gives the representative a cheque and in return receives a promissory note from one of the companies backing the future insurance firm. Some months later, the companies that received funds from investors go bankrupt.

An investigation reveals that the person heading the project never intended to become an insurer. By fabricating falsehoods, he succeeded in duping everyone involved.

Fraudulent tactics

A representative offers his client the opportunity to invest in a young, highly promising company. The client turns him down because he does not know the company and wants to avoid risky investments.

During a second meeting, the representative gives the client a document outlining the company's activities and the opportunities for purchasing principal-protected notes issued by the company. The representative even has on hand a note subscription agreement bearing the company's logo. Reassured, the client makes out a cheque to the company. In exchange, he receives a statement from the representative confirming his purchase.

A few months later, the client receives a notice to attend the first annual meeting of the company's shareholders. The client did not purchase a principal-protected note, as the representative told him, but rather non-voting shares of the company. The client gave the company a cheque based on false documents and the representative's lies.

Misappropriation of funds

An insurance of persons representative suggests that his client take out a $100,000 life insurance policy. In order to put the policy in force more quickly, the representative asks his client to make the first annual premium payment to him personally in trust. The representative says that because he has signed up several clients already that day, the insurer will act more quickly if he gives him one cheque for all his clients.

Even though he has paid the premium, the client never receives his life insurance policy.

Embezzlement

A representative of an unrestricted practice dealer tells his client about an opportunity to purchase shares of a growing multinational. For greater purchasing power, he and four other dealers have set up an investment club. Therefore, five dealers run the club.

The client trusts the representative and makes out a cheque to the investment club. He never receives the shares.

Gross negligence

A mutual fund representative advises his client to take out a leveraged loan to buy mutual funds. The representative assures his client that he will never have to draw on his savings to repay the loan. He can use the returns generated by the mutual funds to pay off the loan without any problem. The client's income is not high and he has no financial leeway to repay the loan if the market drops. The representative persists, and the client signs up for the loan.

It turns out badly. The client receives a margin call and is forced to declare personal bankruptcy.

- **From fraud to gross negligence?**

The definition of fraud is therefore precise and its components can be clearly identified.

There is debate however about the possibility of broadening compensation to another type of misconduct, namely, gross negligence.

Gross negligence refers to abnormal conduct. Without being deliberate, the negligence is reckless and inexcusable. It denotes a complete disregard for the interests of others.

In theory, gross negligence therefore seems to be very different from fraud. In practice however, gross negligence may give the impression that the act was intentional. For this reason, there has been a noticeable shift in protection against misconduct. In fact, a growing number of professional liability insurers are refusing to cover market intermediaries for gross negligence.

– This gradual narrowing of the scope of professional liability insurance indirectly reduces the protection available to consumers.

– The fact that compensation does not cover gross negligence creates a grey area with respect to liability insurance and fraud. As a result, victims of gross negligence are at a disadvantage compared with other consumers of financial products and services.

Product proposed to the consumer

The third condition required for compensation concerns the product offered to the consumer. Under the current rules, the market intermediary must have acted within the limits authorized by his registration. Fraud committed by intermediaries must relate to the products they were licensed to distribute in accordance with their registration.

Under the Québec compensation mechanism, it is not sufficient that the consumer can demonstrate that he was the victim of fraud and that the fraud was committed by a registered market intermediary. He must also prove that the intermediary acted within the scope of the activities he was authorized by the AMF to pursue.

The problem arises because products are similar and often comparable without actually being the same type of product. Consumers see these products as being one and the same, whereas their status under the Compensation Fund is different.

– Given the diversity and complexity of financial products on the market, it is difficult for consumers to determine whether the market intermediary is authorized to sell the proposed product.
– As well, in a fraud, the intermediary often proposes a fake investment product of his own invention, but presents it as a product that actually exists.

In a number of recent fraud cases, consumers could not be compensated because the market intermediary had breached the limits of his registration.

In others, several claims were refused on the grounds that the representative sold products that he was not authorized to offer. In the vast majority of cases, the product in question was securities, such as shares or notes and similar debt instruments.

This rule is misunderstood, and its application regularly sparks discussion.

3.5 COMPENSATION FUND PAYMENTS

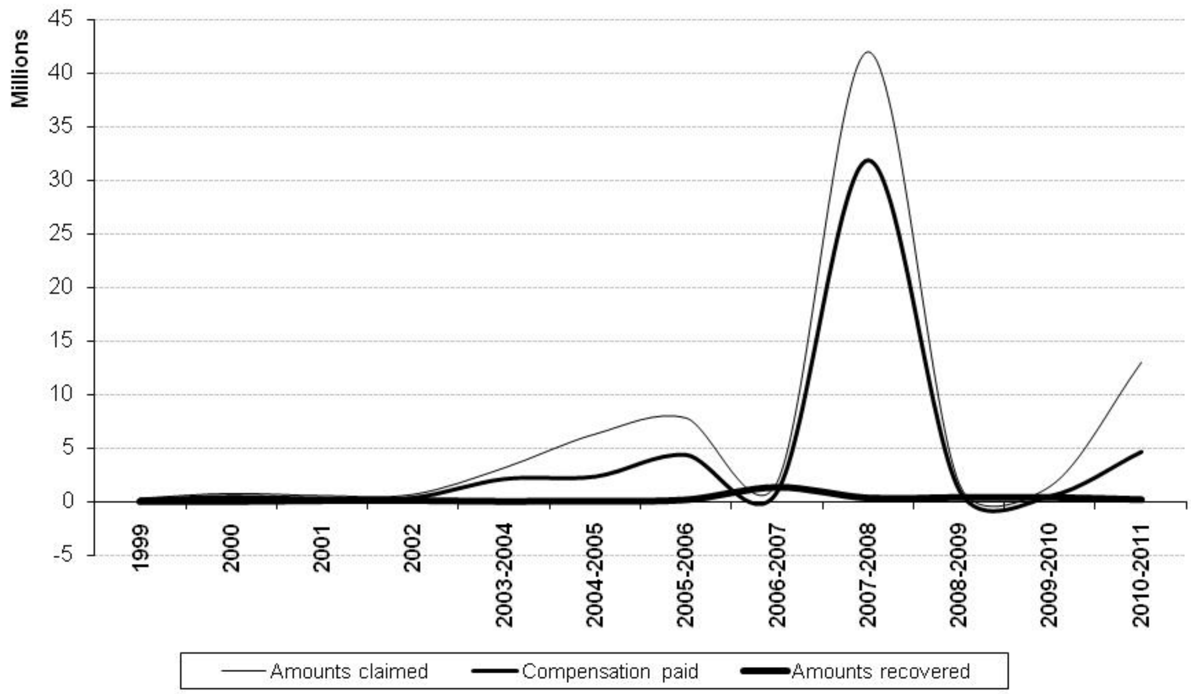
From October 1, 1999 to March 31, 2011, the AMF received 1,399 claims that met the eligibility criteria: The representative or firm involved was duly certified by and registered with the AMF in a category covered by the Compensation Fund, the claimant had demonstrated that he had been the victim of fraud committed by the representative or firm, and the fraud concerned financial products that the representative or firm was legally authorized to offer within the purview of the certificate issued by the AMF.

Claims also met certain other conditions, essentially related to evidence of the transaction.

Amounts claimed totalled close to $79 million for the period from October 1, 1999 to March 31, 2011. The Compensation Fund paid out nearly $49 million in compensation, or 62% of total amounts claimed. This percentage varies depending on the fiscal year. During 2007-2008, the fiscal year during which the Fund paid out the highest amount of compensation, claimants received 76% of amounts claimed. In 2009-2010 and 2010-2011, claimants received 36%.

