

FAIR

Canadian Foundation *for*
Advancement *of* Investor Rights

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RE: Incorporation of Individual Representatives of Registered Dealers and Advisers

FAIR Canada is pleased to offer comments on the possible options for the Incorporation of Individual Representatives of Registered Dealers and Advisers (the “**Options**”) contained in the consultation paper dated December 20, 2010 (the “**Consultation Paper**”) compiled by the working group of provincial/territorial government officials (the “**Working Group**”) and published by Alberta Finance and Enterprise.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary:

- 1. FAIR Canada considers investor protection to be the key priority in assessing the Options. Regulators should not devote scarce investor protection resources in efforts to distort the regulatory system in order to enhance tax avoidance.**

2. **FAIR Canada considers incorporation to be incompatible with the fundamental nature of dealer and adviser regulation; it will weaken control and supervision of sales representatives by registered dealers and advisers.**
3. **FAIR Canada considers incorporation to be incompatible with the need for personal liability of registrants for their conduct because it creates a shield from liability.**
4. **FAIR Canada considers each of the three Options undesirable.**
5. **FAIR Canada encourages governments and regulators to aim at a high standard of supervision and enforcement, and not to join a “race for the bottom” in order to provide tax benefits to industry members that would further entrench inappropriate and investor-unfriendly compensation methods.**
6. **We are pleased to see that the Consultation Paper is not an initiative of the Canadian Securities Administrators. We encourage members of the CSA to make improved investor protection their top priority, and not engage in policy initiatives such as this one which appears to be focused on enhancing registrant tax avoidance rather than on protecting investors.**

1. The framework of the discussion

- 1.1. FAIR Canada agrees with the importance of the principles outlined by the Working Group on page 3 of the Consultation Paper, derived from the 1999 CSA Distribution Structures Committee (the “**Committee**”). In particular, we consider the following principles to be important in assessing the Options:
 - a) the dealer or adviser must be legally responsible for the acts of its sales representatives;
 - b) the dealer or adviser must exercise an appropriate level of supervision over its sales representatives;
 - c) all conflicts of interest must be disclosed to the client and the client must be aware of all of the types of investor protection that are available to the client; and
 - d) the dealer and regulators must be able to perform their oversight function.
- 1.2. FAIR Canada also agrees with the Committee's conclusions that the relationship between the dealer or adviser and its sales representative is the crucial consideration in applying the above principles. FAIR Canada considers the legal character of the relationship between the dealer or adviser and the sales representative to be of fundamental importance in determining the desirability of the Options.
- 1.3. FAIR Canada also considers the practical effects of the Options on the relationships between the client, the sales representative, the dealer or adviser and the regulator to be of fundamental importance. The fundamental importance of the legal character of the relationship between dealer and representative (described in paragraph 1.2 above) results from its impact on this factor.

- 1.4. FAIR also considers investor protection to be a key consideration in assessing the Options. We note that outside of investors' capacity as "stakeholders", investor protection was not considered by the Working Group as a criterion by which the Options should be assessed. FAIR Canada does not agree that investors are mere "stakeholders" in this assessment. Rather, the protection of investors (who are the clients of the dealers or advisers) and their interests should be the central and fundamentally important interest by which the Options are assessed. Any Option that weakens investor protection should be rejected.

