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Investment advisor liability in Canada: Common claims and recent decisions

April 28, 2023

As global capital markets enter a period of volatility and retraction after several years of outsized gains during the COVID-19 pandemic, some investors may have occasion to make a critical assessment of their investment portfolios. Investors who have suffered losses during the recent market downturn may look to place blame on their investment advisors, which may result in an uptick in lawsuits and regulatory complaints against investment advisors and dealers. It is a good time for investment advisors and dealers to refresh their understanding of their civil and regulatory liability and catch up on recent decisions from Canadian courts.

In this article, we provide a high-level overview of investment advisor liability in Canada, including the most common claims brought against investment advisors and dealers in court proceedings. We also summarize recent notable decisions from Canadian courts involving some of those claims and provide a few brief comments on the new regulatory regime for investment advisors that commenced on Jan. 1, 2023.

Civil liability

The most common claims made against investment advisors are in negligence, breach of fiduciary duty and breach of contract, with fraud claims less common.

Negligence

In general, investment advisors owe their clients a duty to carry out client instructions with care, skill and diligence and provide investment advice fully, honestly and in good faith. In most cases, if the investment advisor discharges those duties, then the advisor will not be considered negligent if the resulting investment turns out to be unprofitable.

In some cases, investment advisors will owe additional duties to their client, which will depend on the type of advice requested and provided, the kind of investments at issue and the sophistication of the client. Canadian courts have expressed the duties that may be owed by investment advisors as existing on a “spectrum,” ranging from an advisor who is a “mere order taker” at the low end of the spectrum, to heightened duties for advisors who have been provided discretionary authority by their clients to make trades without obtaining specific instructions for each transaction.

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The “know your client” rule and the corresponding concept of suitability are the cornerstones of the duties owed by investment advisors and dealers to their clients. The “know your client” rule is both a regulatory requirement and a common law obligation that requires the advisor to know and monitor, among other things, the client’s investment objectives, risk tolerance, investment timelines and investment knowledge. The related duty to make sure that the client is placed in suitable investments involves a consideration of the particular characteristics of the client, including age, income, net worth, investment knowledge, investment objectives and risk tolerance.

While investment advisors and dealers are not guarantors of investments made by their clients, they are required to ensure that the client is aware of all positive and negative factors involved in a potential investment. They must also anticipate and provide appropriate advice to mitigate against foreseeable market downturns.

While regulatory rules will provide guidance as to the duties owed by investment advisors to their clients, civil cases are determined on a case-by-case basis; a breach of a regulatory rule does not automatically lead to civil liability.

In order for a court to find that an investment advisor is liable in negligence, the plaintiff must prove that they suffered an investment loss caused by the investment advisor’s act or omission that did not meet the required standard of care.

It bears noting that even where the client is able to establish that the investment advisor was negligent, the advisor may be able to argue that the client was contributorily negligent. This defence may be available if the client’s actions contributed to the loss – for example, failing to make proper inquiry about the risk and nature of their investment holdings or failing to avoid or limit investment losses when given the opportunity to do so. If a contributory negligence defence is available to the investment advisor, then a court may apportion liability according to the relative fault of the advisor and client.

Breach of fiduciary duty

The default position is that the relationship between investment advisor and client is contractual, not fiduciary. However, the court will weigh the following factors to determine whether a fiduciary relationship exists:

- The degree to which the client is in a vulnerable position, having regard to the client’s age, language skills, investment knowledge and education.
- The degree to which the relationship between investment advisor and client is based on trust and confidence.
- The history of dealing between the investment advisor and client, particularly whether there is a history of the client relying on the advisor’s skill and judgment or specialized knowledge of the advisor.
- The degree to which the investment advisor has discretion to make investment decisions in the client’s account.
- The applicable regulatory rules or professional codes of conduct.

No one factor will be used on its own. Instead, the court will consider all five factors to determine, on a case-by-case basis, whether there is a fiduciary relationship between the investment advisor and client. If the court finds such a relationship, then the investment advisor will owe the client a fiduciary duty. This requires, in addition to the

duties identified in the negligence section above, a duty to warn of risks inherent in any investment, avoid all non-disclosed material conflicts of interest and act in the client's best interests.