CHART 3

Claims submitted to the Financial Services Compensation Fund and compensation paid – 1999-2011



Source: AMF

The difference between amounts claimed and compensation paid is due essentially to one of the following reasons:

- amounts claimed exceeded the $200,000 ceiling,
- amounts included a lump-sum amount for moral damages,
- claimants had added other amounts to direct damages, such as accrued interest, redemption fees or the value of false returns,
- amounts included the value of products not covered by the Compensation Fund.

TABLE 1

Claims submitted to the Financial Services Compensation Fund and compensation paid – 1999-2011

Year of decision	Amounts claimed	Compensation paid	Amounts recovered	Number of claims
1999	$264,219.00	$140,491.98	$50.00	7
2000	**$724,677.35**	$437,144.33	$ -	41
2001	$523,585.48	$271,004.12	$78,139.00	12
2002	$628,309.81	$351,480.84	$93,900.00	21
2003-2004	$3,111,178.53	$2,097,142.53	$5,083.00	51
2004-2005	$6,267,115.15	$2,318,561.92	$42,283.00	137
2005-2006	$7,776,042.02	$4,339,568.58	$161,000.00	107
2006-2007	$1,758,509.10	$896,928.98	$1,331,700.00	32
2007-2008	$41,983,801.34	$31,813,599.16	$337,902.00	905
2008-2009	$1,579,642.63	$1,027,047.76	$387,000.00	27
2009-2010	$1,403,227.50	$502,989.59	$388,000.00	12
2010-2011	$12,973,301.40	$4,625,513.23	$173,081.00	47
Total	**$78,993,609.31**	**$48,821,473.02**	**$2,998,138.00**	**1,399**

Source: AMF

Subrogatory recourses

In most cases, the Compensation Fund initiates subrogatory recourses to recover at least a portion of compensation paid out. These recourses are taken against the representatives and firms involved in the fraud, as well against any individual or firm suspected of being implicated.

From October 1, 1999 to March 31, 2011, a total of $3 million was recovered through subrogatory recourses. This is a relatively small amount: It represents only slightly more than 6% of compensation paid and less than 4% of amounts claimed.

3.6 FUNDING

Financial Services Compensation Fund operating expenses consist primarily of compensation payments and administrative expenses.

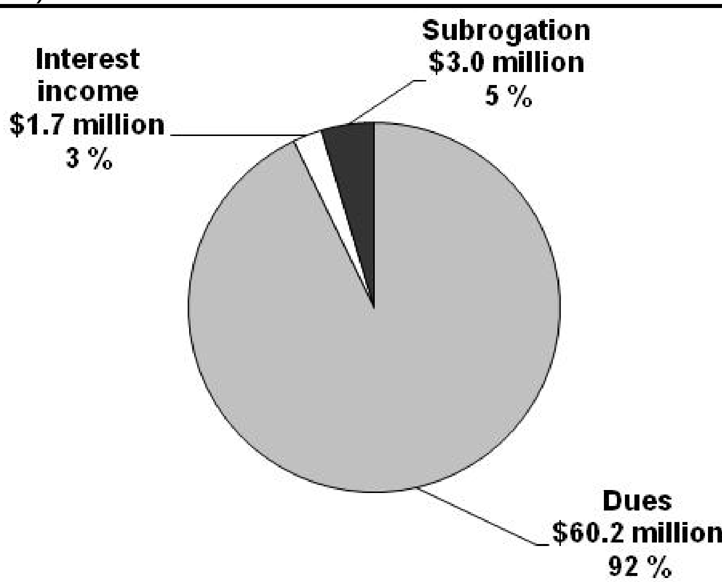
Consumers do not fund the Compensation Fund directly. Funding is derived from three sources:

- dues paid by the firms of the market intermediaries covered by the Compensation Fund,
- amounts recovered through subrogatory recourses initiated by the AMF,
- interest income.

From October 1, 1999 to March 31, 2011, dues generated 92% of funding. Subrogatory recourses and interest income accounted for 5% and 3% respectively of Fund revenues.

CHART 4

Total cumulative funding of Financial Services Compensation Fund – 1999-2011 (in millions of dollars)



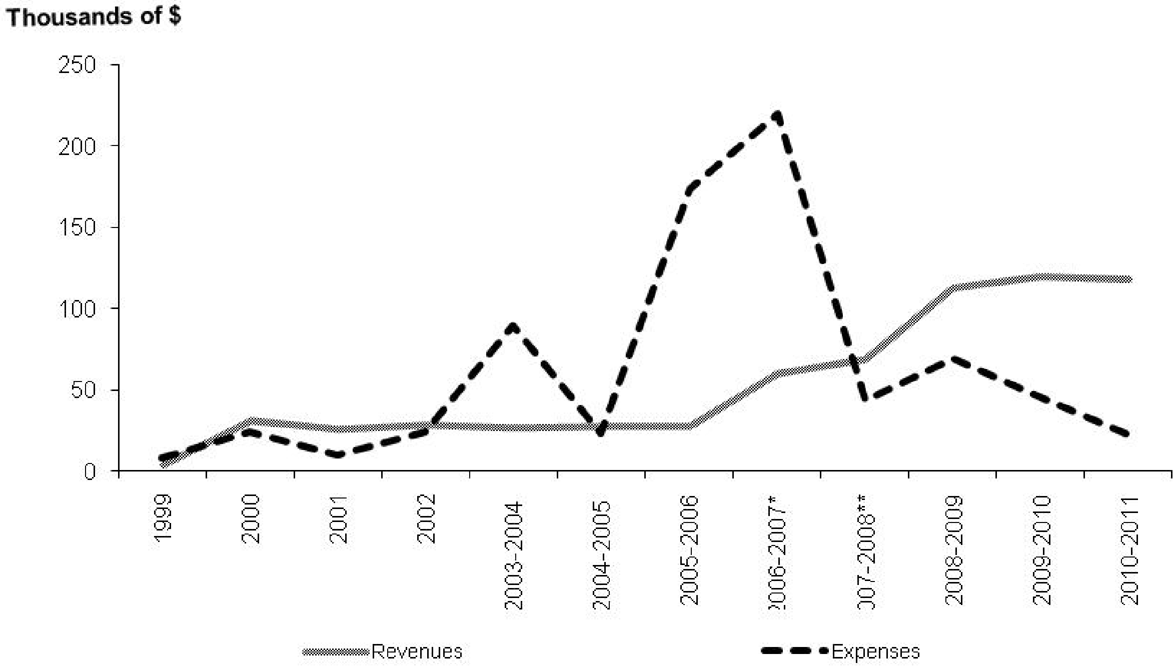
Source: AMF

Gap between revenues and expenses

Up until fiscal 2003-2004, Compensation Fund revenues exceeded expenses. In fiscal 2003-2004, 2005-2006 and 2006-2007, sharp increases in compensation payments resulted in significant Fund deficiencies.

