

Comments on a Statutory Best Interest Duty for Advisors and Dealers

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Agenda

1. **Fiduciary Duties**

- a. What is a Fiduciary Duty?
- b. When does a Fiduciary Duty arise?
- c. What are current standards for dealers and advisors?
- d. What would a CSA Statutory Best Interest Duty entail?

2. ***Recent OSC decision (In the Matter of TD Securities et al.)***

- a. Overview
- b. Effect on Supervision and Compliance

The “F” Word

What is a Fiduciary Duty?

- Broadly speaking – a duty to act in another’s best interest
- Elements of a fiduciary duty:
 - Client interests are paramount
 - Conflicts of interest are to be avoided
 - Clients are not to be exploited
 - Full disclosure of all material information
 - Services performed reasonably prudently

When does a Fiduciary Duty Arise?

Status-Based Fiduciary Relationships

- Existence of fiduciary duty is presumed based on the status of the parties involved
 - Lawyer-client
 - Doctor-patient
 - Trustee-beneficiary
 - Director-corporation

Fact-Based Fiduciary Relationships

- Existence of fiduciary duty depends on the facts of each particular case
- Factors:
 - Vulnerability
 - Level of Trust
 - Reliance
 - Discretion
 - Existence of Rules of Professional Conduct

Legislation

OSC Rule 31-505, *Conditions of Registration*, s. 2.1: A registered dealer shall deal fairly, honestly, and in good faith with his or her clients

IIROC Rule 42.3(2): A Dealer Member must address an existing or potential material conflict of interest in a fair, equitable and transparent manner, and considering the best interests of the client or clients

CSA Companion Policy to National Instrument 31-103: a registrant should

- Avoid conflicts of interest if sufficiently contrary to the interests of a client;
- Control conflicts of interests if they can be effectively managed by internal controls
- Disclose conflicts of interest if a reasonable investor would expect to be informed

Securities Act, R.S.O. 1990, c S.5, s. 116: Every investment fund manager,

- (a) Shall exercise the powers and discharge the duties of their office honestly, in good faith and in the best interests of the investment fund; and
- (b) Shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances

Common Law

“The relationship of the broker and client is elevated to a fiduciary level when the client reposes trust and confidence in the broker and relies on the broker’s advice in making business decisions. **When the broker seeks or accepts the client’s trust and confidence and undertakes to advise, the broker must do so fully, honestly and in good faith.** In any case where a broker has an interest in a particular transaction, **the broker must make full disclosure** and assumes the onus of proving that no advantage was taken of the client, that the transaction was entered into in perfectly good faith and after full disclosure. It is the trust and reliance placed by the client which gives to the broker the power and in some cases, discretion, to make a business decision for the client. Because the client has reposed that trust and confidence and has given over that power to the broker, the law imposes a duty on the broker to honour that trust and respond accordingly.”

Varcoe v. Sterling (1992), 7 O.R. (3d) 204 (Gen. Div.) at para. 86; affirmed (1992), 10 O.R. (3d) 574 (C.A.); leave to S.C.C. denied

Proposed Statutory Best Interest Standard

Canadian Securities Administrators Consultation Paper 33-403: October 25, 2012

Every advisor and dealer (and each of their representatives) that provides advice to a retail client with respect to investing in, buying or selling securities or derivatives shall, when providing such advice:

- (a) act in the best interests of the retail client; and
- (b) exercise the degree of care, diligence and skill that a reasonably prudent person or company would exercise in the circumstances

What's the Difference?

In principle, dealers and advisors already must fulfill all the obligations of a fiduciary duty to clients

- Must make full disclosure of material facts
- Must deal fairly, honestly and in good faith
- Must address actual or potential conflicts of interests considering the best interests of the client

Arguably, imposing a statutory best interests standard is just putting a formal label on something that already exists



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Due Diligence Defence

*In the Matter of TD Securities Inc., Kenneth Nott,
Aidin Sadeghi, Christopher Kaplan, Robert Nemy
and Jake Poulstrup*

What does this decision mean for Supervision and
Compliance?