2. FAIR Canada's answers to the Working Group's Questions

- 2.1. FAIR Canada has considered the six questions posed by the Working Group at page 9 of the Consultation Paper. Our answers are as follows. Explanation for our answers will be found in the discussion of the three Options below.
- 2.2. ***Question 1: Should governments allow a broader range of registered dealers and advisers to redirect remuneration to a non-registered corporation?*** FAIR Canada considers that remuneration for services provided to the registered dealer or adviser *by sales representatives, as sales representatives* should never, under any circumstances, be directed to non-registered corporations.
- 2.3. ***Question 2: Should governments allow individual representatives of registered dealers and advisers to incorporate?*** FAIR Canada considers it unwise to allow individual representatives of registered dealers and advisers to incorporate in respect of any activity undertaken in their capacity as an individual representative.
- 2.4. ***Question 3: If yes to question 2, which incorporation option would in your view be the most effective and balanced alternative?*** Although the answer to Question 2 above also disposes of Question 3, since we consider that governments should not allow the use of unregistered corporations, we do consider the Advocis proposal, Option 2, to be worse than the other Options, for reasons we discuss below in paragraphs 5.7 to 5.10.
- 2.5. ***Question 4: Are there other provisions or options that should be considered to ensure that the use of a corporation continues to preserve the registrant-client legal relationship for both firms and individual sales representatives and provides for proper oversight of individual sales representatives by their registered dealer and adviser?*** FAIR Canada does not consider *any* use of a corporation able to preserve the existing relationships between registrants, clients, and individual representatives. Incorporation, in our view, will fundamentally undermine the legal foundation of such a relationship.
- 2.6. ***Question 5: Do you have any concerns or comments about potential income tax consequences or regulatory obstacles regarding each option?*** FAIR Canada does not have comments regarding potential income tax consequences, except to point out that, for the most part, comparisons with professional corporations and their tax situation are not apt. Professionals who incorporate are in a different contractual situation from sales

representatives and maintain a fundamentally different relationship to their clients, both legally and in practice.

- 2.7. ***Question 6: Do you have any concerns or comments about the potential impact of the incorporation options on investor protection?*** FAIR Canada considers each Option to be likely to significantly impair investor protection.
- 2.8. FAIR Canada has also considered the question posed on page 6 of the Consultation Paper, whether changes are appropriate to the current framework for business structures applicable to individual sales representatives of registered dealers and advisers. We have concluded that, given the fundamental nature of the regulation of registered dealers and advisers and their individual sales representatives, changes to the framework are not appropriate.

3. Incorporation is incompatible with the fundamental nature of dealer and adviser regulation

- 3.1. Investor protection is the fundamental objective of securities regulation. Accordingly, we consider the protection of investors to be the key consideration in assessing the regulation of registered dealers and advisers and the means by which investors are protected is of principal importance.
- 3.2. The primary means by which investors are protected from wrongdoing by sales representatives is through the supervision by dealers and advisers. As individual representatives are not registered dealers or advisers themselves, careful oversight and control by dealers and advisers is required.
- 3.3. Over the past few years, investment case files have exploded at the Ombudsman for Banking Services and Investments (“OBSI”). 2009 saw a 73% increase in new cases on 2008 according to OBSI's annual report, and a 200% increase over 2006. A recent release provided that the last quarter of 2010 saw even more new case files than 2009. Given the booming number of complaints from investors, FAIR Canada believes strongly that any move that may erode investor protection would be ill-advised, particularly at this time.
- 3.4. Currently, compliance at the individual representative level is the responsibility of registered dealers and advisers. It is the registered dealers and advisers that are, by regulation, “responsible for having a compliance system that promotes compliance by the firm and individuals with securities law.”¹ Key to the entire system is the requirement for registered firms to “provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation.”²

¹ Ontario Securities Commission, “Information for: Dealers, Advisers, and Investment Fund Managers” http://www.osc.gov.on.ca/en/Dealers_compliance-system_index.htm.

² National Instrument 31-103, section 11.1.