CHART 5

Changes in Financial Services Compensation Fund revenues and expenses – 1999-2011

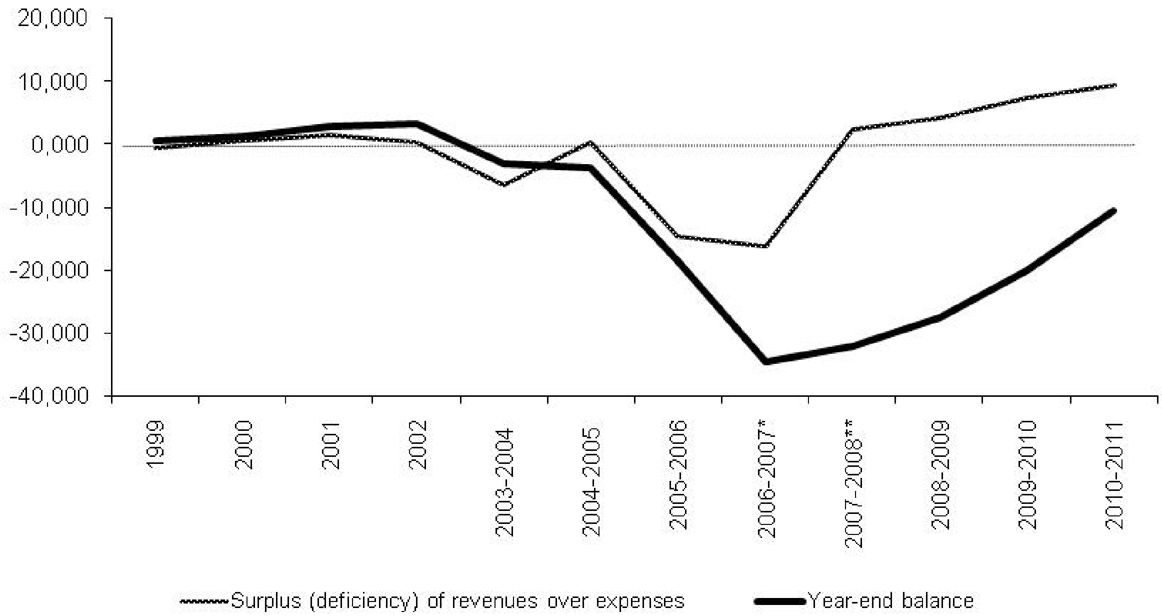


Source: AMF

The readjustment of dues gradually re-established the Fund's financial position. Between fiscal 2007-2008 and 2010-2011, the cumulative Fund deficiency fell from $34.5 million to $20.1 million.

CHART 6

Changes in annual and cumulative balance of the Financial Services Compensation Fund – 1999-2011



Source: AMF

Dues payable to the Financial Services Compensation Fund

Dues are the primary source of funding of the Financial Services Compensation Fund. Firms employing market intermediaries pay annual dues to register each representative in the applicable sectors overseen by the AMF.

Since December 1, 2008, dues payable for each sector have been as follows:

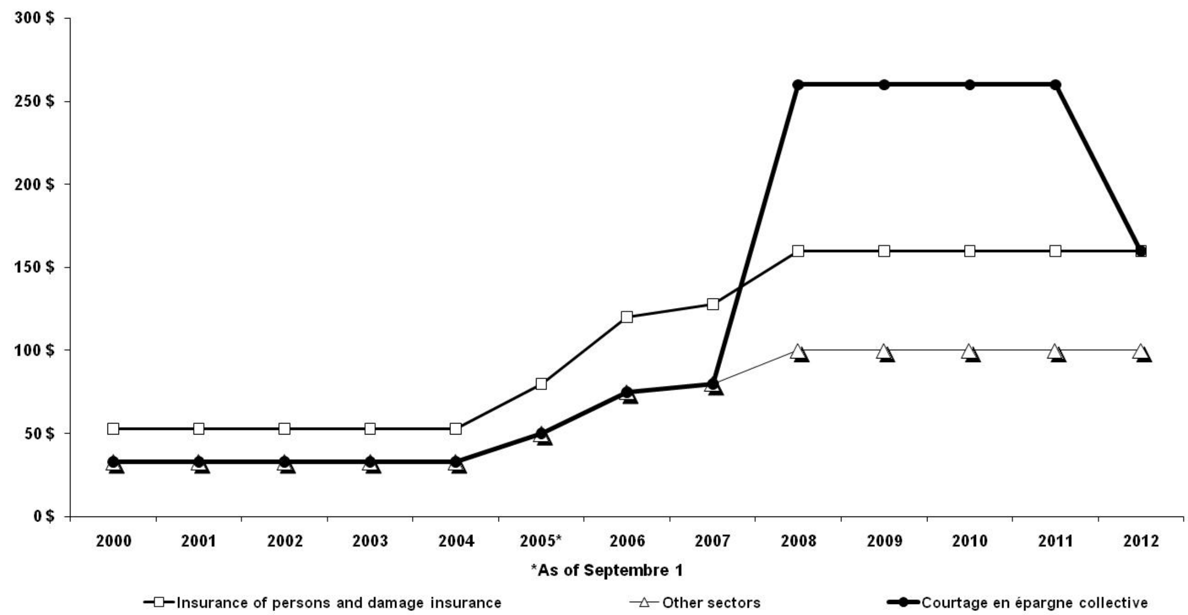
- $160 for damage insurance, insurance of persons and mutual fund brokerage;
- $100 for all other sectors;

If a representative is registered in more than one sector, dues are reduced by $75 for each additional sector.

Exceptionally, for the years 2008 to 2011, mutual fund brokerage dues were increased to $260 as a result of the compensation paid out following the Norbourg affair.

CHART 7

Changes in dues payable to the Financial Services Compensation Fund – 1999-2012



Source: AMF

3.7 ADMINISTRATION

The Financial Services Compensation Fund is managed by the AMF.

- As indicated, compensation decisions are issued by the AMF.
- The Compensation Fund is a form of non-legal remedy for consumers. Generally, they can recover their money more quickly by claiming through the Compensation Fund.

The mechanism is straightforward for consumers. They need not have exhausted other possible remedies in order to submit a claim. The Compensation Fund is not a last-resort mechanism. There is no review mechanism. Claimants can however appeal a decision to Superior Court.

Québec currently has an integrated regulator system. This reduces processing times, and the regulator benefits from broad expertise created by the synergy of responsibilities. This expertise translates into a better understanding of files and issues.

Conservatory measures

All mechanisms previously outlined are intended to compensate victims of insolvency, misconduct or fraud. The range of investor protection also includes so-called "conservatory measures." Conservatory measures exist in most jurisdictions.

- Conservatory measures are measures taken by regulators to promptly halt the activities of a market intermediary where a risk to investors' assets has been identified.
- These measures apply to all financial system participants (financial institutions, fund managers and market intermediaries) and are taken based on reports of suspected participant misconduct. They are independent of the different remedies and protection that could give rise to compensation.

In Québec, the AMF's receivership and winding-up mechanism is a conservatory measure.

Purpose

The primary purpose of conservatory measures is to promptly halt fraud by a financial system participant in order to limit damages and the accumulation of losses by consumers.

The receivership and winding-up mechanism consists in administering the institution and subsequently distributing its assets. The assets are thus preserved and eventually the proceeds of liquidation from the assets are distributed to consumers in accordance with the rights of creditors.

Mechanism

The AMF asks the court to appoint a receiver for the company or individual named in an investigation. The AMF's application is a legal remedy. The court order grants the receiver certain management powers or full administration over the company or individual.

Under the order, the receiver may:

- assume the duties of the failed company's directors and officers,
- take ownership of and administer the property and assets of the individual or financial system participant,
- eventually liquidate and distribute the property and assets to creditors and consumers.

Receivership and winding-up are an exceptional mechanism. Specific conditions must be met to enable the AMF to draw on this mechanism.

Coverage

The AMF may request the appointment of a receiver where it has reasonable grounds to believe that a financial system participant:

- has insufficient assets to meet its obligations,
- is behaving fraudulently,
- is acting in a manner that jeopardizes the protection of consumers.

