

HOW INVESTMENT PROFESSIONALS CAN AVOID LIABILITY

LOOK OUT FOR LIABILITY

The purpose of this brochure is to highlight the legal pitfalls faced by investment advisors and to suggest means of avoiding them.

Canadian equity markets have in the past experienced unprecedented growth due, in part, to the baby-boomers' desire to secure retirement income. However, as we have all learned, with every boom comes a bust, which has a negative impact on the holdings of baby-boomers and others. As the equity markets return to a growth phase, investors and investment professionals are making financial gains. However, as soon as the market experiences another significant correction, investors will begin to scrutinize the advice they have received from their investment counsellors. This may result in legal action and potential liability.

Liability means that the courts will hold an investment advisor responsible for providing advice that has resulted in unnecessary losses. While liability may arise from a variety of circumstances, it will normally stem from a breach of one or a combination of the following three areas of law: 1. the law of negligence; 2. the law of contract; and 3. the law of equity. A clear understanding of each of these areas is necessary in order to avoid liability.

THE LAW OF NEGLIGENCE

The term "negligence" refers to conduct which falls below the standard of what can be reasonably expected of a person. If the advice provided by an investment advisor falls below the standard of what can generally be expected, that person's conduct is considered negligent. As a result, he or she will be held responsible for all resulting losses. The standard used is not one of perfection, but rather that of a reasonable and prudent professional in similar circumstances. As such, mistakes that fall within an acceptable margin of error will not necessarily lead to liability.

The Real Problem – The problem, however, is that many investment advisors fail to understand the standard. Instead, they often believe that an exact execution of a transaction will absolve them of all liability. But such an assumption does not recognize that an investment advisor has a duty to ensure that each transaction conforms to the individual needs and objectives of the investor. Therefore, be sure to determine the standard of conduct against which your advice will be judged so as to minimize legal exposure.

Setting the Standard – Identifying the standard that is expected of an investment advisor is a question of evidence. There are various sources that provide assistance in identifying the standard of conduct. For instance, industry manuals such as *The Conduct and Practices*

Handbook and various other educational materials are available. These materials help to determine whether an investment advisor has recommended a suitable investment. In addition, internal firm compliance and procedure manuals may be used. For example, if a particular investment institution has an established practice and an investment advisor has failed to follow that practice, this information may be an indication that the standard has not been met. Regulations and laws are other means of determining if the standard of conduct has been met.

Keep in mind that a breach of all of these standards will not necessarily lead to a finding of negligence. While it is difficult to determine the standard of conduct in precise terms, industry practices will assist the court in determining whether negligence has occurred. That is why identifying standard business practices, both internally and externally, plays an important role in avoiding liability.

Giving Negligent Advice – In instances where an investment advisor has provided negligent advice, the investor will be awarded damages which restore his or her losses. If the advice is provided within the scope of the advisor's employment, it will generally fall on the investment institution to pay the damages. On the other hand, if the advice is not provided within the scope of employment, the investment advisor may personally be held responsible for the losses. Other individuals, such as a compliance officer, may also be held personally responsible if they fail to adopt adequate policy procedures to prevent the occurrence of improprieties.

The fact that an investment advisor has breached a duty does not mean that he or she will be held responsible for all of the investor's losses. The investment advisor will only be held responsible if the resulting losses were foreseeable. Therefore, technical infractions will not necessarily result in a finding of liability. It is only in cases where the loss flows from the breach that the investment advisor will be held responsible.

The Tables Turn – There are some instances when the acts of the investor may absolve an investment advisor of liability. For instance, if an investor knowingly participates in an unauthorized transaction, he or she cannot point the finger at the investment advisor to make up the losses. Similarly, if an investment advisor informs an investor of the risks associated with a transaction, an investor will not be able to argue that the investment advisor was responsible for the losses. Accordingly, the investor's conduct will be considered when determining the extent of an investment advisor's liability.

THE LAW OF CONTRACT

In the law of contract, the courts try to decide whether the investment advisor has breached a contract with an investor. The contract can be oral and not necessarily in written form. Investment advisors generally enter into a master contract with an investor upon initial introduction, and then enter into subsequent oral contracts every time they receive instructions. Over and above the express terms of these contracts, there can be implied terms within contractual relationships. For example, if an investor states that his or her primary objective is

the preservation of capital, then it becomes an implied term of the contract that the investment advisor will invest in accordance with this objective.

The Written Word – In most cases, investment institutions provide to investors written confirmation of transactions which set out the nature of the transaction. These confirmations state that the investor has a set time within which to dispute the transaction, after which he or she loses the right to have the transaction corrected. While most investment institutions rely on this document as a way of imposing contractual terms, the courts have ruled that contractual terms cannot be unilaterally imposed on investors. Clearly, understanding both the express and implied terms of a contract that has been reached with an investor is important in avoiding liability.

THE LAW OF EQUITY

Equity is justice administered according to the concept of fairness. This contrasts with formulated rules found in the law of negligence and contract. In the case of equity, the courts will assess a relationship, and determine if parties are treating each other fairly and whether the circumstances warrant judicial intervention. However, not all relationships will warrant judicial intervention. In the case of investment advisors, the relationship may vary from continuous to occasional. On one end of the relationship scale is the dependent investor who will give an investment advisor wide discretion to structure his or her investment portfolio. On the other end of the scale is the independent investor who requires investor authorization before any security is traded. Equity is primarily concerned with fairness in relationships on the dependence end of the relationship scale. Commonly referred to as “power-dependent relationships”, it is these relationships that will attract judicial intervention.

