Extending a Fiduciary Duty to all Financial Advisors and Brokers: Will it make a difference?

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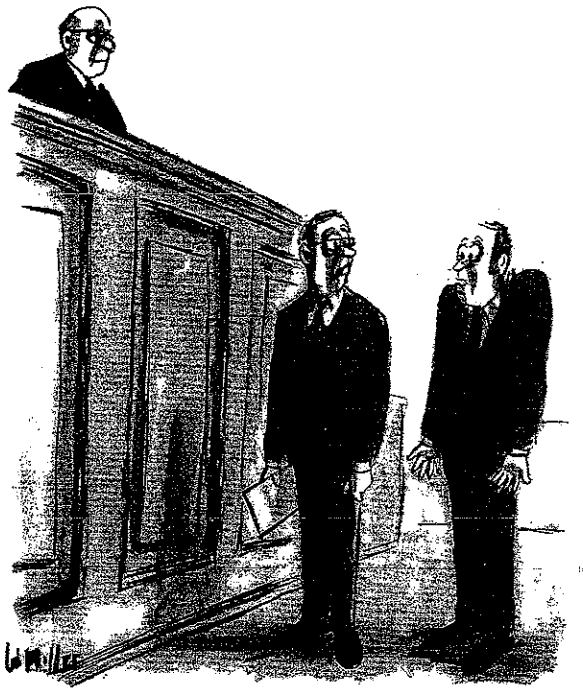

"'Ignorance of the law is no excuse.' Golly! I never heard that one! Did you ever hear that one?"

Will the extension of a fiduciary duty to all financial advisors and brokers have an appreciable affect on the protection of investors and the civil remedies available to them? Our answer is a resounding no. These are our reasons why.

The Fiduciary Duty

The fiduciary standard is a common law construct; the courts will only apply a fiduciary standard to financial advisors and brokers where the circumstances warrant the protection of the weak, vulnerable, or powerless. The nature of the relationship between a client and a financial advisor or broker has been described by the courts as a spectrum:

> Essentially, therefore, one should consider the relationship to be a spectrum. At one end is a relationship of full trust and advice. The broker effectively makes all the decisions because of the great reliance and trust posed in him or her by the client …
>
> This is exacerbated where the account is discretionary, such that the broker has authority to make trades without the client's consent or even knowledge (*e g*, see *Ryder v. Osler, Wills, Bickle* (1985), 49 O.R. (2d) 609 (Ont. H.C.)). Obviously, there is a fiduciary relationship at this end of the spectrum … At the other end is a relationship where the broker is merely an "order-taker" for the client, the client does not rely on any advice from the broker, and the broker has no discretion … Relationships at this end of the spectrum lack the elements of a fiduciary relationship … Most cases fall somewhere in the middle …[1]

The Ontario Court of Appeal summarized the test for determining whether a fiduciary relationship exists in *Hunt v T D. Securities Inc.*:

1. Vulnerability – the degree of vulnerability of the client that exists due to such things as age or lack of language skills, investment knowledge, education or experience in the stock market.

[1] *Kent v May* (2001), 298 A.R. 71 (Alta. Q.B.) at paras. 51-53

2. Trust – the degree of trust and confidence that a client reposes in the advisor and the extent to which the advisor accepts that trust.

3. Reliance – whether there is a long history of relying on the advisor's judgment and advice and whether the advisor holds him or herself out as having special skills and knowledge upon which the client can rely.

4. Discretion – the extent to which the advisor has power or discretion over the client's account.

5. Professional Rules or Codes of Conduct – help to establish the duties of the advisor and the standards to which the advisor will be held.[2]

The test for determining whether a fiduciary relationship exists is heavily dependent on the facts of a specific case, and for good reason. The courts have recognized, for example, that the relationship between a client and a mere-order taker is fundamentally different than the relationship between a client and a financial advisor with total discretionary power over the client's assets, and that a sophisticated investor is not subject to the same power and information imbalance that an unsophisticated investor is when working with a financial advisor.

A fiduciary duty prescribed by statute, which is not limited by the conditions identified in *Hunt v. T.D. Securities Inc* , will put all honest financial advisors and brokers in the same

[2] (2003), 66 O.R. (3d) 481 (Ont. C.A.)

position, regardless of the type of work they are performing on their client's behalf and regardless of the sophistication of their client. The breadth of work which financial advisors and brokers perform is broad and varied, and thus in our view, it would be inappropriate to assign all of them with the same duty and corresponding liability. This will also add significant cost and inefficiency to the relationship.

A fiduciary duty will also not help victims of boiler room fraud, Ponzi schemes, unregistered representatives, and unregistered products. We are amazed at how little real regulatory work is being done to prevent these schemes and how ineffective the regulators are in helping injured investors received compensation for their losses. If there is one area of the marketplace, above all others, in which there should be a renewed effort, it is here.

Alternatives

It is crucial to keep in mind that a finding by the court that a financial advisor or broker does not owe a fiduciary duty to the client rarely marks the end of the road for the disgruntled investor seeking restitution in the courts, nor does such a finding imply that the financial advisor or broker owes no duty to the client at all. There are a number of alternative causes of action which investors can advance aside from breach of fiduciary duty, including breach of contract, negligence, negligent misrepresentation, conspiracy, fraud, and fraudulent misrepresentation.

It is also important to note that many financial advisors and brokers hold designations which impose fiduciary duties on them. The *Conduct and Practices Handbook* (CPH) prescribes fiduciary-like obligations on financial advisors, and those who hold a Certified Financial Planner Licence (CFP) agree to a code of ethics and practice standards which put them in a fiduciary relationship with their clients.