Funding

The AMF assumes the cost of the legal action initiated to obtain a receivership order. The receiver's fees and expenses are taken out of the assets under administration. Therefore, they are ultimately borne by creditors and consumers.

Administration

The AMF may initiate a legal action on its own initiative. The Superior Court issues orders. The AMF makes recommendations to the Court regarding possible receivers. Following its appointment, the receiver reports to the AMF on its management and the results of its investigation. The process leading up to the distribution of the assets is lengthy. The distribution of assets to consumers is known only at the end of the process.

CONCLUSION

Québec is the only jurisdiction in North America to have set up a system that compensates fraud victims. This system complements the protection mechanisms for financial institution insolvency, the remedies available for misconduct and conservatory measures.

Claims made to the Financial Services Compensation Fund must essentially meet the following three eligibility conditions:

- The representative or firm involved must have been duly certified by the AMF in a sector covered by the Compensation Fund.
- Claimants must have demonstrated that they were victims of fraud and that the fraud was committed by the representative or firm.
- The fraud must concern financial products that the representative or firm was authorized to offer within the limits of the certificate issued by the AMF.

The maximum compensation payable by the AMF is $200,000 per claim.

From October 1, 1999 to March 31, 2011, the AMF received 1,399 eligible claims. Amounts claimed totalled close to $79 million. The Compensation Fund paid out nearly $49 million in compensation, or 62% of total amounts claimed. The difference between amounts claimed and compensation paid stems primarily from the type of amounts claimed (claims that exceeded the $200,000 cap, claims that included moral damages, etc.).

The Compensation Fund takes steps to recover at least a portion of compensation paid out. From October 1, 1999 to March 31, 2011, a total of $3 million was recovered through subrogatory recourses. This amount is relatively small, representing only slightly more than 6% of claims paid and less than 4% of amounts claimed.

The cost of operating the Compensation Fund is not directly borne by the consumer. Funding is derived from three sources:

- dues paid by the firms of market intermediaries covered by the Fund,
- amounts recovered through subrogatory recourses initiated by the AMF,
- interest income.

From October 1, 1999 to March 31, 2011, dues generated 92% of funding, while subrogatory recourses and interest income accounted for 5% and 3% respectively of Fund revenues.

Until the 2003-2004 fiscal year, Compensation Fund revenues exceeded expenses. In fiscal 2003-2004, 2005-2006 and 2006-2007, sharp increases in compensation payments resulted in significant Fund deficiencies. The readjustment of dues gradually re-established the Fund’s financial position: Between fiscal 2007-2008 and 2010-2011, the cumulative deficiency fell from $34.5 million to $20.1 million.

The Compensation Fund is managed by the AMF, which issues compensation decisions. Therefore, the Fund is a non-legal remedy for consumers. The mechanism is straightforward. Consumers need not have exhausted other available remedies in order to submit a claim.

However,

- The scope of current coverage under the Compensation Fund is limited and misunderstood, since it varies depending on the intermediary's registration category and the product offered. Norbourg illustrates this complexity and the limitations of the Fund's scope. Under the current system, fraud by fund managers and investment dealers is not covered.

- In addition, representatives offer similar products. Investors see them as being the same product, yet they are not and their status differs under the Compensation Fund. Investors must understand the type of product they are buying and if the product is covered. This is certainly an issue.

These comments prompt discussion on possible changes and an analysis of the impact of their implementation.

APPENDIX 1 – THE FINANCIAL SERVICES MARKET

Financial services

Financial services cover the following four industries:

- deposit institutions,
- insurers of persons (life and health) and damage (P&C) insurers,
- trust and savings companies,
- securities.

Consumers of these financial services are mainly investors. For simplification, they are referred to as “consumers.” The concept of investment does not exist in damage insurance, and most insurance of persons contracts do not contain an investment component.

Financial services offering

Financial services are offered by financial system participants, namely:

- financial institutions,
- fund managers,
- market intermediaries.

- **Financial institutions**

Financial institutions comprise:

- deposit institutions,
- credit unions;
- insurers (insurers of persons and damage insurers),
- trust and savings companies.

- **Fund managers**

Fund managers promote an investment fund. They create, manage and administer the fund. Fund managers may also advertise the investment fund and promote it with registered dealers. Fund managers do not deal directly with consumers.

- **Market intermediaries**

Market intermediaries act as intermediaries between financial institutions and consumers. They offer consumers financial services that are related to either insurance or investment products. Market intermediaries may be firms or they may be individuals acting on their own behalf.

Market intermediaries pursue activities in:

- insurance (insurance of persons, group insurance of persons, damage insurance, claims adjustment);
- financial planning,

- securities (dealers and advisers),
- derivatives (dealers and advisers).

In Québec, fund managers must be registered with the AMF. Market intermediaries must also be registered with the AMF in order to pursue activities related to insurance, financial planning, securities and derivatives.

Categories, sectors and sector classes under AMF jurisdiction

The table below presents the categories, sectors and sector classes under AMF jurisdiction and the related authorized activities.

TABLE 2

Categories, sectors and sector classes under AMF jurisdiction

Category/sector and sector class (corresponding titles)	**Authorized activities**[1]
Sector: Insurance of persons (Financial security advisor) **Sector class:** – **Accident and sickness insurance** (Representative in accident and sickness insurance)	Offer products and advisory services pertaining to individual insurance or individual annuity plans
Sector: Group insurance of persons (Group insurance and group annuity plans advisor) **Sector classes:** – **Group insurance plans** (Group insurance plans advisor) – **Group annuity plans** (Group annuity plans advisor)	Offer products and advisory services pertaining to group insurance or group annuity plans
Sector: Damage insurance (Damage insurance agent or broker) **Sector classes:** – **Personal-lines damage insurance** (Personal-lines damage insurance agent or broker) – **Commercial-lines damage insurance** (Commercial-lines damage insurance agent or broker)	Offer products and advisory services pertaining to property, civil liability and home insurance

TABLE 2

Categories, sectors and sector classes under AMF jurisdiction

Category/sector and sector class (corresponding titles)	**Authorized activities**[1]
Sector: Claims adjustment (Claims adjuster) **Sector classes:** – **Claims adjustment in personal-lines damage insurance** (Claims adjuster in personal-lines damage insurance) – **Claims adjustment in commercial-lines damage insurance** (Claims adjuster in commercial-lines damage insurance)	Investigate claims, assess damages and negotiate settlements
Sector: Financial planning (Financial planner)	Offer financial planning services (The *Institut québécois de planification financière* issues financial planning diplomas.)
Securities dealer **Category:** – **Investment dealer**	A "dealer" means a person engaging in or holding themself out as engaging in the business of: • trading in securities as principal or agent; • distributing a security for their own account or for another's account; • any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of these activities. An investment dealer may act as a dealer or an underwriter in respect of any security.
Securities dealer **Category:** – **Mutual fund dealer**	A mutual fund dealer may act in respect of any security of a mutual fund.
Securities dealer **Category:** – **Scholarship plan dealer**	A scholarship plan dealer may act in respect of a security of a scholarship plan, an educational plan or an educational trust and a security of an investment fund that is a labour-sponsored investment fund corporation or labour-sponsored venture capital corporation under legislation of a jurisdiction of Canada.
Securities dealer **Category:** – **Exempt market dealer**	An exempt market dealer may act as a dealer or an underwriter in respect of securities distributed under a prospectus exemption.
Securities dealer **Category:** – **Restricted dealer**	A restricted market dealer may act as a dealer or an underwriter in accordance with the terms, conditions, restrictions or requirements applied to its registration.