Unlike claims of negligence or breach of contract, the client does not have to prove that he or she suffered an investment loss to establish liability for breach of fiduciary duty. If the client proves that the investment advisor owed a fiduciary duty and the advisor breached that duty, the client can elect to require the advisor to disgorge any profits or other benefits earned as a result of the breach.

Breach of contract

The relationship between investment advisor and client will almost always be governed by an account agreement or other contract. The investment advisor owes an implied contractual duty to discharge their obligations with an appropriate degree of skill and diligence and to ensure that the client is fully informed about all important matters involving the investment portfolio.

If the account agreement states that the investment advisor has discretion to make investment decisions on behalf of the client, then the investment advisor must adhere to the client's investment objectives. If the investment advisor deploys an investment strategy that departs from the client's objectives, then the investment advisor may be at risk of breaching the contract and being liable for any investment losses suffered because of the breach.

If the account agreement states that the investment advisor does not have discretion to make investment decisions on behalf of the client, the investment advisor will require express authorization to make trades in the account. Unauthorized trades that result in investment losses will put the investment advisor at risk of liability for breach of contract.

A breach of contract claim will often be brought concurrently with a claim of negligence or breach of fiduciary duty.

Fraud

A finding of civil fraud requires proof that the investment advisor intended to mislead or deceive the client for the advisor's own financial gain. Fraud claims typically involve fraudulent misrepresentations made by the advisor to the client about the type and nature of the investment, or a flat-out Ponzi scheme. Thankfully, fraud in the investment advisor industry is not prevalent in Canada, although successful claims are established from time to time.

There are four elements that must be present for a finding of civil fraud:

- A false representation made by the investment advisor to the client.
- Some level of knowledge of the falsehood of the representation on the part of the advisor, whether through actual knowledge or recklessness.
- The false representation caused the client to act.
- The client's actions resulted in a loss.

An investment advisor who is found to have committed fraud will be required to make restitution to the client for the amount of the investment plus interest and investigation costs. The client will have the ability to trace liability for recovery to property purchased with the proceeds of fraud and, potentially, to third parties who received proceeds of fraud if they received the funds with knowledge (including constructive knowledge) of the fraud.

Recent civil cases

While most claims brought against investment advisors do not proceed to trial, there are usually a handful of cases each year that result in court published decisions. Since published decisions are relatively rare, they must be scrutinized carefully to determine whether the decision fits within existing authority or whether there are facts that are peculiar to the case that would preclude general applicability to other cases.

We have identified the following decisions, published since 2019, to illustrate the types of claims that have recently been advanced against investment advisors and dealers:

Miller v. RBC Dominion Securities, 2021 BCSC 1811 and 2022 BCSC 485. In this case, the investment advisor changed his client's investment risk profile from medium-risk to high-risk without his client's consent. The advisor also refused to follow his client's instructions to cash out investments for a strategy known as "go-away-May," which involves selling investments in the month of May and purchasing the same securities in June. The client therefore sued the advisor for negligence and breach of contract.

The court held that there was no breach of contract as the client's risk tolerance was not a part of the contract. However, the court held that the advisor acted negligently when he raised the client's risk profile without consent. Since the client was unable to prove any financial loss resulting from the change, the court did not award damages to the plaintiff.

Fisher v. Richardson GMP Limited, 2022 ABCA 123. In this decision on a proposed class action, the Alberta Court of Appeal confirmed that there is an important distinction between the duty of care and standard of care in investor negligence cases. While general duties of care may be broadly applicable to advisors and dealers, the nature and extent of the standard of care will be specific to each client.

In the context of a class action, the standard of care for each client may not be appropriately resolved as a common issue. Instead, whether the standard of care was met by an advisor is a factual question that must be answered in every class member's claim. The answer for one class member will not advance the other class members' claims if their circumstances are too variable.

For further details on this case, please see the summary prepared by the BLG lawyers who argued the case on behalf of Richardson Wealth.

Wu v. Ma, 2022 BCSC 1737. In this case, the investment advisor entered into a trading agreement with an unsophisticated client. The client was a citizen and resident of China who spoke no English and had a high school education. She was considering moving to

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Canada and invested with the advisor while on a visit. The client gave the advisor full authority to make investment decisions. However, the advisor did not have (and never had) a licence to trade securities. The advisor invested most of his client's money into a single stock that lost 90 per cent of its value within six weeks of the investment. The client sued the advisor for negligence, breach of fiduciary duty and breach of contract. The court held that the advisor was liable for negligence and for breach of fiduciary duty.