The Highest Standard of Duty – In a power-dependent relationship, the investor places trust, confidence and faith in the investment advisor. This situation transforms the investment advisor into a “fiduciary”. A fiduciary is a person who undertakes a duty to act for someone else’s benefit, while subordinating his or her own personal interests. A fiduciary duty is one of the highest standards of duty implied by law.

Consequently, an investment advisor’s fiduciary duty obliges him or her to fully, carefully and honestly advise an investor regarding material information affecting the investor’s account. It also requires the investment advisor and the investment institution to avoid any conflicting interest with the investor.

Determining Fiduciary Duty – The determination of when an investment advisor has a fiduciary duty towards an investor is not a perfect science. The court will consider all the facts surrounding a relationship to determine this point. Although it is difficult to specifically define when a power-dependent relationship begins or ends, it is generally true that the opportunity to exercise significant discretion over an investor’s portfolio is a strong indication of a fiduciary relationship.

In cases where an investment advisor has breached a fiduciary duty, the investor's remedies under the laws of equity are much broader than those under the laws of negligence or contract. Remember: a violation of this fiduciary duty carries with it significant repercussions.

DAMAGES

“Damages” refers to the losses suffered by one person that were caused by the fault of another person. In the case of an investor, it can refer to the losses that have been sustained as a result of advice from an investment advisor. The primary objective of awarding damages is to place the investor in the position that he or she would have been in had a breach not been committed. In cases where the investment advisor's behaviour is outrageous, the courts may also award punitive damages as a means of punishing and discouraging such behaviour. Damages will generally be awarded when an investment advisor has been negligent. When there has been a breach of a fiduciary duty, the investor can demand an account for any profits made by the investment advisor as a result of the breach, and may even trace any investments sold and demand their return.

HOW TO AVOID LIABILITY

While there are no hard and fast rules on how to avoid liability, here are some defensive tactics that may be adopted to help minimize risk:

- *Make a record of all conversations with investors.*
A note to file by an investment advisor that is taken in the normal course of business may be introduced as evidence before the courts.
- *Send confirmatory letters to investors.*
Letters that confirm instructions from investors will assist in clarifying instructions.
- *Record all telephone conversations with investors.*
Some investment institutions in Canada record all telephone conversations with investors so as to avoid any misunderstandings. The recording of a telephone conversation is not illegal, but investors should be informed that all telephone calls are being recorded.
- *Adopt internal procedures.*
Internal procedure and compliance manuals are an important source of information and may be clear

evidence of the adherence to high standards. For instance, adopting a procedure that prevents trading without an investor's consent will assist in fulfilling a fiduciary duty.

- *Issue client newsletters.*
If the investment institution is faced with changing market conditions or with a security that has turned sour, it may consider issuing information bulletins or circulars to investors.
- *Evaluate investor objectives at the outset.*
Define an investor's objectives with a complete description of the assets held and a systematic analysis of his or her financial objectives. It is a good idea to regularly update the information.
- *Inform investors of any conflicts of interest.*
A conflict of interest may be evidence that the investment advisor or the investment institution has not acted in an investor's best interest.

QUESTIONS AND ANSWERS

Here are some common questions O'Flynn Weese Tausendfreund LLP receives from the investment community about liability.

Q: Does an investment advisor have an obligation to warn an investor about an investment when the order is unsolicited?

A: An investment advisor has no obligation to prevent a customer from making a poor investment. However, an investment advisor would be in breach of his or her duties if he or she agreed to execute a trade that had no chance of success without warning the investor of the risk.

Q: Does an investment advisor have an ongoing obligation to warn an investor about important market developments?

A: An investment advisor has an obligation to warn of risks to investments in an investor's portfolio posed by ongoing market developments.

Q: Does an investment institution have an obligation to warn investors of an impropriety that may have been committed by an investment advisor in regard to another investor's account?

A: This issue has yet to be decided by the courts. It is conceivable that an investment institution that has dismissed an investment advisor for having breached his or her obligations may be required to advise an investor who is considering moving his or her account to their investment advisor's new institution.

Q: If an investor is a sophisticated professional, such as a chartered accountant or a lawyer, could the relationship still qualify as "power-dependent"?

A: Yes. Even if the client is a sophisticated professional, if he or she grants an investment advisor wide discretion, the relationship could still qualify as power-dependent and the investment advisor will owe the client a fiduciary duty.

Q: If an investor's approval is secured before a trade, has the investment advisor satisfied the fiduciary duty?

A: Not necessarily. If an investor depends on an investment advisor's advice and regularly follows it, then the investment advisor has a duty to carefully and honestly advise the investor.

Q: If advice is provided to an investor to whom fiduciary duties are owed and the advice does not yield the anticipated results, has a fiduciary duty been breached?

A: Not necessarily. If careful, honest and complete advice has been given regarding all the material information surrounding the particular investment in light of the investor's stated objectives and portfolio, then the fiduciary duty has been satisfied.

FOR FURTHER INFORMATION, PLEASE CONTACT:

O'Flynn Weese Tausendfreund LLP
65 Bridge Street East
Belleville, Ontario
K8N 1L8

Telephone: 613-966-5222
Fax: 613-961-7991
Website: www.owtlaw.com

AUTHORS:

Joseph A. Bradford
O'Flynn Weese Tausendfreund LLP
Telephone: 613-966-5222, Extension #264
E-Mail: jbradford@owtlaw.com

Alexander M. Gay
Federal Department of Justice