TABLE 2 Categories, sectors and sector classes under AMF jurisdiction	
Category/sector and sector class (corresponding titles)	**Authorized activities**[(1)]
Derivatives dealer	A derivatives dealer is a person who engages or purports to engage in: • derivatives trading on the person's own behalf or on behalf of others; • any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any derivatives trading.
Securities adviser **Category:** – **Portfolio manager**	An "adviser" means a person engaging in or holding themself out as engaging in the business of advising another with respect to investment in or the purchase or sale of securities, or the business of managing a securities portfolio. A portfolio manager may act as an adviser in respect of any security.
Investment fund manager	An investment fund manager is a person who directs the business, operations and affairs of an investment fund.
Derivatives adviser **Category:** – **Derivatives portfolio manager**	A person who engages or purports to engage in the business of advising others as to derivatives or the buying or selling of derivatives, or in the business of managing derivatives portfolios.

[(1)]An Act respecting the distribution of financial products and services, R.S.Q., c. D-9.2, sections 3 through 11; Securities Act, R.S.Q., chapter V-1.1, section 5; Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations, c. V-1.1, r. 10, sections 2.1 through 2.3 and 7.1 through 7.3; Derivatives Act, R.S.Q., c. I-14.01, section 3; Derivatives Regulation, c. I-14.01, r.1, sections 11.2 and 11.5.

APPENDIX 2 – PROFESSIONAL ORDERS, PROFESSIONAL LIABILITY INSURANCE AND COMPENSATION FUNDS IN QUÉBEC

The *Office des professions du Québec* ensures that professionals act with competence and integrity in their dealings with the public. The 46 professional orders in Québec are governed by the Professional Code.[25]

Professional liability insurance

Under the Code, professional orders are required, among other things, to ensure that their members maintain professional liability insurance covering them against fault or negligence committed in the course of their practice. Fault or negligence committed in the course of a professional's practice is therefore covered by professional liability insurance.

Compensation funds to cover fraud

Fraud committed by professionals in the course of their practice is not covered by professional liability insurance. To address what could be perceived as a gap in public protection, some professional orders decided to provide their clients with additional protection through compensation funds. These funds are governed under section 89.1 of the Professional Code, which provides that compensation be limited to cases where a member uses "funds or property for purposes other than those for which they were entrusted to the member in the practice of his profession."

The following professional orders have compensation funds: *Ordre des administrateurs agréés* (chartered administrators), *Barreau du Québec* (Québec Bar), *Ordre des comptables agréés du Québec* (chartered accountants), *Ordre des comptables en management accrédités du Québec* (certified management accountants), *Ordre des comptables généraux accrédités du Québec* (certified general accountants), *Chambre des huissiers de justice du Québec* (bailiffs) and the *Chambre des notaires du Québec* (notaries).

Professional liability insurance coverage

Québec's 46 professional orders can require their members to have any of the following three types of mandatory coverage:

– An insurance fund,

– A group insurance contract,

– An individual insurance contract. Each professional must also demonstrate that he has the minimum coverage required by his professional order.

[25] R.S.Q., chapter C-26.

Coverage is not identical because each order is at liberty to adopt the regulation best suited to the situation of its members and the public it protects.

Therefore:

– Professional orders have leeway regarding a member's required coverage. The content and type of insurance coverage vary depending on the professional's activities.

– The types of conduct covered and the exclusions are also very different.

– The definition of the conduct covered may sometimes be restrictive and only encompass exclusive acts or acts committed while employed at a firm, or it can cover any act by a professional committed in the course of his practice.

– Some professional orders require that even criminal acts or acts committed under the influence of narcotics be covered, unless it is the professional who has committed or is complicit in the act.[26]

– The amount of coverage or compensation varies from one professional order to another. In principle, the minimum amount of coverage varies based on the risk the professional activity represents.

– Situations where a professional could be exempted from coverage also vary among orders.

[26] Règlement sur l'assurance de la responsabilité professionnelle des physiothérapeutes (Regulation respecting professional liability insurance of physiotherapists), C-26, r. 195, section 5 (in French only).

APPENDIX 3 – PREVENTION INITIATIVES TO PROTECT QUÉBEC FINANCIAL CONSUMERS

The AMF launched a series of prevention initiatives to prevent misconduct and fraud.

Prevention is accomplished through, in particular:

– consumer education;
– self-regulatory organizations;
– an adapted regulatory framework embedding registration requirements, rules of conduct and inspections.

Consumer education

Over the past five years, the AMF has earmarked substantial financial and professional resources to raise awareness and educate consumers of financial products and services. The AMF channelled its efforts into three broad types of initiatives.

– Tailored communication tools to help consumers make informed decisions. The AMF draws on its internal expertise to design and prepare brochures, calculators and Web content using simple language and a user-friendly format.

– Partnerships with established organizations across Canada. These partnerships allow the AMF to benefit from vast distribution networks and understand the specific needs of members or clients.

– Consumer outreach via a mobile conference team. Each year, some 50 conferences are held to inform clients on various topics of interest, such as fraud prevention, the Financial Services Compensation Fund and the assistance services offered free of charge by the AMF.

Over the past three years, the AMF has focused on public awareness strategies. Initiatives such as the *Before investing, investigate!* campaign with Québec TV personality Guy Mongrain, the TV campaign about deposit insurance launched in partnership with the Canada Deposit Insurance Corporation, the distribution of inserts in Gesca Group newspapers and the multimedia campaign (TV, web and print) with Quebecor have helped to educate thousands of consumers on the importance of being informed before purchasing a financial product or service.

Self-regulatory organizations

The AMF is supported in its efforts by self-regulatory organizations.

The main self-regulatory organizations are the *Chambre de la sécurité financière*, the *Chambre d'assurance de dommages* and the Investment Industry Regulatory Organization of Canada.

- **Chambre de la sécurité financière**

The *Chambre de la sécurité financière* (CSF) was created in 1999 with the coming into force of the Distribution Act. The CSF is headed by an 11-member board of directors. The CSF oversees the training, ethics and discipline of nearly 32,000 members who work in five sectors and registration categories:

- financial planning,[27]
- insurance of persons,
- group insurance of persons,
- scholarship plan brokerage,
- mutual fund brokerage.

- **Chambre de l'assurance de dommages**

The *Chambre de l'assurance de dommages* (ChAD) was also created in 1999 with the coming into force of the Distribution Act. The ChAD is headed by a 13-member board of directors. It ensures the protection of the public in the areas of damage insurance and claims adjustment.

The ChAD oversees the mandatory continuing professional education, ethics and discipline of its nearly 14,000 members forming the following three groups of certified professionals:

- damage insurance agents,
- damage insurance brokers,
- claims adjusters.

It acts in a preventive capacity, regulating the professional practice of professionals working in these sectors.

- **Syndics**

In order to properly fulfill their mandate, in particular with respect to ethical and disciplinary matters, the respective boards of directors of the CSF and the ChAD appoint a syndic. Section 329 of the Distribution Act sets out the syndic's role.

- Briefly, the syndic investigates the actions of a representative where it has information that leads it to believe that the representative has violated the Act or its regulations.

- Where the syndic has reasonable grounds to believe that an offence has been committed, it files a complaint with the discipline committee.

- Complaints filed against a representative are brought before the discipline committee. The discipline committee is formed of three members: one lawyer and two representatives from the same marketing sector. The discipline committee hears complaints and may impose sanctions, specifically fines and suspension of the accused representative's certificate.

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[27] For the financial planning sector, the CSF oversees only the ethics and discipline of its members. The *Institut québécois en planificiation financière* is responsible for training.