In addition, instead of altering what is a common law test developed by the courts by way of legislative intervention, the duty owed by financial advisors and brokers to investors could be made more strenuous by modifying IIROC's proposed Client Relationship Model, and in particular its proposals concerning conflict management and disclosure.

Improving the Remedies Available to Investors

The problem is not that there are insufficient remedies available to investors, but rather that investors are not sufficiently aware of what remedies are available to them, and that these remedies are often lengthy, complicated, and cost prohibitive.

(i) the Courts

As noted above, investors can seek a remedy in court based on a variety of causes of action, including breach of fiduciary duty, breach of contract, negligence, negligent misrepresentation, conspiracy, fraud, and fraudulent misrepresentation. However, pursuing legal action in court against a typically well-funded investment advisor or

broker is something few investors can afford. Given the economics of litigation, a loss which to an investor represents a significant and perhaps even life-altering amount, is often eclipsed by the legal costs which recouping that amount in the courts would incur.

(ii) Ombudsman for Banking Services and Investments (OBSI)

OBSI provides a free and independent process by which investment disputes can be resolved. However, OBSI can only recommend compensation of up to $350,000, and its recommendations are non-binding (though to this date they have almost always been adhered to).

(iii) IIROC Arbitration

IIROC's Arbitration Program offers investors a method by which they can resolve disputes with IIROC Dealer Members outside of the courts. IIROC Dealer Member Rule 37.1 requires all Dealer Members to participate in the binding Arbitration Program if a client requests it. However, rewards under the Arbitration Program are even lower than those at OBSI, they are capped at $100,000. Furthermore, unlike at OBSI, investors participating in the Arbitration Program must pay to access the program by paying a portion of the fees charged by the arbitrator, generally have to pay a lawyer to represent them, pay for their own expert, and also run the risk of having costs awarded against them by the arbitrator. The risk and expense investors must undertake in order to win

what will likely be a relatively modest award, is likely the reason why only 8 cases for arbitration were opened in 2009, 9 in 2008, and 4 in 2007.[3]

IIROC's Arbitration Program is currently under review[4]. The removal of an award limit, using roster experts, and the reduction or removal of arbitration costs would likely encourage further participation by investors in the program. IIROC should also consider using its restricted funds, those collected by way of the monetary sanctions meted out in its disciplinary process, to subsidize the Arbitration Program. However, even if that were to occur, investors will likely still have to hire a lawyer and pay the corresponding legal costs.

The Mechanics of the Investor and Financial Advisor/Broker Relationship

Unfortunately, whether they seek remedies in the court or in a more robust IIROC Arbitration Program, investors will still face high legal costs and the risk that they may not recoup those cost even with a successful result. The introduction of a statutorily enshrined fiduciary duty for all financial advisors and brokers will not change that reality, and in any event really does not address the most fundamental issues.

In our view, more progress can be made by addressing the root cause of most investor complaints – the imbalance of information and conflict which often exists between

[3] http://www.iiroc.ca/English/Investors/MoneyBack/Arbitration/Documents/ArbitrationStatistics_en.pdf
[4]http://docs iiroc.ca/DisplayDocument.aspx?DocumentID=6A9589ECA3684E949ECF5809BE2D53A0&Language=en

investors and their advisors, rather than on expanding an already adequate range of potential remedies. We offer three examples of how progress can be achieved.

(i) Improving Financial Literacy

The goal of improving financial literacy is certainly not new, but it is an important one. The OSC's Investor Education Fund and the federal government's recently created Task Force on Financial Literacy are good investments in what is a long term project. However, it should be kept in mind that the goal need not be that ordinary Canadian have a sophisticated understanding of the financial system; financial advisors exist for good reason. The goal should be that all Canadians know enough to be able to ask questions and be skeptical about the answers they receive, and so that they turn a critical eye to the advice and products offered to them. A statutory fiduciary duty will not prevent boiler room fraud, but better financial literacy will make Canadian less susceptible to it.

(ii) Improving point of sale disclosure

The CSA has recently proposed the implementation of mandatory point of sale disclosure for mutual funds in a designated form (the Fund Facts document). The Fund Facts must be written in plain language, fit on both sides of one page, and including information such as past performance of the fund, risks to the fund, and information on the cost of investing (including how advisors are paid). We consider the CSA's proposal to be a step

in the right direction, and suggest that the CSA consider expanding mandatory point of sale disclosure to other types of financial products as well.

(iii) Modifying how financial advisors and brokers get paid

The FSA has proposed changes to the manner in which financial advisors are compensated, and specifically is recommending that advisors be prohibited from receiving commissions from financial product providers, and that instead compensation come entirely from their clients.[5] If implemented, it will remove a significant source of conflict for financial advisors. The FSA's proposal should be seriously considered in Canada.

Conclusion

The extension of a fiduciary duty to all financial advisors and brokers will have no appreciable affect on the protection of investors and the civil remedies available to them. The test in court for determining whether a fiduciary relationship exists is dependent on the facts of a specific case, and reflects the broad and varied roles investment advisors and brokers take. A statutory fiduciary standard which puts all investment advisors and brokers in the same position does not reflect the realities of the market place, and will not improve the remedies available to investors. There are other areas where more meaningful progress can be made, such as the mechanics of the relationship between investors and financial advisors and brokers.

[5] http://www.fsa.gov.uk/pubs/cp/cp09_18.pdf