- 3.5. The escalating number of investment cases before OBSI suggest that, even now, registered dealers and advisers are not succeeding in their efforts to ensure compliance. FAIR Canada considers it likely that allowing sales representatives to incorporate will weaken these efforts further.
- 3.6. **Corporations cannot be employees. An employee, at law, is an individual who has entered a contract of service with the employer.** Currently, section 6.1 of NI 31-103 effectively requires sales representatives to be an employee, partner or agent of a registered adviser or dealer in order for the individual's registration to be valid³; in each case, this means practically that acts of the representative are acts of the registered dealer or adviser.
- 3.7. FAIR Canada notes that no benefits other than tax efficiency are proposed by the Working Group. The four benefits mentioned on page 5 of the Consultation Paper are all different ways of saying "tax efficiency will benefit sales representatives". The other principal 'benefit' we can identify from incorporation, limitation of liability, is not mentioned.
- 3.8. In order to obtain the tax benefits of incorporation, a sales representative's corporation will need to contract independently with the registered dealer or adviser, or carry on business in partnership with it. If the only business of a corporation is providing the personal services of its principal to an employer, it will fall afoul of the "personal services business" rules under the *Income Tax Act* and tax benefits will be lost.⁴
- 3.9. FAIR Canada therefore considers it not only likely, but logically necessary, that any changes in rules allowing sales representatives to incorporate must include rules that allow for independent contractual relationships between representatives and their registered dealer or adviser. Only through an independent contractor relationship, or carrying on business via a partnership, can a sales representative obtain the desired tax benefits.
- 3.10. Regulation and enforcement of professionals in other fields occurs at the individual level. Regulation and enforcement of sales representatives, however, takes place primarily through the registered dealer or adviser for whom they work, which must have control over their sales representatives in the most direct possible way. Permitting sales representatives to become independent contractors would completely disrupt the current compliance structure.
- 3.11. In order for registered dealers and advisers to exercise the closest possible control over sales representatives, those sales representatives should be contracted directly to the registered dealer or adviser; the parties should enjoy "privity of contract". Any situation where a sales representative contracts with a registered dealer or adviser through his or her corporation (in order to access the tax benefits of being remunerated through the corporation) would result in greatly reduced oversight of the registered dealer or adviser over the individual

³ IIROC Dealer Member Rule 39 also allows employment and agency, but not any incorporated salespeople.

⁴ CRA Interpretation Bulletin IT-73R6, at paragraphs 18-19.

sales representative, because registered dealers and advisers would only be able to enforce the terms of the contract.

- 3.12. FAIR Canada considers it likely that if such independent contractor relationships were allowed, registered dealers and advisers would use the remoteness of their contractual relationships with individual sales representatives to disclaim liability for their conduct. **We note that the comments of Kenmar Associates on the Consultation Paper, dated December 28, 2010, contain an example of such disclaiming behaviour within the insurance industry, which does allow firms to contract remotely with sales representatives.**
- 3.13. FAIR Canada considers that changes that would allow individual sales representatives to disclaim liability for their conduct would be materially detrimental to the interests of investors. As NI 31-103 makes it the responsibility of registered dealers and advisers to ensure compliance by their sales representatives, any system of engaging sales representatives that potentially allows dealers and advisers to wash their hands of their representatives' conduct poses a grave danger to the effectiveness of the securities regulation and enforcement system, particularly when it comes to retail investors.
- 3.14. A contract of service, in particular, allows the greatest possible control over the conditions of work, and therefore FAIR Canada considers it necessary that contracts of service be used to engage sales representatives.
- 3.15. In determining whether a contract of service (and therefore an employment relationship) or a contract for services (and therefore an independent contractor relationship) exists, Canada Revenue Agency (“CRA”) states that it will look above all else to the degree of control or autonomy that the worker enjoys. In particular, it looks to whether “[t]he relationship is one of subordination. The payer will often direct, scrutinize, and effectively control many elements of how the work is performed.”⁵
- 3.16. FAIR Canada considers it important that CRA will require this independent relationship in order for incorporated sales representatives to enjoy the tax benefits that incorporation is intended to achieve. In other words, sales representatives will need to *not* be subordinated to their registered dealer or adviser, and the dealer or adviser will *not* often direct, scrutinize or effectively control how the work is performed.
- 3.17. FAIR Canada considers such a relationship between the sales representative and the dealer or adviser to be entirely unacceptable from an investor protection perspective, and fundamentally incompatible with NI 31-103 and with the nature of the securities regulation system. It is a principle of the system that the work and methods of sales representatives be carefully scrutinized by registered dealers and advisers, and the principle that those sales representatives be answerable to those dealers and advisers.

⁵ Canada Revenue Agency, RC4110 *Employee or Self-Employed?*, at page 4. These tests are related to the cases *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, [2001] 2 S.C.R. 983, 2001 SCC 59 and *Wiebe Door Services Ltd. v. M.N.R.*, [1986] 3 F.C. 553 that considered the fundamental nature of an “independent contractor” relationship.