- **Investment Industry Regulatory Organization of Canada**

The Investment Industry Regulatory Organization of Canada (IIROC) was created in 2008 through the consolidation of the Investment Dealers Association of Canada and Market Regulation Services Inc. IIROC is the national self-regulatory organization which oversees all investment dealers and trading activity on debt and equity marketplaces in Canada. IIROC sets high quality regulatory and investment industry standards, protects investors and strengthens market integrity while maintaining efficient and competitive capital markets.

IIROC carries out its regulatory responsibilities through setting and enforcing rules regarding the proficiency, business and financial conduct of dealer firms and their registered employees, who are grouped in the following categories:

- partners of IIROC dealer members;
- directors of IIROC dealer members;
- officers of IIROC dealer members;
- dealer member personnel conducting or supervising regulated activities.

IIROC also sets and enforces market integrity rules regarding trading activity on Canadian equity marketplaces. The AMF recognizes IIROC as a self-regulatory organization.

Adapted regulatory framework

- **Registration requirement for market intermediaries**

The registration requirement provides consumers with assurance that the individuals offering financial services are competent, honest and solvent.

This requirement is based on general criteria, as well as on specific rules regarding competence, integrity, solvency and compliance.

- **Requirements regarding basic and continuous training and the competence of market intermediaries**

Oversight of registered market intermediaries assumes that intermediaries have the appropriate qualifications.

It also presupposes that market intermediaries will comply with certain requirements to upgrade their skills and knowledge in order to maintain their registration.

- **Rules of conduct set out by regulators and self-regulatory organizations**

As with other professional activities, the financial services industry sets out specific rules of ethics and conduct.

These rules require that in their dealings with investors and in the execution of the mandates entrusted to them, market intermediaries act with all the care that may be expected of a knowledgeable professional. They must act with honesty, loyalty and diligence.

- **Requirement for financial institutions and firms to set up internal compliance programs**

Financial institutions and firms employing market intermediaries are required to enforce strict rules of conduct.

These rules are applied through compliance programs. Financial institutions and firms are responsible for adhering to these rules.

- **Inspection programs established by regulators and self-regulatory organizations**

Regulators and self-regulatory organizations establish and implement inspection programs.

These programs are intended to verify and foster compliance by registered market intermediaries with various aspects of regulations.

APPENDIX 4 – PROTECTION MECHANISMS IN OTHER CANADIAN JURISDICTIONS

Protection against financial institution and market intermediary insolvency

Protection mechanisms in Québec are essentially similar to those in the rest of Canada.

The only difference is that consumers outside Québec are protected against mutual fund dealer insolvency.

- The Investor Protection Corporation (IPC), operated by the Mutual Fund Investment Dealers Association of Canada (MFDA), covers funds entrusted to mutual fund dealers for investment purposes.
- IPC provides coverage to customers of MFDA members.
- Maximum coverage is $1 million per account.
- IPC is funded by MFDA members. Seven provinces have recognized the MFDA as a self-regulatory organization.

Protection against misconduct

The legal system outside of Québec is based on common law and provides for individual or class actions in damages.

In general, regulators rely on insolvency funds and bonding insurance rather than on the requirement to maintain professional liability insurance.

- All securities dealers and advisers must be members of a self-regulatory organization according to their registration category and must participate in a complaint examination mechanism.
- The securities commissions of Manitoba, Saskatchewan and New Brunswick have the power to order, at the investor's request, compensation for losses incurred following securities misconduct by a financial system participant.
- Other jurisdictions have compensation powers through the courts.

Fiduciary duty

Fiduciary duty is a common law doctrine. It accounts for the fact that in a contractual relationship, the contracting parties are not equal. Fiduciary duty means that the trustee has an enhanced advisory duty. He must act diligently and place the client's interests before his own. The fiduciary relationship goes beyond a simple business relationship.

Theoretically, the concept of fiduciary duty seems to be very broad and therefore offer extensive protection to investors. In practice, however, the Supreme Court of Canada has set out the essential characteristics of a fiduciary relationship:

- The trustee (in this case, a market intermediary), holds a certain discretionary power.

– The trustee may unilaterally exercise this discretionary power so as to have influence over the legal or practical interests of the beneficiary (i.e., the consumer).
– The beneficiary is especially vulnerable to or dependent on the trustee holding discretionary power.

Protection against fraud

Québec is the only province to have a specific fraud protection mechanism. Victims in the rest of Canada must draw on mechanisms designed to protect against misconduct.

TABLE 3

Mechanisms protecting consumers of financial products and services in Canada

Jurisdiction	Entity	Insolvency protection	Fraud protection	Funding	Compensation limit
Québec	Financial Services Compensation Fund	☐	☒	Dues from firms of covered market intermediaries	$200,000 per claim
Canada-wide	Property and Casualty Insurance Compensation Corporation (PACICC) Assuris (life insurance)	☒	☐	Insurer membership dues	PACICC: $100,000 Assuris: $250,000[28]
	Canadian Investor Protection Fund (CIPF)	☒	☐	Membership dues (IIROC investment dealers)	$1 million
Canada, except Québec	MFDA Investor Protection Corporation (IPC)	☒	☐	Membership fees (MFDA members)	$1 million
Manitoba, New Brunswick, Saskatchewan	Provincial securities commissions	☐	☒	N.A.	Manitoba: $250,000 New Brunswick: $100,000 Saskatchewan: $100,000

[28] http://www.pacicc.com/

APPENDIX 5 – OVERVIEW OF CONSUMER PROTECTION MECHANISMS IN CERTAIN DEVELOPED COUNTRIES

Developed countries have implemented mechanisms to protect consumers of financial products and services. These include insurance and securities compensation funds, guarantee funds and post-mediation compensation orders.

Below is an overview of existing mechanisms in:

- the United States,
- the European Union,
- France,
- the United Kingdom,
- Germany.

In general, current mechanisms are intended to facilitate conflict resolution through mediation or arbitration. They are sometimes combined with a minimum last-resort monetary arrangement (insolvency fund) if the liable party is unable or refuses to comply with the mediator's or arbitrator's recommendation. Thus, compensation is based on a decision by a judicial or quasi-judicial body.

United States

- **Protection against securities dealer insolvency**

The financial securities system in the United States is mainly overseen by the U.S. Securities & Exchange Commission (SEC). This system includes an investor protection body that compensates consumers of financial products when a securities dealer is in financial difficulty or insolvent.

- The Securities Investor Protection Corporation (SIPC) is a non-profit corporation. Membership in SIPC is mandatory for SEC members registered in certain categories, including mutual fund distributors.
- SIPC manages a compensation fund that assists consumers in recovering securities purchased or held on their behalf from financially troubled SIPC members.
- SIPC participates in the liquidation of firms and may, depending on the product, compensate consumers for losses up to a maximum determined by law.

The maximum compensation recoverable from a failed firm is US$500,000 per consumer, including a maximum of US$250,000 for cash claims.

SIPC is funded by member assessments and interest on investments in U.S. Government securities. Minimum membership assessments are US$150 annually.

- **Protection against securities fraud**

The U.S. does not have a fraud compensation fund.

Section 308 of the Sarbanes-Oxley Act of 2002 permits disgorgement orders of profits realized from a breach of U.S. securities law or an SEC regulation.

- Disgorgement amounts and civil penalties may be deposited in a disgorgement fund rather than repaid to the U.S. Treasury Department, so that they can be used to compensate the victims of breaches of the U.S. Securities Act through the Federal Account for Investor Restitution (FAIR) Fund.
- The Act authorizes the SEC to return funds recovered through disgorgement procedures to investors along with any civil penalties imposed.

- **Protection against insurer insolvency**

Oversight of the U.S. insurance industry is state-run.