The court evaluated the facts of the case according to the five factors outlined above and concluded that there was a fiduciary duty owed by the advisor to the client and that the advisor had breached that fiduciary duty.

Agar Corporation Ltd v. Lee, 2019 ABQB 886. This decision is an example of a successful claim against an investment advisor for civil fraud, breach of fiduciary duty and negligence. In this decision, the investment advisor recommended a high-risk $2-million investment in a company that was not suitable for his client's investment objectives. The advisor failed to disclose to his client that he was an officer and director of the company and did not fully explain the risks involved with the investment.

The client was a corporation with a principal investment objective of capital preservation. The advisor described the investment as safe. However, in the prospectus, the investment was described as "speculative, with a high degree of risk and suitable only for those willing to risk a total loss of their investment and who had no immediate need for liquidity." The investment advisor also failed to tell the client that the company's liabilities exceeded its assets and that its debentures had little or no liquidity. The resulting investment represented 48 per cent of the client's portfolio.

The court awarded the client over $2 million in damages and noted that this was a particularly egregious example of a breach of the investment advisor's fiduciary duty to his client.

Boal v. International Capital Management, 2022 ONSC 1280. In this proposed class action, the representative plaintiff advanced a claim arising from her purchase of a high-interest promissory note from her investment advisor, who was also a licensed mutual fund salesperson. The plaintiff alleged that her investment advisor, his colleague, and the affiliated mutual fund dealer failed to properly disclose that the promissory notes were issued by a company that was controlled by the investment advisors and their family members. By the time of the certification motion in December 2020, the proposed class members had not suffered any investment losses, and it appeared unlikely that they would do so in the future. Accordingly, at certification, Ms. Boal focused solely on causes of action that did not require proof of loss, such as breach of fiduciary duty.

A majority of the court dismissed the certification motion in its entirety. The plaintiff's claim rested on the argument that an investment advisor's ad hoc fiduciary duty can be established on a class-wide basis (for over 170 individual clients) based on the Mutual Fund Dealers Association's rules and bylaws and the Certified Financial Planners Code of Ethics alone. In particular, the plaintiff argued that the advisor's regulatory requirement to act "in the best interests of the client" created a fiduciary duty with respect to all of the advisor's dealings with his client. The court did not agree that this regulatory standard in itself created a fiduciary duty relating to existing or potential conflicts of interest between the client and advisor. Whether or not a fiduciary duty exists in a financial advisory relationship depends on the facts of each case.

In every province and territory except Québec, the relationship between investment advisors and their clients is not presumed to be fiduciary in nature. Instead, based upon the facts of a particular case, clients may be owed ad hoc fiduciary duties. The existence of an ad hoc fiduciary duty is determined by a contextual, multi-factor analysis. The relevant factors of the analysis include the claimant's vulnerability, the degree of discretionary power exercised by the alleged fiduciary, and applicable professional rules or codes of conduct.

For further details on this case, please see the summary previously published by BLG.

The new SRO

Historically, investment advisors in Canada have been regulated by two separate self-regulatory organizations under the authority of the provincial Securities Acts: the Mutual Fund Dealers Association (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC).

Effective Jan. 1, 2023, the MFDA and IIROC merged to become a single self-regulatory organization called the New Self-Regulatory Organization of Canada (new SRO), which is responsible for regulating both investment advisors and mutual fund dealers.

BLG hosted a webinar on Jan. 17, 2023, that identified key regulatory enforcement trends and what is known and unknown about the new SRO.

The organizations formerly known as the MFDA and IIROC will continue to operate in silos for a few years while integration takes place. From an investigations and enforcement perspective, it is expected to be business as usual for now, although investment advisors should stay tuned for investigation and enforcement changes that may be announced by the new SRO in the coming months.

If you have questions about your civil or regulatory liability, would like advice on complying with current regulations or help preparing for changes under the new SRO, contact the authors or any of the key contacts below.

By

Hunter Parsons, Curtis Fawcett, Sadie Howe

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BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

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