3.18. The Working Group itself, in identifying core principles to be respected in non-traditional structures, stressed the importance of a registered dealer or adviser “be[ing] legally responsible for the acts of its sales representatives,” and “exercis[ing] an appropriate level of supervision over its sales representatives.” The Working Group also noted the importance of dealers and advisers being able to perform their oversight function. FAIR Canada considers it highly problematic for dealers and advisers to exercise this appropriate level of supervision over independent contractors. FAIR Canada considers it likely that independent contractor relationships will encourage dealers and advisers to disclaim legal responsibility for their sales representatives because of this lack of supervision. Finally, FAIR Canada considers independent contractor relationships to be a significant obstacle to dealers' oversight function, as well as a significant obstacle to the oversight function of regulators, as regulators' oversight activities are largely conducted through and with the cooperation of dealers and advisers.

4. Incorporation will shield assets from enforcement proceedings

- 4.1. FAIR Canada is concerned that allowing remuneration to be passed to incorporated entities separate from individual sales representatives will allow profits to be shielded from enforcement or legal action where fines, penalties or damages are imposed.
- 4.2. It is not possible for regulators to regulate the contractual relationships in each case between individual sales representatives and their corporations. It will therefore be possible for individual representatives to use such contracts to shield their corporations (and therefore their remuneration) from liability for the acts of the representatives.
- 4.3. FAIR Canada considers this use of a corporation as a liability shield to be further problematic where persons other than the individual sales representative are allowed to hold shares in the corporation. This raises the possibility of remuneration being streamed to persons for whom statutory liability will not apply. FAIR Canada considers it likely that, were incorporation of sales representatives to be permitted, any person attempting to abuse their position as an individual sales representative in an unethical manner will make use of the corporate shield, and possibly of related taxpayers, in order to shield their ill-gotten gains from enforcement.

5. FAIR Canada's assessment of the three Options

- 5.1. **FAIR Canada considers each of the three Options to be highly undesirable both from the point of view of investor protection and from the point of view of regulatory burden. Each Option, if adopted, would make protecting investors from harm by sales representatives more difficult. Each Option, if adopted, would also make regulatory enforcement more difficult. Finally, each Option would serve to weaken the fundamental relationships upon which the system of regulation of dealers, advisers and their sales representatives is built.**
- 5.2. The fundamental issue that FAIR Canada has identified with each Option is that the incorporation of a sales representative, or the direction of a sales representative's

remuneration to an unregistered corporation, is fundamentally at odds with the principle that representatives are bound to registered dealers and advisers by a contract of service. FAIR Canada is concerned that adopting any of the Options will erode the control that registered dealers and advisers currently must exercise over their sales representatives.

- 5.3. FAIR Canada is also concerned that if such a regime were to come into effect, registered dealers and advisers would use the Options to attempt to avoid responsibility for the conduct of their sales representatives, citing the contractual remoteness of those representatives as a way of deflecting responsibility.
- 5.4. FAIR Canada is also concerned that incorporation, under each Option, will result in fewer assets being available to clients or to regulators in the event of fines or judgements awarded in legal or regulatory proceedings. Incorporation will serve to hide and distribute assets where they cannot be accessed, allowing sales representatives to act with impunity in situations of wrongdoing.
- 5.5. FAIR Canada also has specific concerns with each of the three Options that we shall address below.

Option 1: Alberta Securities Commission Legislative Proposal

- 5.6. FAIR Canada considers the Alberta Securities Commission Legislative Proposal to be particularly problematic for three reasons. First, FAIR Canada considers a permit system to be unnecessarily bureaucratic and to impose additional costs and regulatory burdens on individual sales representatives. Second, FAIR Canada considers that allowing shares of professional corporations to be held by persons other than the individual sales representative will allow for a greater ability to shield assets from enforcement. Third, FAIR Canada considers it impossible to design a system of incorporation that will not adversely impact the registrant-client legal relationship, for the reasons discussed above at paragraph 3.6 to 3.18. As dealers and advisers deal with clients primarily through dealing representatives and advising representatives, any system that weakens the control of dealers and advisers over those representatives negatively impacts that registrant-client legal (and practical) relationship.