Insurance commissioners, who are appointed by the governor or are elected, head the state insurance department and monitor and regulate insurance activity within the state. The commissioner is also responsible for determining when an insurance company domiciled in the state should be declared insolvent and for asking the state court to order the liquidation of the company.

- Guaranty funds, which compensate life and property and casualty insurance policyholders, are present in each of the 50 U.S. states, the District of Columbia and Puerto Rico.
- The National Conference of Insurance Guaranty Funds (NCIGF) is a non-profit association that provides national assistance and support to the property and casualty guaranty funds located in each state.
- The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) assists guaranty associations with life and health insurance issues.

In both cases, the insolvency of an insurance company is determined by the insurance commissioner of the state where the company is domiciled and confirmed by a court. Once the insolvency is determined, liquidation of the company is ordered.

- Policyholder claims are transferred to the state guaranty association and policyholders are compensated.
- Each guaranty association is funded though insurers doing business in that state based on the amount of premiums that they collect in that state.
- Coverage limits vary from state to state and by insurance contract. The coverage benefit cap is generally $300,000.

European Union

Directive on Investor-Compensation Schemes

- **Protection against securities fraud and insolvency**

In March 1997, the European Parliament and the Council of Ministers adopted the Directive on Investor-Compensation Schemes (ICSD, Directive 97/9/EC).[29] This Directive was modeled on the Directive on Deposit Guarantee Schemes (Directive 94/19/EC), which sets minimum rules for compensation of customers of credit institutions that fail. Consistency between the two Directives is considered essential in the case of banks acting as investment firms, because banks must comply with both Directives by belonging to a single compensation scheme.

[29] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997L0009:EN:HTML.

On July 12, 2010, the European Commission released a proposal[30] to amend the Directive on Investor-Compensation Schemes. The new directive is scheduled to come into effect at the end of 2012. The changes to the Directive proposed by the European Commission are currently being debated by different levels of national and EU governments. The text of the new Directive has yet to be finalized.

- **Purpose of current Directive**

Each EU Member State is required to implement a protection scheme that provides a minimum level of compensation to investors (mainly small investors) in the event an investment firm (whether or not a bank) fails and therefore is not able to return clients' cash or securities. The Directive protects investors against the risk of fraud or administrative malpractices or operational errors which render the investment firm unable to return assets to clients.

- **Key elements of current Directive**

Member States must establish investor compensation schemes for investment firms authorized in a Member State that carry on investment activities. Exemptions exist for credit institutions that meet certain criteria, including participation in an equivalent compensation scheme.

Under the Directive, an investment firm means any legal person the regular occupation or business of which is the provision of investment services (securities, mutual fund units, money market instruments, futures contracts) for third parties on a professional basis.

Therefore, investors can be compensated when:

– the competent authorities have determined that an investment firm appears, for the time being, for reasons directly related to the financial circumstances of the investment firm, to be unable to meet its obligations arising out of investors' claims and has no early prospect of being able to do so; or
– a judicial authority has made a ruling, for reasons directly related to the financial circumstances of the investment firm which has the effect of suspending investors' ability to make claims against the firm.

Under the Directive, coverage must be provided for claims arising out of an investment firm's inability (third party custodian holding assets for the investment firm are therefore excluded from the application of the Directive) to repay money owed to or belonging to investors or return to investors any instruments belonging to them.

If an investment firm is also a credit institution, the Member State of origin determines which of the two Directives applies (Deposit Guarantee Scheme or Investor Compensation Scheme). No claim may be eligible for compensation under both Directives (double compensation).

[30] http://ec.europa.eu/internal_market/securities/isd/investor_en.htm.

The level of compensation cannot be less than €20,000 per investor; however, Member States may provide higher coverage. They may also provide that certain investors be excluded from the coverage of the scheme or be granted a lower level of coverage.

- **Administration and funding**

The administration and funding of investor compensation schemes are at the discretion of Member States. Usually, funding comes from contributions paid by registered firms.

France

Protection against securities fraud and insolvency

Oversight of France's financial system is the responsibility of the *Autorité des marchés financiers* of France ("AMF France"), an independent public agency that regulates and monitors the country's financial markets.

The *Fonds de garantie des dépôts* (deposit guarantee fund) manages three guarantee mechanisms:

- a "cash guarantee" for bank deposits (credit institutions),
- a securities guarantee (securities trading firms), and
- a warranties guarantee.

The deposit guarantee fund therefore covers the main financial industry intermediaries.

Through its *mécanisme de garantie des titres* ("MGT" or "securities guarantee mechanism"), the deposit guarantee fund protects consumers in the event of insolvency by an intermediary offering investment services.

- The securities guarantee is triggered on the unavailability of securities concurrently with the inability of a member institution to restore the securities held for reasons that could be related to its financial situation. The *Commission Bancaire* (banking commission) requests the intervention of the deposit guarantee fund.
- Securities covered by the guarantee are equities, debt securities, mutual fund shares or units, investment funds and futures. The guarantee includes cash deposits with a securities trading firm related to an investment service.
- Maximum coverage is €140,000 per person, or €70,000 for cash deposits when they qualify as securities guarantees and €70,000 for financial instruments.

The MGT is funded by all members of the deposit guarantee fund. Each member's contribution is calculated by the banking commission based on defined criteria, provided that the total amount claimed does not endanger the stability of the banking system.

- **Consultation and recommendations**

In early 2010, AMF France created a working group to study possible improvements to the investor compensation scheme. The group's report, entitled *Rapport relatif à l'indemnisation des préjudices subis par les épargnants et les investisseurs*[31] (Report on investor compensation), was released in January

[31] http://www.amf-france.org/documents/general/9822_1.pdf (in French only)

2011. The report recommends an amicable dispute settlement approach.

Although AMF France already offers a mediation service, it seems that this option is not well-known to the public and is under-used by firms. The report recommends that firms use an internal mediator as a first line of assistance to investors. Subsequently, investors who are still dissatisfied or who do not wish to pursue mediation through the firm could ask AMF France to assume their file in order to have access to mediation. The report does not mention a mandatory mediation service.

The report highlights the difficulties faced by individual investors when filing a legal action against a firm, particularly high court costs. The report therefore recommends setting up a litigation fund that would be funded in part by penalty recoveries. The report also examines French law, which allows only a very few class actions in financial matters.

The report does not mention the establishment of a last-resort compensation fund (as exists in the U.K.) or the rules that will apply further to the recommendations of the European Commission.

- **Protection against insurer insolvency**

All insurers in France are registered. The *Autorité de Contrôle Prudentiel* (Prudential Supervision Authority) may sometimes withdraw an insurer's registration, which generally results in the winding up of the company and its insolvency. Under certain conditions, the *Fonds de Garantie des assurances obligatoires* (FGAO), a damage insurance guarantee fund, or the *Fonds de garantie des assurances de personnes* (FGAP), a life and health insurance guarantee fund, assumes the insurer's obligations and settles related claims.

– In the event an insurer fails, the FGAO[32] covers civil liability insurance contracts in respect of certain sectors (e.g., construction, healthcare, property administration, insurance brokerage or intermediation), and mandatory damage insurance guarantees (e.g., construction defects).
– In the same way, the FGAP protects life insurance policyholders. Although this fund is under the responsibility of the French Ministry of the Economy, it is funded exclusively by insureds and insurers.

There is no direct compensation mechanism to cover fraud or insolvency by an insurance intermediary.

United Kingdom

Protection against securities and insurance insolvency or fraud

The financial system in the United Kingdom is under the responsibility of the Financial Services Authority (FSA), the U.K.'s primary regulator of the securities and insurance industries.