IIROC Hearing Panel, (Decision released November 30, 2010 – [2010] IIROC No. 55)

- Allegations by IIROC Staff that individual proprietary traders of the Firm entered artificial closing bids contrary to Universal Market Integrity Rules (“UMIR”) Rule 2.2 and Policy 2.2 over the course of May 1 to October 31, 2005
- Allegations by IIROC Staff that the Firm failed to comply with its trading supervision obligations contrary to UMIR Rule 7.1 and Policy 7.1 stemming from the allegations against the individual traders
- Individual trader reported large increase in shareholdings of company as an accidental “fat finger” order; The Firm’s supervisory staff conduct monitoring and investigation procedures that lead up to the suspension and dismissal of two individual traders
- The Firm reported the matter to IIROC on November 16, 2005 (**Gatekeeper Report**) (caused exhaustive investigation by IIROC leading to the allegations against both the Firm and the individual traders)
 - IIROC alleges, *inter alia*, that TDSI failed to implement adequate supervisory practices and procedures

IIROC Hearing Panel, (Decision released November 30, 2010 – [2010] IIROC No. 55)

- Proprietary traders entered numerous artificial closing bids (bidding within the context of the market for the purpose of maintaining a closing bid price, with no *bona fide* intention to purchase the securities); allegations are proven
- Held that TD Securities **did not fail to comply with its trading supervision obligations**
- UMIR Rule 7.1 and Policy 7.1: a participant must make an effective assessment of the risks associated with the types of trading in which it engages and **adopt and implement policies and procedures that are adequate**
 - Para. 407: “TDSI implemented written policies and procedures that covered its entire business to ensure compliance with UMIR Rules and UMIR Policy including the Rules and Policy governing market manipulation”
 - The random review approach employed by TDSI trade desk supervisors for reviewing bids placed late in the day “was **reasonable and realistic**” having regard to:
 - The fact that there was no software program available to detect time/sequence of late bids; and
 - The trade room scenario relating to detecting and investigating late bids
 - Para. 447: “TDSI **deserves credit, not criticism** for the manner in which it monitored and detected the bidding improprieties...and for the prompt filing of the Gatekeeper Report on November 16 (21 days after the discovery of the wash trade)”



Ontario Securities Commission, Decision on Application to Review IIROC Hearing Panel Decision (Decision released July 19, 2013)

- IIROC Staff appeal the IIROC Hearing Panel decision of November 30, 2010, seeking Order overturning IIROC Hearing Panel decision and finding that TDSI failed to comply with UMIR Rule 7.1 and Policy 7.1
- “We reject the allegation that the IIROC Hearing Panel did not address the evidence of how TDSI’s “random review approach” failed in the circumstances. On the contrary, **we find that the IIROC Hearing Panel included an analysis of the entire supervisory structure in its Decision and addressed how the artificial bidding behaviour could have passed undetected. We find that it was reasonable for the IIROC Hearing Panel to conclude, based on the evidence before it, that TDSI met its responsibilities with respect to supervision.**”
- “Ultimately, we accept that the IIROC Hearing Panel came to its conclusion about the adequacy of TDSI’s supervision on grounds other than that TDSI had an erroneous understanding of what they were supervising for. **The fatal flaw referenced by the IIROC Hearing Panel refers to only one element of a compliance and supervision system, and not the system in its entirety.** The IIROC Hearing Panel analyzed various parts of TDSI’s compliance and supervisory system and, considering them together, **concluded that the system was acceptable.** For these reasons, **we do not find that the IIROC Hearing Panel erred in law or proceeded on an incorrect principle when it dismissed the allegations against TDSI.**”

Key Takeaways

- The compliance and supervision system employed does not need to be perfect, nor does it need to prevent/detect every impropriety – The system needs to be duly diligent
- It must be reasonable and realistic in the circumstances, bearing in mind the resources and technology available
- Compliance professionals can protect themselves from scrutiny by ensuring their supervision systems and policies are adequate and by responding promptly to improprieties.