Option 2: Advocis Legislative Proposal

- 5.7. FAIR Canada considers the Advocis Legislative Proposal to be particularly problematic for three reasons. First, the extremely cumbersome Advocis proposal to have regulators assess (and registrants and representatives report) the suitability of shareholders and directors of representatives' corporations, would be expensive; and due to the volume of review, would be far more likely to result in unsuitable persons becoming directors and shareholders of such corporations. The ability to funnel remuneration to unrelated persons would also raise uncomfortable issues with the responsibility of sales representatives to their clients.
- 5.8. FAIR Canada considers it of paramount importance that dealers and advisers, and the sales representatives they employ, put their clients' interests first. FAIR Canada considers that only

in a system where client interests are considered before all others can investors be adequately protected in the marketplace. However, the Advocis proposal would put representatives in the position of needing to meet the interests of unrelated shareholders first, fatally compromising their core duty to their clients.

- 5.9. Second, FAIR Canada considers the Advocis proposal to have sales representatives (and their corporations) maintain errors and omissions insurance to be problematic for two significant reasons. First, the maintenance of E&O insurance will impose additional costs on the industry, which may ultimately be borne by investors. Adding a layer of expensive bureaucracy to spread risk over the securities industry cannot be justified by the provision of some tax benefits to representatives by incorporation. Second, the maintenance of E&O insurance by representatives will irrevocably shift the primary responsibility for the supervision of sales representatives from registrants to the insurers. This is entirely unacceptable. The primary responsibility of supervision must lie with dealers and advisers, who must be ultimately responsible for their sales representatives' conduct, financially, legally and morally.
- 5.10. Third, FAIR Canada considers the possibility raised at page 8 of the Consultation Paper that representatives might be “otherwise engaged” than by employment with their individual corporations to be unacceptable. Our comments regarding control, privity of contract and independence at paragraphs 3.6 to 3.18 above apply equally to representatives' own corporations. The Advocis proposal raises the possibility that a sales representative could be insulated by two layers of independent contract from the dealer or adviser that is supposed to supervise him or her.

Option 3: Redirection of Remuneration to Unregistered Corporations

- 5.11. FAIR Canada considers the third Option, the redirection of remuneration to unregistered corporations, to be particularly problematic for the reasons identified in paragraph 4.3 above, and because the “redirection” of remuneration, if it is to be effective at obtaining tax benefits, requires a contractual relationship that, as discussed above, will weaken the employment relationship between representative and registrant.

6. Comments of Kenmar Associates and Weigh House

- 6.1. FAIR Canada has a number of comments to offer echoing points made by Kenmar Associates (“**Kenmar**”) in their comment letter of December 28, 2010 on this matter, and by Weigh House Investor Services (“**Weigh House**”) in their comment letter on this matter.
- 6.2. First, FAIR Canada would concur with Kenmar that allowing registered sales representatives of MFDA members to be paid sales commissions directly into non-registered corporations was an unfortunate development. For the reasons we have detailed above, FAIR Canada would have preferred that the MFDA require its members to mandate privity of contract between themselves and their sales representatives. The mutual fund industry already suffers from systemic issues regarding compensation and commission practices that are

unlikely to be helped by the funnelling of commissions to corporations that do not earn them. Securities administrators would be wise not to extend these practices any further.