The U.K. has mechanisms in place to protect consumers of financial services, namely, a complaint examination and mediation process and a compensation mechanism.

– The complaint examination and mediation process is mandatory for different U.K. financial industry intermediaries. It is overseen by the Financial Ombudsman Service.

[32] It is important to note that the main purpose of the *Fonds de Garantie des assurances obligatoires* was originally to compensate victims of traffic accidents involving uninsured or unidentified parties. It is only since August 1, 2003 that the law has extended the scope of this fund to cover insureds in the event of the failure of a licensed damage insurer.

– Following the examination of a complaint and mediation, the Financial Ombudsman Service issues a decision which may include ordering a firm to pay financial compensation to the consumer. The firm is required to respect the Financial Ombudsman Service's decision.

The compensation mechanism is administered by the Financial Services Compensation Scheme.

– This is a compensation fund of last resort for firms registered with the FSA that are in default or are insolvent. The fund compensates consumers for various financial products, such as insurance, securities, deposits and mortgages.
– The compensation program covers conduct by firms authorized by the FSA if a firm can no longer continue operating, meet its commitments to its clients or repay its clients.

If a firm becomes insolvent, the compensation program can cover two types of claims:

– claims where the firm can no longer pay a return on investments or pay the money it owes clients;
– claims for financial losses related to bad advice, misrepresentations or poor investment management.

A compensation limit is set for each product distributed by firms registered with the FSA. This limit is based either on a percentage of funds lost or on a maximum level of compensation, depending on the type of product. For insurance claims, compensation is subject to an upper limit and to an element of co-insurability. Co-insurability means that the claimant must assume 10% of the loss, but there is no compensation limit.

The compensation program is member funded. Firms pay a levy according to the class of activities for which they are authorized by the FSA.

Germany

The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or "BaFin") was established in 2002 as the sole regulator of banks, insurers and financial markets.

- **Protection against securities firm insolvency**

The Compensatory Fund for Securities Trading Companies (*Entschädigungseinrichtung der Wertpapierhandelsunternehmen* or "EdW**"**) is based on the EU Investor-Compensation Scheme Directive (Directive 97/9/EC).

– This fund covers investment firms such as securities dealers and credit institutions that do not accept deposits. All securities dealers must be members of the fund.
– As stated in the EU Directive, coverage is provided for losses if an investment firm fails to repay money or return financial instruments held on a client's behalf, and protects investors against the risk of fraud or administrative malpractices or operational errors which render the investment firm unable to return assets to clients. The declaration of insolvency is made by the regulator, the BaFin.
– The fund is administered independently and managed by a German public bank, but remains under the supervision of BaFin.

– Compensation is 90% of the claim, to a maximum of €20,000. The fund applies the co-insurance principle, whereby the investor is required to assume a portion of the loss (10%).

– Funding is from registered securities trading companies based on the type of licence, commissions collected, etc., to a maximum of 10% of each company's annual net income. Contributions are determined based on the risk associated with the activities and type of licence, and are calculated by regulation.

- **Protection against insurer insolvency**

The German system provides two protection mechanisms against insurer insolvency:

– the Guarantee Fund for Life Insurers, and
– the Guarantee Fund for Private Health Insurers.

These funds guarantee the continuation of insurance contracts in the event an insurer is unable to meet its obligations. Compensation is not available under these funds.

– These funds cover life and health insurance contracts. The regulator, BaFin, confirms the default of the insurer. The fund assumes in-force contracts until they expire or transfers the portfolio to another insurer.
– The funds are administered by two private insurance companies, respectively, Protektor Life Insurance Company and Medicator Health Insurance Company, under the supervision of BaFin.
– The funds do not pay out any compensation; they ensure that contracts are continued or transferred to another insurer.
– Both the Guarantee Fund for Life Insurers and the Guarantee Fund for Private Health Insurers are funded by contributions from insurers. All life insurance companies in Germany must be members of these funds.

There is no direct compensation mechanism for fraud or insolvency by an insurance intermediary.

Australia

The Australian Securities & Investments Commission (ASIC) is Australia's financial industry regulator. The ASIC oversees the financial services industry, protects consumers and ensures market integrity. The Australian Prudential Regulation Authority (APRA) is the prudential regulator of deposit institutions and insurers.

The Australian financial system does not provide a direct consumer compensation scheme for consumers of either insurance or securities products.

- **Consultation and report**

In 2010, the Australian government ordered a report[33] to evaluate the need for, and costs and benefits of, a statutory compensation scheme. The report, released in 2011, does not contain specific recommendations (these are forthcoming), but rather observations about the strengths and shortcomings of the Australian compensation scheme.

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[33] Richard St. John, *Review of Compensation Arrangements for Consumers of Financial Services*, Future of Financial Advice (Consultation paper), 2011. On-line http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_CP/downloads/Compensation_Consultation_Paper.pdf.

- **Complaint examination and dispute resolution**

Under the Australian financial system, registered firms are required to carry professional liability insurance to meet consumer losses caused by employee negligence or misconduct.

The complaint examination and mediation mechanism is a graduated system.

– Consumers must first raise their complaint with their representative or firm that provided the product or service. They must inform the firm of their expectations, so that the problem can be resolved.
– If not satisfied with the response, the consumer can escalate their complaint to the ASIC. This will trigger a complaint examination process.
– Mediation services are free of charge for consumers and mandatory for firms. Mediation is provided by an independent mediator, who will make a recommendation at the end of the process. If the consumer agrees with the mediator’s recommendation, the firm is required to comply. The mediator may recommend compensation.

TABLE 4

Consumer protection mechanisms in the United States, the European Union, France, the United Kingdom, Germany and Australia

Jurisdiction	**Organization**	**Insolvency**		**Fraud**		**Complaint examination system**	**Funding**	**Compensation limit**
		Insurance	**Securities**	**Insurance**	**Securities**			
United States	*Securities Investor Protection Corporation* (SIPC)	☐	☒	☐	☐	☐	Securities dealers	US$500,000 per client
	Insurance Guaranty Fund in each state	☒	☐	☐	☐	☐	State-licensed insurance companies.	Based on state law. In general, US$300,000 per insurance contract
European Union	Investor-Compensation Scheme Directive (ICSD)	☐	☒	☐	☐	☐	Based on Member State In general : contributions from registrant firms	€20,000 or more
France	Deposit Guarantee Fund – securities guarantee mechanism (MGT)	☐	☒	☐	☐	☐	Deposit Guarantee Fund members.	€140,000 per client : €70,000 for financial instruments and €70,000 for cash deposits (guaranteed securities)

	Fonds de Garantie des assurances obligatoires (FGAO) and Fonds de garantie des assurances de personnes	☒	☐	☐	☐	☐	Insureds and insurers	N.A.
United Kingdom	*Financial Services Compensation Scheme*	☒	☒	☒	☒	☐	Intermediaries	Ceiling based on product distributed; 10% co-insurability for insurance claims
	Financial Ombusman Service	☐	☐	☐	☐	☒	N.A.	N.A.
Germany	*Compensatory Fund for Securities Trading Companies* (EDW)	☐	☒	☐	☐	☐	Securities dealers	€20,000; 10 % co-insurability
	Guarantee Fund for Life insurers and *Guarantee Fund for private health insurers* Administered by *Protektor Life insurance Company* and *Medicator Health Insurance Company*	☒	☐	☐	☐	☐	Contribution des assureurs	Transfer of contracts to another insurer – no compensation
Australia	*Australian Securities & Investments Commission*	☐	☐	☐	☐	☒		N.A.