- 6.3. Second, and even more importantly, FAIR Canada agrees with Kenmar that attempts to provide tax advantages for sales commissions over other types of income is exactly the worst possible step to take from an investor protection point of view. Not only are commissions paid directly by investors, they vary directly according to a representative's ability to convince investors to churn their investments. However, such churning is both costly to investors and damaging to the health of their investments. FAIR Canada considers that the compensation structure and financial incentives in the sale of mutual funds and other investment products already creates a situation where the interests of investors and the interests of sales representatives and dealers and advisers are diametrically opposed. Encouraging the tax attractiveness of such compensation is a strike against investors' interests and exacerbates conflicts created by the compensation structure.
- 6.4. FAIR Canada, as discussed above in our comments on the Advocis option at paragraphs 5.7 to 5.10, shares Kenmar's concern that the Advocis proposal in particular appears to presuppose that individual sales representatives will cease to act as agents and employees of their registered dealer or adviser. The idea that advisers would maintain separate errors and omissions insurance, and that sales representatives might be "otherwise engaged" than by employment with a personal corporation, indicate multiple layers of remoteness between a representative and his or her registered dealer or adviser. This would be unacceptable.
- 6.5. **FAIR Canada agrees with Weigh House that "we feel the focus [of regulators and administrators] should be on removing the inequities between the public and their 'advisors' before worrying about inequities between different groups of salespeople."**
- 6.6. FAIR Canada also strongly agrees with Weigh House in encouraging governments and regulators to explore ways of requiring registered dealers and advisers (and their representatives) to put the interests of their clients first in their professional dealings. Requirements to put clients' interests first will aid investors by helping them to be better informed, and will better protect investors by ensuring a clear and far stricter standard of conduct by registered dealers and advisers. The same requirements will aid registered dealers and advisers by helping to restore public confidence in the industry and by fostering closer and more trustworthy relationships between investors and sales representatives, a goal that over the long term is in everyone's interests.

7. Regulatory Priorities

- 7.1. FAIR Canada is concerned that the current system of regulation for registered representatives has many flaws. We would recommend that the government and regulators focus on fixing investor-unfriendly flaws rather than engaging in an initiative such as this one, which seeks to weaken oversight and supervision in order to achieve tax avoidance for the industry.

- 7.2. Self-regulatory organizations (“SROs”) currently have primary responsibility for regulating and enforcing the standards of practice and business conduct of their members and the members’ registered representatives. Regulators maintain that these SROs do so “with a view to promoting the protection of investors and the public interest.”⁶ However, in practice, FAIR Canada considers the SROs to be ill-equipped to enforce sanctions in a meaningful way on registered representatives.
- 7.3. **In 2009-2010, IIROC was able to collect only 17.5% of the fines that it levied against individual representatives, fines often levied for drastic violations of regulations and good conduct. (In 2009-2010 the most common reasons for discipline of individuals were inappropriate personal financial dealings; inappropriate account handling; gatekeeper issues; and theft, fraud or misrepresentation.⁷) A crucial element of this is that IIROC has stated that it considers itself to have little leverage to require or force banned individuals to pay their fines.⁸ Furthermore, IIROC has no jurisdiction to require firms to pay fines when individuals do not. FAIR Canada considers the ability of individuals who commit serious breaches to leave a member firm without anyone paying the relevant penalties to be a serious flaw in the securities regulatory enforcement system.**
- 7.4. Firms themselves are rarely disciplined; over 80% of IIROC hearings in 2009-2010 were against individuals and not firms.⁹ Firms are not punished; individuals are, but due to IIROC's inability to enforce joint liability for individual penalties, both the individuals *and* their firms escape the financial penalties imposed upon them. This weakens the incentives for SRO member firms to carefully enforce, supervise, and oversee their registered representatives.
- 7.5. **This major flaw in our regulatory system has existed, and has been well known and understood, for a long time. Yet FAIR Canada observes that no proposals have been forthcoming to fix it. Weakening the system of oversight and supervision in order to achieve tax benefits for sales representatives is not merely opposite to what the regulatory priorities should be: FAIR Canada considers it to be a symptom of an unwillingness to deal with serious shortfalls in the current regulatory system.**

⁶ Ontario Securities Commission, “Information for: Marketplaces, SROs and Clearing Agencies.”
http://www.osc.gov.on.ca/en/Marketplaces_sro_index.htm

⁷ IIROC Annual Report 2009-2010

⁸ Advisor.ca, “Market Chatter Rises, Complaints Decline: IIROC” September 13, 2010

<http://www.advisor.ca/news/industry-news/market-chatter-rises-complaints-decline-iiroc-696>

⁹ IIROC Annual Report 2009-2010

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/ ermanno.pascutto@faircanada.ca or Ilana Singer at 416-572-2215/ ilana.singer@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights