



Canadian Securities
Administrators

Autorités canadiennes
en valeurs mobilières

**CANADIAN SECURITIES ADMINISTRATORS
CONSULTATION PAPER 33-403:
*THE STANDARD OF CONDUCT FOR ADVISERS AND DEALERS:
EXPLORING THE APPROPRIATENESS OF INTRODUCING A STATUTORY
BEST INTEREST DUTY WHEN ADVICE IS PROVIDED TO RETAIL CLIENTS***

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Administering the Canadian Securities Regulatory System
Les autorités qui réglementent le marché des valeurs mobilières au Canada

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1) INTRODUCTION

The purpose of this Canadian Securities Administrators (CSA) consultation paper (the **Consultation Paper**) is to provide a forum for stakeholder consultation of the desirability and feasibility of introducing a statutory best interest duty to address potential investor protection concerns regarding the current standard of conduct that advisers and dealers in Canada owe to their clients. While this Consultation Paper describes a possible statutory best interest standard for purposes of consultation, no decision has been made whether a statutory best interest standard should be adopted (and on what terms), whether another policy solution would be more effective or whether the current Canadian standard of conduct framework is adequate. No such decisions will be made without broad public consultation and discussion. This Consultation Paper is the initial step in soliciting comments from all interested stakeholders on these important issues.

The Consultation Paper is comprised of eight additional parts. Part 2 of the Consultation Paper summarizes certain of the background of the fiduciary duty debate. Part 3 describes what a fiduciary duty is and when it arises at common law. Part 4 discusses the current standard of conduct for registrants in Canada (including both statutory and common law requirements). Part 5 reviews what the United States (U.S.), the United Kingdom (U.K.), Australia and the European Union (E.U.) are doing in this area. Part 6 identifies the five key investor protection concerns with the current standard of conduct applicable to advisers and dealers in Canada. Part 7 seeks input on one possible articulation of a statutory best interest standard for advisers and dealers. Part 8 reviews the potential benefits and competing considerations of imposing the best interest standard described in Part 7. Part 9 describes the process for making submissions as part of this consultation.

We welcome comments or clarifications on any of the issues raised in this Consultation Paper.

2) BACKGROUND

The 2008 global financial crisis and its aftermath have generated significant debate on the standard of conduct that advisers and dealers owe to their clients when they provide advice on investing in financial products. The principal question is whether advisers and dealers should have an obligation to act in the best interests of their clients when providing advice to them. Several related questions have featured prominently in this debate, including:

- What are the current obligations of an adviser/dealer when providing advice to a client?
- Do investors and advisers/dealers understand the nature of their relationship?
- Do investors believe (and expect) that their advisers and dealers act in their best interests?
- Would a best interest standard affect the different compensation structures of advisers and dealers?
- What problems would be solved by the introduction of a statutory best interest standard for advisers and dealers?

- If a best interest standard were imposed, in what circumstances should it apply?

Against this backdrop, several international securities regulators are reconsidering the relationship between clients and the advisors who provide them with advice on investing in securities. This has included an examination of the standard of conduct applicable to advisers and dealers and/or consideration of some of the core elements of this relationship, such as how conflicts of interest, compensation structures and proficiency should be addressed and whether a statutory fiduciary (or best interest) duty should be imposed. In this respect, the U.K. and E.U. already impose a qualified best interest standard on their advisors, Australia has passed legislation making such a standard mandatory by July 1, 2013, and in the U.S., staff of the U.S. Securities and Exchange Commission (**SEC**) has recommended such a uniform standard be introduced for broker-dealers and investment advisers although both a detailed SEC cost-benefit analysis and an SEC draft rule have yet to be completed.

The standard of conduct debate occurring in other international jurisdictions has also arisen in Canada. There have been several Canadian conferences on the topic of whether Canada should, or should not, impose a statutory fiduciary duty on advisers and dealers. At an early such conference hosted by Canadian Foundation for Advancement of Investor Rights (**FAIR Canada**) and the Hennick Centre for Business and Law (York University),¹ there appeared to be a lack of consensus on many of the important issues surrounding the possible imposition of a fiduciary duty. For example, the panellists did not agree on what a fiduciary duty encompasses, when it should apply and whether the current regulatory regime for advisers and dealers is functionally equivalent to such a standard, in any event. Regardless, most of the experts agreed that if a fiduciary duty is imposed, it is important to clearly address the expectations around the standard of conduct expected of advisers and dealers in providing advice.²

The fiduciary duty debate in Canada is an important one. The debate has highlighted the need to consider enhancements to investor protection where advice is being given to investors since it is the advice that will often determine a client's decision to invest.

The fiduciary duty debate in Canada is not a new issue. In 2004, the Ontario Securities Commission (the **OSC**) published the Fair Dealing Model consultation paper which included, in part, a proposal exploring the application of a statutory fiduciary duty to advisers and dealers in certain circumstances.³ Although the Fair Dealing Model did not proceed in its original form, it evolved into the Client Relationship Model (**CRM**) policy initiative that is currently being pursued by the CSA and the two Canadian securities self-regulatory organizations (**SROs**): the Investment Industry Regulatory Organization of Canada (**IIROC**) and The Mutual Fund Dealers Association of Canada (**MFDA**). Key CRM features such as conflicts of interest disclosure and relationship disclosure feature prominently in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)*.⁴ The CSA and the

¹ Hennick Centre for Business and Law & FAIR Canada, The Fiduciary Standard and Beyond: Rethinking the Financial Advisor-Client Relationship, March 25, 2010 (<http://hennickcentre.ca/Fiduciarystandardconference.html>).

² Megan Harman, "Opinions divided over whether fiduciary standard should apply to Canadian advisors" *Investment Executive* (March 28, 2010), online: <http://www.investmentexecutive.com/-/news-52967>.

³ Ontario Securities Commission, *The Fair Dealing Model* (January 2004), online: (http://www.osc.gov.on.ca/documents/en/Securities-Category3/cp_33-901_20040129_fdm.pdf).

⁴ (2009) 32 OSCB (Supp-2) (July 17, 2009).

SROs are pursuing a variety of additional CRM initiatives, such as improved cost and compensation disclosure and performance reporting. A statutory best interest standard for advisers and dealers providing advice was not, however, introduced under NI 31-103.

For the purposes of this Consultation Paper, when we refer to a “statutory” fiduciary duty or best interest standard, we mean any such duty that may be imposed under the securities laws, regulations, instruments or rules of a jurisdiction of Canada (**Securities Legislation**).

3) **FIDUCIARY DUTY: WHAT IT IS AND WHEN IT ARISES AT COMMON LAW**

Fiduciary Duty – An Overview

A fiduciary duty is a duty of a person to act in another person’s *best interests*.⁵ For our purposes, a fiduciary duty applicable to an adviser or dealer means that the adviser or dealer (the **fiduciary**) would have to act in the best interests of her client. In general, acting in your client’s best interest means that the fiduciary must ensure that:

- Client interests are paramount,
- Conflicts of interest are avoided,
- Clients are not exploited,
- Clients are provided with full disclosure, and
- Services are performed reasonably prudently.

We discuss each of these elements below.

Elements of a General Fiduciary Duty at Common Law

Client interests are paramount

Fiduciaries must ignore all considerations other than single-mindedly serving the interests of their clients in all matters related to the service provided – they must place their clients’ interests ahead of their own.⁶ This is sometimes referred to as the duty of loyalty⁷ or duty of “utmost good faith” and “imports a requirement that the fiduciary act toward the beneficiary with a heightened sense of loyalty and fidelity.”⁸ This means that a fiduciary cannot balance her own interests (or the interests of her employer) against her client’s interests if it means that her client’s interests are in any way compromised. All other fiduciary obligations emanate from this foundation duty.⁹

⁵ Leonard I. Rotman, *Fiduciary Law* (Toronto: Thomson-Carswell, 2005) at 309. See also *Galambos v. Perez*, [2009] 3 S.C.R. 247 at para. 66, online: <http://scc.lexum.org/en/2009/2009scc48/2009scc48.html> [Galambos].

⁶ *Ibid.* at 339. See also *Shelanu Inc. v. Print Three Franchising Corp.* (2003), [2003] O.J. No. 1919 (Ont. C.A.).

⁷ *Galambos*, *supra* note 5 at para. 75.

⁸ Mark Vincent Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Carswell, 1988) at section 4 of Chapter 1.

⁹ Rotman, *supra* note 5 at 305.

Conflicts of interest are avoided

Fiduciaries must scrupulously avoid placing themselves in a possible or potential conflict of interest with their beneficiaries.¹⁰ This is sometimes referred to as the “no conflict” rule. If an actual or potential conflict of interest is unavoidable, it cannot be cured by disclosure alone. Rather, the client must explicitly consent to allow a fiduciary to place herself in an actual or potential conflict of interest. This requires that the fiduciary provide full and frank disclosure of the nature of the conflict to the client and may require that she advise the client to seek independent advice before the client decides whether to give their consent. Regardless of disclosure to a client of an actual or potential conflict, the fiduciary must always ensure that the client’s interests remain paramount.

Clients are not exploited

Fiduciaries must carefully avoid any personal pursuit inconsistent with the best interests of the client.¹¹ This is sometimes referred to as the “no profit” rule. If fiduciaries learn of an opportunity as a result of acting as a fiduciary for a client, the fiduciary must not take advantage of the opportunity even if the client cannot take advantage of it themselves. A fiduciary must not be rewarded for pursuing interests other than single-mindedly serving the interests of their clients in all matters related to the service provided.¹²

Clients are provided with full disclosure

Fiduciaries must provide full disclosure of any material information related to the service provided.¹³ Being in a position of highest confidence, the fiduciary is obliged to make the client aware of all relevant matters regarding the provision of the services. This means that fiduciaries must take reasonable steps to ensure that clients are aware of the available options and the potential benefits and risks associated with them.

Services are performed reasonably prudently

Fiduciaries must ensure that they perform their services with the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.¹⁴

Almost as important as understanding the content of a fiduciary duty is to understand what it does *not* include. Canadian courts have been clear that a fiduciary duty does not require the fiduciary to act as “guarantor” or “insurer” in respect of his or her advice. Put another way,

¹⁰ See Ellis, *supra* note 8 at Chap 1, s.4(2)(a)

¹¹ *Ibid.* at subpar. 4(2)(b), (c) and (d)(iii) of Chapter 1.

¹² CSA staff recognizes that this element of a unqualified common law fiduciary duty may need to be qualified if securities regulators wish to apply it to advisers and dealers in Canada.

¹³ Ellis, *supra* note 8 at subpart 4(2)(d)(i) of Chapter 1. See also *Capobianco v. Paige* (2007), [2007] O.J. No. 3423 (Ont. S.C.J.) at para. 238; *Burns v. Kelly Peters & Associates Ltd.* (1987), 16 B.C.L.R. (2d) 1 (C.A.).

¹⁴ See, e.g., Rotman, *supra* note 5 at 352-355. Note that in certain situations, this duty is separated from the best interest duty, as is the case under the corporate law requirements. Some commentators take the position that because this duty of care is not unique to a fiduciary duty, it is not substantive component of what constitutes a fiduciary duty.

advisors are “under no duty to offer only successful financial advice”; they “will inevitably make wrong predictions and it is difficult, in hindsight, to question honest investment advice.”¹⁵

When does a fiduciary duty arise at common law?

In addition to the content of a fiduciary duty, it is important to understand *when* a fiduciary duty arises at common law. To understand this, one must understand the underlying purpose of fiduciary law. Canadian courts have recognized that the underlying purpose of fiduciary law is to “maintain the integrity of socially and economically valuable or necessary relationships of high trust and confidence that are essential for the effective interdependent functioning of society.”¹⁶

In certain types of relationships (lawyer/client, doctor/patient, trustee/beneficiary), a fiduciary duty presumptively arises at common law (these are called *per se* fiduciary relationships). In all other kinds of relationships (including investor advisory relationships¹⁷), whether the relationship is fiduciary in nature depends on the nature of the relationship. Courts will determine whether a fiduciary relationship exists based on the factual circumstances of the relationship (these are called *ad hoc* fiduciary relationships).¹⁸

Canadian courts have identified five interrelated factors to be considered when determining whether “financial advisors” stand in a fiduciary relationship to their clients:¹⁹

1. **Vulnerability:** the degree of vulnerability of the client due to such things as age or lack of language skills, investment knowledge, education or experience in the stock market.²⁰
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 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.

¹⁵ *Mills v. Merrill Lynch Canada Inc.*, 2005 CarswellBC 219, 2005 BCSC 151 (B.C. S.C.) at para. 129. Other jurisdictions have also been careful not to suggest that a fiduciary duty would be tantamount to a guarantor. For example, Australia states that in introducing a statutory fiduciary duty for advisers, “the focus of the duty should be on how a person has acted in providing advice rather than the outcome of that action.” (Australian Government, *Future of Financial Advice Information Pack* (April 28, 2011) at 12, online: <http://ministers.treasury.gov.au/Ministers/brs/Content/pressreleases/2011/attachments/064/064.pdf>).

¹⁶ Rotman, *supra* note 5 at 13.

¹⁷ *Varcoe v. Sterling* (1992), 7 O.R. (3d) 204 (Gen. Div.) at 234 [Varcoe]; affirmed (1992), 10 O.R. (3d) 574 (C.A.); leave to S.C.C. denied. See also *Hodgkinson v. Simms* [1994] 3 S.C.R. 377 [Hodgkinson].

¹⁸ *Ibid.* See also *LAC Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 S.C.R. 574. Galambos, *supra* note 7, provides a more recent discussion of this distinction.

¹⁹ *Hunt v. TD Securities Inc.* (2003), 2003 CarswellOnt 3141 (Ont. C.A.).

²⁰ While vulnerability in the broad sense resulting from factors external to the relationship is a relevant consideration, a more important one is the extent to which vulnerability arises *from* the relationship: see Hodgkinson, *supra* note 17 at 406.

4. **Discretion:** the extent to which the advisor has power or discretion over the client’s account or investments.
5. **Professional Rules or Codes of Conduct:** such rules and codes help to establish the duties of the advisor and the standards to which the advisor will be held.

These five factors are not intended to be exhaustive and evidence relevant to one factor may be relevant to a consideration of one or more of the other factors.²¹

Fiduciary duty created by statute

A fiduciary duty can be created by statute. Securities Legislation imposes a fiduciary duty on investment fund managers in respect of the funds that they manage. For more information about this duty, see the section entitled “Statutory best interest standard for investment fund managers” in Part 4 below.

Another example is the fiduciary duty owed by a director to a corporation as set out in applicable corporate statutes. In exercising her powers and discharging her duties, a director is required to:²²

- “(a) act honestly and in good faith *with a view to the best interests* of the corporation; and
- (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.” (italics added)

The duty referred to in (a) above is generally referred to as the duty of loyalty and is at the core of the fiduciary duty owed by directors. The duty referred to in (b) above is referred to as the duty of care.

We believe that a statutory fiduciary duty would likely support a private law cause of action for damages by a beneficiary against a fiduciary for breach of the duty, because it establishes the nature of the relationship and therefore eliminates the need to prove the existence of a fiduciary duty. For additional discussion on this, see the section entitled “Strengthens legal remedy to retail clients for breach of fiduciary duty” in Part 8 below.

Conclusion

We believe that imposing a statutory duty on an adviser or dealer to “act in the best interests” of clients constitutes imposing a fiduciary duty. It is a separate question whether certain of the elements of a fiduciary duty referred to above should be qualified to take into account the particular circumstances and business models of advisers and dealers. Any statutory best interest duty imposed under Securities Legislation should address such issues. For further discussion, see Part 8 below.

²¹ *Hunt, supra* note 19 at para. 41.

²² See subsection 122(1) of the *Canada Business Corporations Act*.

Because acting in a client’s “best interests” is at the heart of a fiduciary duty, we will generally refer in this Consultation Paper to a fiduciary duty as a “best interest” standard or duty.

4) WHAT IS THE CURRENT STANDARD OF CONDUCT OF REGISTRANTS?

In this section, we will review the Canadian registration regime and address the following elements of the standard of conduct required of registrants:

- Current statutory standard of conduct requirements,
- Common law fiduciary duty in some cases,
- Suitability obligations,
- Responding to conflicts of interest, and
- Other requirements.

The registration regime in Canada

A person or company can be registered under Securities Legislation as an adviser, dealer and/or investment fund manager, depending on the nature of their activities. In general terms, only advisers and dealers can provide advice on investing in securities. Investment fund managers direct the business, operations or affairs of one or more investment funds; they do not provide advice on investing in securities unless they are also registered as an adviser (i.e., portfolio manager) or dealer.

The standard of conduct applicable to registrants is defined by reference to a number of different Securities Legislation requirements. Advisers and dealers that are members of an SRO are also subject to the separate rules of the SRO that apply to them. Those rules are based on similar principles underlying the equivalent Securities Legislation requirements.

Current statutory standard of conduct requirements

Duty to act fairly, honestly and in good faith

Securities Legislation in Canada imposes a duty on registered advisers and dealers to deal fairly, honestly and in good faith with their clients.²³ This duty applies to advisers and dealers broadly in all dealings with their clients.²⁴

²³ See section 2.1 of OSC Rule 31-505 *Conditions of Registration*; section 14 of the *Securities Rules*, B.C. Reg. 194/97 [**B.C. Regulations**] under the *Securities Act* (British Columbia), R.S.B.C. 1996, c. 418 [**B.C. Act**]; section 75.2 of the *Securities Act* (Alberta) R.S.A. 2000, c.S-4 [**Alberta Act**]; section 33.1 of the *Securities Act* (Saskatchewan), S.S. 1988-89, c. S-42.2 [**Saskatchewan Act**]; subsection 154.2(3) of *The Securities Act* (Manitoba) C.C.S.M. c. S50 [**Manitoba Act**]; section 160 of the *Securities Act* (Québec), R.S.Q., c. V-1.1 [**Québec Act**]; section 39A of the *Securities Act* (Nova Scotia), R.S.N.S. 1989, c. 418 [**N.S. Act**]; subsection 54(1) of the *Securities Act* (New Brunswick) S.N.B. 2004, c. S-5.5 [**N.B. Act**]; section 90 of the *Securities Act* (Prince Edward Island), R.S.P.E.I. 1988, c. S-3.1 [**P.E.I. Act**]; subsection 26.2(1) of the *Securities Act* (Newfoundland and Labrador),

A threshold question is whether the obligation to act fairly, honestly and in good faith creates, or is equivalent to, a best interest standard. Many commentators believe that it is not (by itself) equivalent to, and falls short of, a best interest standard.²⁵ Others disagree.²⁶ We are not aware of any court or regulatory decision that has concluded that this duty creates, or is equivalent to, a fiduciary duty.²⁷

Statutory best interest standard for investment fund managers

Investment fund managers (**IFMs**) are currently subject to a general *statutory* best interest standard of conduct. Every IFM must (i) exercise the powers and discharge the duties of their office honestly, in good faith and in the *best interests* of the investment fund, and (ii) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.²⁸ The articulation of that duty is consistent with the duty imposed on directors under applicable corporate law.

R.S.N.L.1990, c. S-13 [**Newfoundland Act**]; section 90 of the *Securities Act* (Nunavut), S.Nu. 2008, c. 12 [**Nunavut Act**]; section 90 of the *Securities Act* (Northwest Territories), S.N.W.T. 2008, c. 10 [**N.W.T. Act**]; and section 90 of the *Securities Act* (Yukon), S.Y. 2007, c. 16 [**Yukon Act**].

²⁴ Regulatory decisions involving a breach of the duty to deal with clients fairly, honestly and in good faith have involved various situations, including: dealer did not disclose conflict of interest and charged excessive mark-ups (*Arlington Securities Inc. v. Ontario Securities Commission*, 2002 CSLR ¶900-035, 25 O.S.C.B. 4247); excessive mark-up when selling securities to client (*Re Curia*, 2000 CSLR ¶ 900-005, 23 O.S.C.B. 7505); unauthorized trades (*Hayward v. Hampton Securities Limited*, 2004 CSLR ¶ 900-086 (Ont.C.A.)); unsuitable investment recommendations (*Re Daubney and Littler*, 2008 CSLR ¶ 900-259); used client's money to support dealer's own lifestyle (*Re Kinlin*, 2000 CSLR ¶ 900-014, 23 O.S.C.B. 6535); artificially inflated NAV estimates and discriminated among investors in honouring redemption requests (*Re Norshield Asset Management*, 2010 CSLR ¶900-344 (Ontario Securities Commission)); took control of client's accounts and changed investment objectives so that funds could be allocated to aggressive trading (*Sidiropoulos v. Manitoba Securities Commission*, 1999 CSLR ¶900-047 (Manitoba Securities Commission)).

²⁵ See, e.g., Edward Waitzer, "Make advisors work for investors" *Financial Post* (February 14, 2011), online: <http://opinion.financialpost.com/2011/02/14/make-advisors-work-for-investors/>; Ken Kivenko, "Why A Fiduciary Standard For Investment Advisers Is Urgent And Crucial" *Canadian MoneySaver* (June 2012), online: <http://faircanada.ca/wp-content/uploads/2012/06/Why-A-Fiduciary-Standard -Kivenko.pdf>.

²⁶ Laura Paglia, a partner at Torys LLP specializing in securities litigation, has stated that "the core principles being debated in the U.S., which revolve around disclosure of conflicts of interest and putting the client's interest first, were already generally accepted in Canada under the duty of care owed by all financial advisers to their clients." (Michael McKiernan, "Lawyers clash over imposing statutory fiduciary duties for financial advisers" *Law Times* (April 4, 2010), online: <http://www.lawtimesnews.com/201004056641/Headline-News/Lawyers-clash-over-imposing-statutory-fiduciary-duties-for-financial-advisers>). In addition, Philip Anisman, a leading Canadian securities lawyer and commenter, noted that "[a]lthough our courts have not yet recognized that it does so, this rule arguably imposes a fiduciary obligation on ... registrants with respect to their clients." Mr. Anisman's recommendation is that "[o]ur regulators may be better advised to ... enforce [the duty to deal fairly, honestly and in good faith with their clients] rigorously." (Philip Anisman, "FP Letters to the Editor: Existing rule requires 'good faith'" *Financial Post* (February 15, 2011), online: <http://opinion.financialpost.com/2011/02/15/fp-letters-to-the-editor-existing-rule-requires-%E2%80%98good-faith%E2%80%99/>).

²⁷ CSA staff is aware of certain decisions where the OSC stated that a dealer or adviser had a duty to act in the client's best interest. For example, see *Re Gordon-Daly Grenadier Securities*, (2000) 23 O.S.C.B. 5512. Notwithstanding these decisions, it is Staff's view that the OSC was likely referring to the common law duty that the OSC felt the registrant owed to the client, rather than concluding that the duty to act fairly, honestly and in good faith created, or was equivalent to, a best interest standard.

²⁸ See section 116 of the *Securities Act* (Ontario) R.S.O. 1990, c. S.5; section 159.3 of the Québec Act; section 125 of the B.C. Act; subsection 75.2(3) of the Alberta Act; subsection 33.1(2) of the Saskatchewan Act; subsection 154.2(1) of the Manitoba Act; subsection 26.2(3) of the Newfoundland Act; subsection 90(1) of the P.E.I. Act;

Statutory best interest standard for advisers and dealers in four provinces when discretionary authority present

Four provinces (Alberta, Manitoba, Newfoundland and Labrador, and New Brunswick) have a statutory requirement that when advisers or dealers have discretionary authority over their clients' investments, the adviser or dealers must act in the clients' best interests.²⁹ This is consistent with, as discussed above, the common law where an adviser or dealer that has discretionary authority over a client's assets virtually always owes the client a fiduciary duty.³⁰

Québec

In Québec, according to both the general civil law and the *Securities Act* (Québec), registered dealers and advisers are currently subject to a duty of loyalty and a duty of care and must act in the client's best interest.

The 1994 reform of the *Civil Code of Québec*³¹ (the **Civil Code**) led to the introduction of these standards for specific legal relationships, namely, the administration of the property of others, the contract for services and the mandate.

In addition to remaining subject to the general regime of contractual liability under the Civil Code, the relevant doctrine and jurisprudence indicate that a relationship between an adviser or a dealer and a client is governed by the rules underlying those legal relationships (the determination of the applicable rules depends on the nature and scope of the relationship).

In any case, a duty of loyalty and, at a minimum, a duty to act in the best interests of a client as well as a duty of care are provided for in sections 1309, 2100 and 2138, respectively, of the Civil Code:

subsection 39A(3) of the N.S. Act; subsection 54(3) of the N.B. Act; subsection 90(2) of the Yukon Act, N.W.T. Act and Nunavut Act. This statutory duty was recommended at least as early as 1969 when the *Report of the Canadian Committee on Mutual Funds and Investment Contracts - Provincial and Federal Study*, 1969 (Ottawa: Queen's Printer, 1969) made this recommendation at page 293.

²⁹ See subsection 75.2(2) of the Alberta Act; section 154.2 of the Manitoba Act; subsection 26.2(2) of the Newfoundland Act; and section 54 of the N.B. Act.

³⁰ There are other isolated examples of narrow statutory best interest duties arising in certain situations. For example, unregistered foreign-based sub-advisers to Canadian registered advisers are required in certain circumstances to act in the best interests of the Canadian registered adviser as well as such Canadian adviser's clients and the Canadian registered adviser must contractually agree with its clients that it is liable for any loss by its clients resulting from a breach of this standard of care by the unregistered foreign-based sub-adviser. See, e.g., section 7.3 of OSC Rule 35-502 *Non-Resident Advisers* and section 2.10 of National Instrument 81-102 *Mutual Funds*. In both cases, it is expressly stated that the client cannot relieve the Canadian registrant from its contractual liability described above. CSA staff believes the intention in applying the best interest standard in this context was to codify the Canadian common law practice of advisers for managed accounts owing a fiduciary duty to their clients.

³¹ S.Q. 1991, c. 64.

“1309. An administrator shall act with prudence and diligence.

He shall also *act honestly and faithfully in the best interest* of the beneficiary or of the object pursued.

2100. The contractor and the provider of services are bound *to act in the best interests* of their client, with prudence and diligence.

2138. A mandatary is bound to fulfill the mandate he has accepted, and he shall act with prudence and diligence in performing it.

He shall also *act honestly and faithfully in the best interests* of the mandator, and avoid placing himself in a position that puts his own interest in conflict with that of his mandator.” (italics added)

It is worth noting that according to the authors Crête, Brisson, Naccarato and Létourneau, this obligation to act with loyalty (or “faithfully”) is comparable to that of the common law fiduciary standard:

“As Professor Naccarato mentioned in his study on the legal nature of trust, the higher degree of trust in contractual relationships develops when a person entrusts (rooted in the word “trust”) property or a portion of his or her estate to another person who will act in the name or on behalf of the client. Such a higher degree of trust is also reflected in the complexity of services offered that require specialized knowledge as well as specific skills and abilities. The greater the imbalance between the respective parties’ degree of knowledge, the more the vulnerable party will rely on the competency and honesty of the co-contractor. Under the civil law of Québec, this type of relationship, characterized by the presence of this higher degree of trust, could underpin a contract of mandate or other form of administration of the property of others, while under common law, the contractual relationship could be described as a ‘fiduciary relationship’ to which fiduciary duties are connected.”³²

The extent of these obligations under the Civil Code varies depending on the legal context and nature of the investment advisory relationship (e.g. discretionary account or non-discretionary account, executing broker only), taking into account the degree of trust, dependence and vulnerability of the client. The Supreme Court of Canada has acknowledged the higher degree of these obligations in the case of a portfolio manager as well as the prevailing role of trust in the mandate regime:

³² R. Crête, G. Brisson, M. Naccarato and A. Létourneau, « La prévention dans la distribution de services de placement » [Prevention in the distribution of investment services], colloquium proceedings: *La confiance au coeur de l'industrie des services financiers* [Confidence at the heart of the financial services industry] edited by Raymonde Crête, Marc Lacoursière, Mario Naccarato and Geneviève Brisson, Cowansville, Éditions Yvon Blais, 2009, at 259 [translated by CSA].

“As in the case of any mandate, the mandate between a manager and his client is imbued with the concept of trust, since the client places his trust in the manager — the mandatary — to manage his affairs. ... This spirit of trust is reflected in the weight of the obligations that rest on the manager, which will be heavier where the mandator is vulnerable, lacks specialized knowledge, is dependent on the mandatary, and where the mandate is important. The corresponding requirements of fair dealing, good faith and diligence on the part of the manager in relation to his client will thus be more stringent.”³³

Most importantly and as mentioned previously, sections 160 and 160.1 of the *Securities Act* (Québec) also require that all registered dealers and advisers and their representatives “deal fairly, honestly, *loyally* and in good faith with their clients” (italics added) and “[i]n their dealings with clients and in the execution of the mandates entrusted to them by their clients, ... act with all the care that may be expected of a knowledgeable professional acting in the same circumstances.”

Common law fiduciary duty in some cases

As discussed above, depending on the nature of the relationship between the client and their adviser or dealer, Canadian courts (except in Québec, where the common law does not exist in respect of private law matters) may find that an adviser or dealer stands in a common law fiduciary relationship to their clients. As we have seen, Canadian courts have identified five non-exclusive and interrelated factors to assist in this determination: vulnerability, trust, reliance, discretion (over the client’s account or investments), and professional rules or codes of conduct (see “When does a fiduciary duty arise at common law?” in Part 3 above).

The fourth factor, discretion, is an especially important element in the context of an investment advisory relationship because the advisory industry generally distinguishes between clients based on whether they have discretionary accounts or non-discretionary accounts. A discretionary account (also known as a managed account) is a type of client account for which an adviser or dealer has the discretion to make investment decisions and transact in securities without the client’s express consent to each transaction; in a non-discretionary account, the client must consent to each transaction.

Accordingly, a common law fiduciary duty will virtually always arise where the client has a discretionary account. A fiduciary duty may also arise where the client has a non-discretionary account depending on the actual power or influence that the adviser or dealer has over the client, and the extent to which the client relies on the adviser or dealer. On this point, the Supreme Court of Canada recently stated that:

³³*Laflamme v. Prudential-Bache Commodities Canada Ltd.*, [2000] 1 S.C.R. 638 at para. 28. This interpretation has been reaffirmed in *Loevinsohn c. Services Investors ltée*, 2007 QCCS 793 (CanLII) at para. 41:

“The contract of mandate is a relationship based upon the trust that a client is entitled to have in the competence and professional integrity of the mandatary. The sense of trust is characteristic of a contract of mandate and has an impact on the state of mind of a client convinced of the professional qualifications of the person upon whom the client relies.”

“[t]he nature of this discretionary power to affect the beneficiary’s legal or practical interests may, depending on the circumstances, *be quite broadly defined. It may arise from power conferred* by statute, agreement, perhaps from a unilateral undertaking or, in particular situations *by the beneficiary’s entrusting the fiduciary with information or seeking advice in circumstances that confer a source of power*”³⁴ (italics added).

This statement builds on previous caselaw that suggested that with regard to unsophisticated clients especially, the court will find that a fiduciary relationship exists even if “the ultimate discretion or power in the disposition of funds remained with the beneficiary.”³⁵

Canadian courts explain this approach by noting that advisers and dealers fall into a continuum in providing advice, with discount brokers at one end (who provide no advice but simply execute transactions on a client’s express instructions and who therefore are not subject to a common law fiduciary duty standard) and advisers or dealers with clients in discretionary accounts at the other end (who have complete discretionary trading authority and who therefore would be subject to a common law fiduciary duty). Whether a common law fiduciary duty applies to a relationship that falls somewhere in between in this continuum is a question of fact to be determined based on the nature of the client relationship in all the circumstances.³⁶

The following table summarizes when a statutory or common law fiduciary duty currently arises based on a registrant’s activities:

³⁴ *Galambos*, *supra* note 5 at para. 84. See also *Frame v. Smith*, [1987] 2 S.C.R. 99 at 136 (Wilson J. – dissenting).

³⁵ *Hodgkinson*, *supra* note 17 at 182.

³⁶ See *Kent v. May* (2001), 298 A.R. 71 (Alta Q.B. at paras 51 – 53). See also, e.g., *875121 Ontario Ltd. v. Nesbitt Burns Inc.*, [1999] O.J. No. 3825 (Sup.Ct.); *Hunt v. TD Securities Inc.* (2003), 66 O.R. (3d) 481 (Ont. C.A.); and *Young Estate v. RBC Dominion Securities* (2008), [2008] O.J. No. 5418 (Ont. S.C.J.).

Type	Category	Registerable Activity	Account Types ³⁷	Does a Fiduciary Duty Apply?		Direct Regulatory Oversight
				Statutory or rules based ³⁸	Common law	
Adviser	Portfolio manager (PM)	Advising others on the buying or selling of, and investing in, securities.	Discretionary	No ³⁹	Yes	CSA
			Non-discretionary	No	It depends	
Dealer	Full-service investment dealer (ID)	Trading (and advising) in any kind of securities as principal or agent.	Discretionary	No ⁴⁰	Yes	IIROC
			Non-discretionary	No	It depends	
			Discount brokerage	No	No	
	Mutual fund dealer (MFD)	Trading (and advising in) mutual fund (or labour-sponsored fund) securities as principal or agent.	Non-discretionary	No	It depends	MFDA
	Exempt market dealer (EMD)	Trading (and advising) in exempt market securities as principal or agent.	Non-discretionary	No	It depends	CSA
	Scholarship plan dealer (SPD)	Trading (and advising) in scholarship or educational plan securities as principal or agent.	Non-discretionary	No	It depends	CSA
Investment fund manager	Investment fund manager (IFM)	Directing the business, operations or affairs of an investment fund.	N/A	Yes ⁴¹	Likely	CSA

³⁷ A discretionary account, also known as a managed account, is a type of client account for which an adviser or dealer has to sole discretion to make investment decisions and buy or sell securities without the client's express consent to each transaction.

³⁸ As discussed previously, a duty of loyalty and a duty of care currently apply in Québec for all registered advisers and dealers.

³⁹ Four provinces (Alberta, Manitoba, Newfoundland and Labrador, and New Brunswick) have a statutory requirement that when advisers or dealers have discretionary authority over their clients' investments, the adviser or dealers must act in the clients' best interests.

⁴⁰ *Ibid.*

⁴¹ *Supra* note 28.

The question that is discussed in this Consultation Paper is whether a statutory best interest standard should be introduced that applies to all categories of advisers and dealers referred to above. As discussed below, we recognize that any fiduciary duty imposed on dealers would likely need to be qualified to take into account the circumstances and business models of particular categories of dealers. See the discussion below in Part 8 for more information and related consultation questions.

Suitability Obligations

In general, advisers and dealers must collect “know-your-client” (KYC) information, and, prior to:

- making a recommendation, or accepting an instruction from a client, to buy or sell a security for a client’s non-discretionary account, or
- buying or selling a security for a client’s discretionary account,⁴²

take reasonable steps to ensure that the purchase or sale of the security is suitable for the client. They cannot delegate their suitability obligations to anyone else or satisfy the suitability obligation by simply disclosing the risks involved with a transaction.

According to the companion policy to NI 31-103, in some cases, an adviser or dealer will need extensive KYC information, for example, if they have discretionary authority over a client account.⁴³ In these cases, the adviser or dealer should have a comprehensive understanding of the client’s:

- investment needs and objectives, including the client’s time horizon for their investments,
- overall financial circumstances, including net worth, income, current investment holdings and employment status, and
- risk tolerance for various types of securities and investment portfolios, taking into account the client’s investment knowledge.

In other cases, the adviser or dealer may need less KYC information. For example, if they only occasionally deal with a client who makes small investments relative to their overall financial position.⁴⁴

The suitability obligation requires advisers and dealers to determine, based on the KYC information of the client, whether a proposed purchase or sale of a security for the client is suitable. In determining suitability, advisers and dealers must understand:

- (i) the KYC information relating to their client and any other factors necessary for them to be able to determine whether a proposed purchase or sale is suitable, and

⁴² Note that IROC and the MFDA have both revised their suitability rules so that the suitability analysis would have to be conducted not just on a buy/sell basis but also upon the occurrence of certain triggering events (e.g., change in representative servicing the account or a material change in the client’s KYC information).

⁴³ See heading “KYC information for suitability depends on circumstances” in section 13.3 of Companion Policy to NI 31-103, *supra* note 4.

⁴⁴ *Ibid.*

- (ii) the attributes and associated risks of the investment products they are recommending to clients (known as “know-your-product” or **KYP**).

If a client has more than one account, the adviser or dealer should indicate whether the client’s investment objectives and risk tolerance apply to a particular account or to the client’s whole range of accounts.

A Canadian securities regulator has described the suitability obligation as:

“the obligation of a registrant to determine whether an investment is *appropriate* for a particular client. Assessment of suitability requires both that the registrant understands the investment product and knows enough about the client to assess whether the product and the client are a *match*.”⁴⁵ (italics added)

Conversely, an unsuitable investment and/or recommendation is one that is not appropriate for the client. IIROC states that this means that the investment and/or recommendation:

“is inconsistent with the client’s personal circumstances including current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the current investment portfolio composition and risk level of the other investments within the client’s account or accounts at the time of the investment and/or recommendation.”⁴⁶

The suitability obligation requires that a dealer or adviser ensure that an investment is suitable or appropriate. This does not necessarily mean that the product must be the “best” product for the client.

It is generally accepted that, in some circumstances, an adviser or dealer providing advice can comply with its suitability obligation and yet not provide investment recommendations that are in the best interest of the client. We would describe that concept as follows: there may be a large number of potentially suitable investment products, but the question is whether the advice to the client must identify a smaller range of products that are, in the adviser’s view, in the client’s best interest. One consideration in giving that advice would be the relative cost to the client of the product.

Recent SRO Developments

IIROC has recently amended its rules to expand the obligation of IIROC member firms to undertake suitability assessments beyond assessing suitability at the time a transaction recommendation is made.⁴⁷ The amended provisions require that a review of account suitability must be conducted within one day of the firm becoming aware of any of the following triggering events:

⁴⁵ *Re Daubney* (2008), 31 O.S.C.B. 4817 at 4819, para. 16.

⁴⁶ IIROC, *IIROC Notice 12-0109: Know your client and suitability – Guidance* (March 26, 2012), online: http://www.iiroc.ca/Documents/2012/d21b2822-bcc3-4b2f-8c7f-422c3b3c1de1_en.pdf.

⁴⁷ *Ibid.*

- a transfer or deposit of securities into the account;
- a change in representative on the account; or
- a material change to the “know your client” information.

A suitability determination will not be required following a triggering event if the transaction is executed on the instructions of another IIROC member firm, portfolio manager, exempt market dealer, bank, trust company or insurer. For both retail and institutional clients, suitability determinations will not be required if the account is an order execution-only account.

IIROC has also published draft guidance stating that, when its members are determining the suitability of account types for their clients, “one of the key factors that [members] should consider is the account’s compensation structure.”⁴⁸

The MFDA has also similarly amended its suitability requirements.⁴⁹

Conflicts of Interest

In general, registrants must identify and respond to material existing and potential conflicts of interest by avoiding, controlling or disclosing them. The CSA provides principle-based guidance in the companion policy to NI 31-103 about how registered firms should apply these rules:

- The registrant should ***avoid*** the conflict if it is sufficiently contrary to the interests of a client (or the integrity of the capital markets) that there can be no other reasonable response.
- The registrant should ***control*** the conflict if it can be effectively managed by internal controls such as organizational structures, lines of reporting and physical locations.
- The registrant should ***disclose*** the conflict to their clients if a reasonable investor would expect to be informed about it, in addition to any other methods the registered firm may use to control the conflict.

Although the general rule is that advisers and dealers are able to decide for themselves how to apply these principles, Securities Legislation also contains specific prohibitions and restrictions. For example, NI 31-103 prohibits a registered adviser from engaging in certain transactions in investment portfolios for managed accounts where the relationship may give rise to a conflict of interest or a perceived conflict of interest.⁵⁰ The prohibited transactions include transactions in securities in which a responsible person or an associate of a responsible person may have an

⁴⁸ IIROC, *IIROC Notice 12-0253: Request for comments on draft guidance regarding compensation structures for retail investment accounts* (August 14, 2012), online: http://www.iiroc.ca/Documents/2012/cdb04cab-2ff1-4e60-898c-0738df8d8ccd_en.pdf, at 6.

⁴⁹ MFDA, *MFDA Bulletin #0459: Transition Periods for MFDA Rule and Policy Amendments Implementing the Client Relationship Model Proposals* (December 3, 2010), online: <http://www.mfda.ca/regulation/bulletins10/Bulletin0459-P.pdf>

⁵⁰ NI 31-103, *supra* note 4 at s. 13.5.

interest or over which they may have influence or control.⁵¹ NI 31-103 also requires disclosure in most cases in order for a firm to recommend the buying, selling or holding of a security of a related or connected issuer.⁵²

Client Relationship Model

IIROC also recently amended its rules to adopt the core elements of the Client Relationship Model for investment dealers.⁵³ These rule amendments address, among many matters, the responsibility of a dealer to address conflicts of interest between the dealer and its clients. In this respect, IIROC rule 42.3(2) provides as follows:

42.3. Dealer Member responsibility to address conflicts of interest

- (2) The Dealer Member must address the existing or potential material conflict of interest in a fair, equitable and transparent manner, *and considering the best interests of the client or clients.*(italics added)

In response to a comment that the reference to the “best interests of the client” may be interpreted as creating a fiduciary duty, IIROC staff stated as follows:

“IIROC does not believe that the phrase ‘best interests of the client’ on its own creates a fiduciary duty relating to existing or potential material conflicts of interest, and it is not IIROC’s intention to do so. Whether or not a fiduciary duty exists in an account relationship depends on the facts of each case, including, among other things, the services being provided to the client and the degree to which the client relies on the firm/adviser in making investment decisions. While the standard of conduct established by the proposal is not as high as the fiduciary standard, it is intended to strengthen investor protection by clarifying IIROC’s expectations on how existing or potential material conflicts of interest are to be addressed as between the Approved Person and the client, as well as between the Dealer Member and clients generally.”⁵⁴

The IIROC rule requires only that the Dealer Member “consider” the best interests of the client in addressing conflicts of interest.⁵⁵ While that may not create a fiduciary duty,

⁵¹ Section 13.5 of the Companion Policy to NI 31-103, *supra* note 4.

⁵² NI 31-103, *supra* note 4 at s. 13.6.

⁵³ IIROC, *IIROC Notice 12-0107: Client Relationship Model – Implementation* (March 26, 2012), online: <http://docs.iroc.ca/DisplayDocument.aspx?DocumentID=C168CD670F80468EB38BC6EF773ECC41&Language=en>.

⁵⁴ *Ibid.* at 25.

⁵⁵ Interestingly, subsection 42.2(2) of IIROC Dealer Member Rule 42 states that an “Approved Person must address all existing or potential material conflicts of interest between the Approved Person and the client in a fair, equitable and transparent manner, and *consistent with the best interests of the client or clients.*” (italics added) Subsection 42.2(3) states that “[a]ny existing or potential material conflict of interest between the Approved Person and the client that cannot be addressed in a fair, equitable and transparent manner, and *consistent with the best interests of the client or clients,* must be avoided.” (italics added) Although IIROC has stated that its intention is not to create a fiduciary duty, the conflict of interest rule applicable to Approved Persons suggests a higher standard than the rule applicable to the Dealer Member (which only requires “considering” the client’s best interest).

IIROC believes that it does impose a higher standard intended to “strengthen investor protection.”

In response to the IIROC consultation on the changes adopted to its rules, a number of comments were made with respect to the costs versus the benefits of the proposed amendments. In response to those comments, IIROC staff stated as follows:

“Although it is difficult to quantify with any degree of precision, comments received from investors indicate that a significant benefit of these proposals will be to enhance investors protection through greater disclosure of account relationship, firm/advisor conflict of interest and account performance information and through more frequent assessment of the suitability of the account assets. IIROC staff have received considerable input on cost issues throughout the rule-making process. We believe that we understand and have fully considered the cost issues noted in the comments. Wherever possible, IIROC has developed its proposals to achieve the investor protection goals of the CRM project while minimizing the potential implementation costs and ongoing costs of compliance.”⁵⁶

The MFDA’s rules on conflicts of interest are similar to IIROC’s.⁵⁷

Other Requirements Applicable to Advisers and Dealers

There are a number of additional principle-based and rule-based requirements under securities law currently applicable to advisers and dealers that directly affect the client relationship, including:

(i) Relationship disclosure information⁵⁸

Advisers and dealers must provide clients with all information that a reasonable investor would consider important about their relationship with the adviser/dealer. This includes all costs for the client of operating the account, the costs that the client will incur in buying, holding and selling investments, and the compensation paid to the adviser or dealer for securities purchased through the adviser or dealer.

(ii) Referral arrangement disclosure⁵⁹

Advisers and dealers must disclose to their clients details about all referral arrangements, whether or not they relate to the firms’ regulated activities.

⁵⁶ *Supra* note 53 at 17-18.

⁵⁷ See section 2.1.4 of the rules of the MFDA (MFDA, *Rules*, online: <http://www.mfda.ca/regulation/rules.html>).

⁵⁸ NI 31-103, *supra* note 4 at Division 2 of Part 14.

⁵⁹ *Ibid.* at Division 3 of Part 13.

(iii) Dispute resolution service⁶⁰

Advisers and dealers must document, and effectively and fairly respond to, each complaint made about any product or service offered by the firm or its representatives and ensure that independent dispute resolution services or mediation services are made available to a client at the firm's expense.⁶¹

(iv) Compensation and incentive restrictions for most mutual funds⁶²

For most mutual funds, there are restrictions and prohibitions on practices related to commissions, trailing commissions and internal dealer incentive practices, such as prohibitions against volume-based increases in commission rates paid by mutual funds to their participating dealers.

5) RECENT DEVELOPMENTS IN THE U.S., U.K., AUSTRALIA AND THE E.U.

Recent developments in the U.S., U.K., Australia and the E.U. regarding the investment advisory relationship are relevant to the issues discussed in this Consultation Paper. All four jurisdictions have either implemented, or are proposing to implement, a qualified statutory best interest standard. The following is a general description of the initiatives in each jurisdiction.

United States

As mandated by the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)*,⁶³ staff of the SEC released a report on January 21, 2011, summarizing the findings of a study it conducted of the obligations of brokers,⁶⁴ dealers,⁶⁵ and investment advisers⁶⁶ (the **SEC Study**).⁶⁷ The SEC Study was meant to inform the SEC's decision whether to introduce a statutory, uniform best interest standard on broker-dealers and advisers when providing personalized investment advice about securities to retail investors.

⁶⁰ *Ibid.* at Division 5 of Part 13.

⁶¹ Note that this requirement (which does not apply in Québec by reason of the existing regime in that jurisdiction) is not yet in force for firms that were registered on the date that NI 31-103 came into force. See CSA Staff Notice 31-330 *Omnibus/Blanket Orders Extending Certain Transition Provisions Relating to the Investment Fund Manager Registration Requirement and the Obligation to Provide Dispute Resolution Services* (July 5, 2012), online: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120705_31-330_dispute-resolution.htm.

⁶² See National Instrument 81-105 *Mutual Fund Sales Practices* (1998) 21 O.S.C.B. 2713 (May 1, 1998).

⁶³ H.R. 4173, 111th Cong. (2010).

⁶⁴ A "broker" is anyone engaged, as agent, in the business of effecting transactions in securities for the account of others.

⁶⁵ A "dealer" is anyone engaged, as principal, in the business of buying and selling securities for a person's own account through a broker or otherwise. The term "broker-dealer" is often used because of the frequent overlap of their duties.

⁶⁶ An "investment adviser" is anyone who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

⁶⁷ Securities and Exchange Commission (Staff), *Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011), online: <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

Currently, all U.S. investment advisers are subject to a fiduciary standard (note that investment advisers exclude any broker or dealer whose performance of such services is solely incidental to the conduct of her business as a broker or dealer and who receives no special compensation as a result thereof).⁶⁸ In contrast, broker-dealers are generally subject to a suitability standard, along with a broader duty of fair dealing and other requirements.⁶⁹ While broker-dealers are generally not subject to a fiduciary duty under federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty.⁷⁰

In the SEC Study, staff noted that investment advisers and broker-dealers are regulated extensively under different regulatory regimes. However, many retail investors do not understand and are confused by the roles played by investment advisers and broker-dealers. SEC staff noted that many investors are also confused by the standards of care that apply to investment advisers and broker-dealers when providing personalized investment advice about securities. The SEC Study further stated that retail investors should not have to parse through legal distinctions to determine the type of advice they are entitled to receive. Instead, retail customers should be protected uniformly when receiving personalized investment advice about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. At the same time, SEC staff noted that retail investors should continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide.⁷¹

Based on the comments it received as well as research that it commissioned prior to the financial crisis, the SEC staff recommended in the SEC Study that the SEC establish a fiduciary standard that is at least as stringent as the current fiduciary standard applicable to investment advisers under the Advisers Act. The SEC Study recommended that the uniform fiduciary standard of conduct:

“for all brokers, dealers, and investment advisers, when providing *personalized investment advice about securities to retail customers* (and such other customers as the Commission may by rule provide), shall be to act in the *best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser* providing the advice.” (italics added)

⁶⁸ Although the *Investment Advisers Act of 1940* (the **Advisers Act**) does not use the word “fiduciary” or the phrase “best interest” to apply to the standard of conduct to which an investment adviser is held, the U.S. Supreme Court has held that an investment adviser in fact has a fiduciary duty; see, e.g., Michael V. Seitzinger (Congressional Research Service), *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Standards of Conduct of Brokers, Dealers, and Investment Advisers* (August 19, 2010), online: www.fas.org/sgp/crs/misc/R41381.pdf, for additional detail.

⁶⁹ See SEC Study, *supra* note 67 at 46-83. We note that the fair dealing obligation on broker-dealers is not statutory in that it is derived from the antifraud provisions of the U.S. federal securities laws. This suggests that there are technically no equivalent statutory provisions to the statutory provisions currently in place in Canada.

⁷⁰ *Ibid.*, 54-55.

⁷¹ SEC, *Press Release 2011-20: SEC Releases Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers* (January 22, 2012), online: <http://www.sec.gov/news/press/2011/2011-20.htm>.

SEC staff made a number of other implementation-related recommendations in the SEC Study related to its recommended best interest standard, including that its Commission should:

- prohibit certain conflicts and facilitate the provision of uniform, simple and clear disclosures to retail investors about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest;
- address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading;
- consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking and/or interpretive guidance (minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor);
- engage in rulemaking and/or issue interpretive guidance to explain what it means to provide “personalized investment advice about securities”; and
- consider additional investor education outreach as an important complement to the uniform fiduciary standard.⁷²

The SEC Study also included some detailed yet preliminary cost-benefit analysis.⁷³

The release of the SEC Study was not without controversy. Two Republican SEC Commissioners jointly published a statement criticizing what they viewed as the SEC Study’s analytical shortcomings, citing in particular a lack of (i) evidence of investor harm caused by the current regulatory regime, and (ii) a reasonable cost-benefit analysis of imposing the proposed standard.⁷⁴

Reaction in the U.S. to the possibility of a statutory best interest standard has been mixed. On one hand, the main U.S. securities self-regulatory organization (the Financial Industry Regulatory Authority (**FINRA**)) as well as key industry organizations (e.g. Securities Industry and Financial Markets Association (**SIFMA**) and the Investment Adviser Association (**IAA**)) all *support* the introduction of a uniform best interest standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.⁷⁵ On the other hand, FINRA and SIFMA (but not the IAA) also vigorously argue that such a standard should be *applied differently* to broker-dealers and investment advisers to take into account their different business models and, at least in the case of broker-dealers, to allow the standard to be modified in part by the contract between the broker-dealer and the client.⁷⁶ They argue that it would be a mistake to simply export to broker-dealers the regulatory scheme currently applied to investment advisers. This concern was also articulated by one of the namesakes of the Dodd-Frank Act, Congressman Barney Frank, in his own letter to the SEC on

⁷² SEC Study, *supra* note 67 at vii.

⁷³ *Ibid.* at Part V.

⁷⁴ SEC, *Statement by SEC Commissioners: Statement Regarding Study On Investment Advisers And Broker-Dealers* (January 21, 2012), online: <http://www.sec.gov/news/speech/2011/spch012211klctap.htm>.

⁷⁵ See, e.g., <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121983.pdf>, <http://www.sifma.org/issues/private-client/fiduciary-standard/position/>, and <http://www.sec.gov/comments/4-606/4606-2563.pdf> (**IAA Letter**).

⁷⁶ *Ibid.*

May 31, 2011.⁷⁷ The IAA and other U.S. stakeholders have been critical of the position taken by FINRA and SIFMA, essentially suggesting that they are encouraging a watered-down, less authentic fiduciary standard.⁷⁸

One of the reasons why broker-dealers are sensitive about how a fiduciary duty would apply to them in practice relates to the uncertainty regarding whether such a duty would restrict or prohibit certain of their current transaction-based compensation practices. This uncertainty was reinforced by the Dodd-Frank Act, which explicitly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities would not, in and of itself, violate the uniform fiduciary standard of conduct applied to a broker-dealer;⁷⁹ however, the Dodd-Frank Act also states that the SEC can prohibit or restrict certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.⁸⁰ In response, a group of leading consumer and adviser industry organizations supporting a uniform fiduciary duty provided the SEC with a roadmap for resolving the debate about how to create a uniform statutory fiduciary duty.⁸¹ This roadmap was noteworthy for various reasons, not least because the organizations recognized the possibility of broker-dealers maintaining many of the compensation practices currently in place even if a fiduciary duty was imposed.

The best interest standard as recommended in the SEC Study provides an example of a foreign regulator developing a qualified best interest standard applicable to advisers and dealers:

- First, it would only apply to firms when they provide “personalized investment advice”⁸² and not in other interactions between a firm and its client. SEC staff believes that such a definition, at a minimum, should encompass the making of a “recommendation” as developed under applicable broker-dealer regulation and should not include “impersonal investment advice” as developed under the Advisers Act.⁸³
- Second, it would only apply to retail investors, which would be defined as natural persons using investment advice primarily for personal, family, or household purposes.

⁷⁷ <http://media.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf>.

⁷⁸ IAA Letter, *supra* note 75.

⁷⁹ *Dodd-Frank Act*, *supra* note 63 at s. 913.

⁸⁰ *Ibid.*, para. 913(h)(2).

⁸¹ <http://www.consumerfed.org/pdfs/SIFMA-FrameworkResponse3-29-12.pdf>.

⁸² SEC staff states that it “recommends that the Commission engage in rulemaking and/or issue interpretive guidance to define and/or interpret ‘personalized investment advice about securities’ to provide clarity to broker-dealers, investment advisers, and retail investors. SEC staff believes that such a definition at a minimum should encompass the making of a ‘recommendation,’ as developed under applicable broker-dealer regulation, and should not include ‘impersonal investment advice’ as developed under the Advisers Act. Beyond that, the Staff believes that the term also could include any other actions or communications that would be considered investment advice about securities under the Advisers Act (such as comparisons of securities or asset allocation strategies), except for ‘impersonal investment advice’ as developed under the Advisers Act.” SEC Study, *supra* note 67 at 27.

⁸³ The SEC has defined some services that investment advisers may provide as “impersonal investment advice,” which means “investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts”: *ibid.* at 123.

- Third, although there is a request from industry in the U.S. to clarify this,⁸⁴ the duty would only apply to broker-dealers when the advice is provided and thus would likely not constitute an on-going duty with respect to advice previously given.

Although rulemaking in this area seems to remain a priority for SEC staff (the draft rule was originally supposed to be published in the spring of 2011), the SEC has been significantly delayed in releasing a rule because of its attempts to conduct a robust cost-benefit analysis at this stage. As part of this process, the SEC is planning to ask investment advisers and others to provide data about the costs and benefits of the recommended best interest standard.⁸⁵ It is unclear at this time when the SEC will move forward on this initiative.

Recent U.S. Research Studies on the Possible Impact of a Fiduciary Duty Standard

There are two prominent studies that have attempted to determine the impact that a statutory fiduciary duty would have when applied to broker-dealers in the U.S.

The first study, published in October 2010 and entitled *Standard of Care Harmonization: Impact Assessment for SEC*, was commissioned by SIFMA and conducted by Oliver Wyman (the **SIFMA Study**).⁸⁶ The SIFMA Study was meant to examine the likely impact of the wholesale adoption of the Advisers Act for all brokerage activity in the U.S. Oliver Wyman collected data from a broad selection of retail brokerage firms to assess the impact of significant changes to the existing standard of care for broker-dealers and investment advisers. A total of 17 firms provided data. These firms serve 38.2 million households and manage \$6.8 trillion in client assets. According to Oliver Wyman, that means that its study captures approximately 33% of households and 25% of retail financial assets in the U.S.⁸⁷

According to the SIFMA Study, retail investors would experience “reduced product and service availability and higher costs” under a uniform standard of care for investment advisers and broker-dealers “that does not appropriately recognize the important distinctions among business models.”⁸⁸ In particular, the SIFMA Study stated that a uniform standard of care for investment advisers and broker-dealers would lead to reduced access to:

- an investor’s preferred investment and advisory model;
- investment products distributed primarily through broker-dealers; and
- the most affordable investment options.

⁸⁴ See <http://thomsonreuters.com/content/corporate/docs/informer-article.pdf> at page 43 and SIFMA’s May 2012 letter to the SEC (<http://www.sec.gov/comments/4-606/4606-2977.pdf> in Scenario 2 of Appendix A.

⁸⁵ See, e.g., Liz Skinner, “SEC wants industry data as it shapes fiduciary proposal” *Investment News* (February 24, 2012), online: <http://www.investmentnews.com/article/20120224/FREE/120229945>.

⁸⁶ Oliver Wyman, *Standard of Care Harmonization - Impact Assessment for SEC* (October 2010), online: <http://www.sifma.org/issues/item.aspx?id=21999>.

⁸⁷ *Ibid.* at 3.

⁸⁸ SIFMA, *Press Release: Study Shows Negative Impact on Retail Investors if Fiduciary Standard Does Not Recognize Different Business Models* (November 1, 2010), online: <http://www.sifma.org/news/news.aspx?id=21910>.

In sum, the SIFMA Study concludes that the wholesale adoption of the Advisers Act for all brokerage activity is likely to have a negative impact on consumers (particularly smaller investors) across each of the following dimensions: choice, product access, and affordability of advisory services.

The second study, published in March 2012 and entitled *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice*, was sponsored by the Roger and Brenda Gibson Family Foundation, Fi360, the Committee for the Fiduciary Standard, and the Financial Planning Association and was conducted by Michael Finke (Texas Tech University) and Thomas Patrick Langdon (Roger Williams University) (the **Academic Study**).⁸⁹ The Academic Study summarises the results of the authors' study of the impact and effect of a fiduciary duty on U.S. broker-dealers and their relationship with clients. The study is based on the fact that a fiduciary duty is already imposed on broker-dealers under state law in four different U.S. states.

As discussed above, the SEC Study recommended the adoption of a uniform fiduciary standard for investment advisers and broker-dealers advising retail customers. The authors were trying to determine what impact this would have on broker-dealers. The Academic Study describes the study undertaken by the authors and the conclusions reached as follows:

“This study explores the regulation of registered representatives of broker-dealers in order to estimate whether the proposed application of a universal fiduciary standard will have a significant impact on the financial adviser industry. We take advantage of differences in the application of a fiduciary standard to representatives among states in order to test whether representatives already subject to a stricter fiduciary requirement are affected by the higher standard. We conduct a survey of 207 representatives within the four states that apply a strict fiduciary standard and the 14 states that apply no fiduciary standard and find no statistical differences between the two groups in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance.

...

Empirical results provide no evidence that the broker-dealer industry is affected significantly by the imposition of a stricter legal fiduciary standard on the conduct of registered representatives. The opposition of the industry to the application of stricter regulation suggests that agency costs that exist when brokers are regulated according to suitability are significant. Imposition of a universal fiduciary standard among financial advisers may result in a net welfare gain to society, and in particular to consumers who are ill equipped to reduce agency costs on their own by more closely monitoring an adviser with superior information, although this will likely occur at the expense of the broker-dealer industry. These results provide evidence that the industry is likely to operate

⁸⁹ Michael S. Finke & Thomas Patrick Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice* (March 9, 2012), online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019090.

after the imposition of fiduciary regulation in much the same way it did prior to the proposed change in market conduct standards that currently exist for brokers.”

In sum, the Academic Study concludes that “[e]mpirical results provide no evidence that the broker-dealer industry is affected significantly by the imposition of a stricter legal fiduciary standard on the conduct of registered representatives.” In part, that is because broker-dealers are already subject to suitability requirements that have the effect of imposing significant costs on the industry.

United Kingdom

Since late 2007, all U.K. securities firms (whether advising or dealing) have been subject to a statutory requirement to “act honestly, fairly and professionally in accordance with the best interests of its clients.”⁹⁰ Our understanding is that the U.K. Financial Services Authority (FSA) interprets this standard as not an absolute requirement for advisors to act in accordance with the best interests of their clients (and thus not a “pure” best interest standard) but rather a qualified standard. The FSA’s fundamental principles for investment firms support the conclusion that the FSA’s best interest standard is not an unqualified fiduciary duty standard.⁹¹ Instead, it is qualified to accommodate the various business models of the U.K. investment advisory industry.

In addition to the U.K. qualified best interest standard, rules focused on various tiers of advice that retail clients can be offered have been finalized and are awaiting introduction. In June 2006, the FSA launched its “Retail Distribution Review” (**U.K. Reforms**) with a view to examining how investments were distributed to retail consumers in the U.K.⁹²

In the course of its review, the FSA identified various long-running problems that affected the quality of advice and consumer outcomes, as well as confidence and trust, in the U.K. investment market. Specifically, the FSA was concerned that:

- The ways in which firms that advise on investment products describe their services to consumers was unclear;
- The professional standards required of investment advisers were too low; and

⁹⁰ U.K. Financial Services Authority, *Conduct of Business Sourcebook*, online: <http://fsahandbook.info/FSA/html/handbook/COBS> at s. 2.1.1. This requirement was introduced in 2007 as part of the broader E.U.’s *Markets in Financial Instruments Directive*. For additional information about this directive and the proposed reforms thereof that are underway, see the section below in this part of the Consultation Paper on the proposed European Union reforms.

⁹¹ Further support can be found in the request by the U.K.’s leading investor protection group for advisers and dealers to be made subject to a fiduciary duty: see <http://www.fs-cp.org.uk/publications/pdf/fiduciary-duty.pdf>. The Financial Services Consumer Panel (FSCP) is established by the FSA under the *Financial Services and Markets Act* to represent the interests of consumers. The FSCP is independent of the FSA and can speak out publicly on issues where it considers this appropriate. See also John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making – Final Report* (July 2012), online: <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf>.

⁹² See FSA, Retail Distribution Review Website, online: <http://www.fsa.gov.uk/rdr>.

- There was significant potential for adviser remuneration to distort consumer outcomes.

The U.K. reforms have introduced various rules focused specifically on retail investors, including:

(i) Clearer tiers of advice. Retail investors can be offered two broad tiers of advice:

- *Independent advice* is advice that considers all products and providers that could meet an investor’s needs and is thus free from any restrictions or bias when making recommendations. Firms providing such advice must (a) consider a broader range of products (retail investment products), (b) provide unbiased and unrestricted advice based on a comprehensive and fair analysis of the relevant market, and (c) inform its clients, before providing advice, that it provides independent advice (i.e., advice without restrictions or qualifications).⁹³
- *Restricted advice* is advice that is restricted in some way (e.g. by offering only proprietary products or certain kinds of products). Firms providing restricted advice must disclose in writing and orally, before providing advice, that they provide restricted advice and explain the nature of the restriction. “Basic advice”⁹⁴ and “simplified advice”⁹⁵ are specific forms of advice within the broader restricted advice category.

(ii) Prohibition on embedded commissions. Advisors that offer independent or most kinds of restricted advice (but not “basic advice”⁹⁶) must set their own charges in an agreement with their retail investor clients before they identify suitable products for the customer. Product providers will be banned from offering pre-determined levels of commission to independent and restricted advisors. However, the cost of the advisory services can be incorporated into payments made by the client for the financial product purchased.

(iii) Professionalism. Advisors will need to:⁹⁷

- subscribe to a code of ethics;
- hold an appropriate qualification;
- carry out at least 35 hours of continuing professional development a year; and
- hold a Statement of Professional Standing from an accredited body.

⁹³ See FSA, *Retail Distribution Review: Independent and restricted advice – finalized guidance* (June 2012), online: <http://www.fsa.gov.uk/static/pubs/guidance/fg12-15.pdf>.

⁹⁴ Basic advice is a short, simple form of financial advice where advisors use pre-scripted questions to identify the investor’s financial priorities and decide whether a product from within their range of low-cost, highly regulated saving and investment “stakeholder products” is suitable for the customer.

⁹⁵ *Supra* note 93 at 8.

⁹⁶ *Ibid.*

⁹⁷ See, e.g., <http://www.fsa.gov.uk/about/what/rdr/firms/professionalism>.

These standards will be maintained and enforced by the FSA. If existing advisers do not meet these standards they will not be able to make personal recommendations to retail customers from January 1, 2013.⁹⁸

Significant cost-benefit and market impact analysis of the U.K. Reforms was conducted by the FSA and external consultants.⁹⁹ The FSA has indicated it will be conducting a post-implementation review of the U.K. Reforms.¹⁰⁰

The FSA provides another example of how a foreign regulator has developed a qualified approach:

- First, our understanding is that the FSA's best interest standard is not an absolute requirement for advisers to act in accordance with the best interests of their clients (and thus not a "pure" best interest standard) but rather a qualified standard.
- Second, depending on the nature of the advice provided to retail investors (independent or restricted), advisers will be subject to a tailored suite of regulatory requirements.

The UK Reforms will come into effect on January 1, 2013, and will apply to all advisers in the retail investment market, regardless of the type of firm for which they work (e.g. banks, product providers, independent financial advisers or wealth managers).¹⁰¹

Australia

In November 2009, the Australian Parliamentary Joint Committee on Corporations and Financial Services released a report that (i) examined the high-profile collapse of two Australian securities firms, and (ii) made several recommendations for regulatory changes (the **JPC Report**).¹⁰² The JPC Report found that stricter regulation of financial advisers was required and put forward 11 recommendations, including a recommendation that a fiduciary duty be imposed on advisers that would require them to place their clients' interests ahead of their own.

Currently, the Australian *Corporations Act 2001* (**Corporations Act**)¹⁰³ sets out a number of conditions or obligations applying to securities licence holders and their representatives,

⁹⁸ *Ibid.*

⁹⁹ See, e.g., FSA, *Distribution of retail investments:*

Delivering the RDR - feedback to CP09/18 and final rules (March 2010), online:

http://www.fsa.gov.uk/pubs/policy/ps10_06.pdf at Part 6; Deloitte LLP, *Firm Behaviour and Incremental Compliance Costs: Research for the Financial Services Authority*, dated May 14, 2009, online:

<http://www.fsa.gov.uk/pubs/other/fbicc.pdf>; Oxera, *Retail Distribution Review Proposals: Impact on Market Structure and Competition*, Prepared for the Financial Services Authority, dated Mar. 2010, online:

http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf.

¹⁰⁰ FSA, *RDR post-implementation review - Measuring progress and impact* (November 2011), online:

<http://www.fsa.gov.uk/pubs/RDR-baseline-measures.pdf>.

¹⁰¹ <http://www.fsa.gov.uk/about/what/rdr/firms>.

¹⁰² Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia* (November 2009), online:

http://www.aph.gov.au/binaries/senate/committee/corporations_ctte/fps/report/report.pdf.

¹⁰³ Cth.

including the obligation to provide relevant financial services efficiently, honestly and fairly.¹⁰⁴ In addition, advisors providing personal financial advice must ensure that there is a reasonable basis for that advice, often referred to as the ‘suitability rule’.¹⁰⁵ Subsection 945A(1) of the Corporations Act stipulates that:

- (1) The providing entity must only provide the advice to the client if:
 - (a) the providing entity:
 - (i) determines the relevant personal circumstances in relation to giving the advice; and
 - (ii) makes reasonable inquiries in relation to those personal circumstances; and
 - (b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and
 - (c) the advice is appropriate to the client, having regard to that consideration and investigation.

In other words, the adviser must know their client, know the product and/or the strategy they are recommending, and ensure that the product and/or strategy is appropriate to the clients’ particular needs. This standard does not require that personal advice needs to be ‘ideal, perfect or best’.¹⁰⁶

As a result of the findings and recommendations from the JPC Report, on April 26, 2010, the Australian Government announced its “Future of Financial Advice” reform initiative.¹⁰⁷ This initiative culminated in two separate bills¹⁰⁸ passed by the Australian government in late June 2012 that contain three key reforms (**Australian Reforms**):

- **Introduction of a qualified best interest standard.** The Australian Reforms introduce a statutory best interest standard for advisors requiring them, when providing personal advice¹⁰⁹ to retail clients,¹¹⁰ to act in the best interests of their clients and to place the

¹⁰⁴ *Ibid.* at paragraph 912A(1)(a).

¹⁰⁵ This summary of the current standard of conduct for advisers in Australia was taken from JPC Report, *supra* note 102 at paras. 2.20 and 2.21.

¹⁰⁶ *Ibid.* at para. 2.21.

¹⁰⁷ See <http://futureofadvice.treasury.gov.au/Content/Content.aspx?doc=home.htm>.

¹⁰⁸ *Corporations Amendment (Future of Financial Advice) Bill 2012*

(http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4689) (**FoFA Bill 1**); *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2012*

(http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4739) (**FoFA Bill 2**).

¹⁰⁹ Currently in Australia, a “recommendation or a statement of opinion, or a report of either of those things constitutes financial product advice if:

- (a) it is, or could reasonably be regarded as being, intended to influence a person or persons in making a decision about a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products (s766B); and
- (b) it is not exempted from being a financial service (e.g. where reg 7.1.29 of the Corporations Regulations 2001 (Corporations Regulations) applies).”

interests of their clients ahead of their own. The duty would include a prescribed reasonable steps “safe harbour”¹¹¹ so that advisers are only required to take reasonable steps to discharge the duty. In addition, according to draft guidance published by the Australian Securities and Investments Commission (ASIC),¹¹² ASIC considers that the concept of leaving the client in a better position is key in determining whether the best interest duty has been complied with.¹¹³ Whether the advice provider has in fact left the client in a better position should be assessed objectively, based on the facts existing at the time the advice is provided and by reference to the subject matter of the advice sought by the client.¹¹⁴

The best interest standard (and associated “safe harbour”) was also explicitly designed to accommodate “scaled” advice. In the context of the Australian Reforms, scaled advice is advice that only considers a specific issue (for example, single issue advice on retirement planning) whereas “holistic” or comprehensive advice looks at all the financial circumstances of the client.¹¹⁵ For example:

“the client might prefer to receive more targeted advice on a matter that is particularly concerning them rather than comprehensive advice. As long as the provider acts reasonably in this process and bases the decision to narrow the subject matter of the advice on the interests of the client, the provider will not be in breach of their obligation to act in the client’s best interests. The scaling of advice by the provider must itself be in the client’s best interests, especially since the client’s instructions may at times be unclear or not appropriate for his or her circumstances.”¹¹⁶

The Australian Reforms require that if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product, the advice

Financial advice triggers suitability obligation. See ASIC Regulatory Guide 175, pages 8 and 34

[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg175-010411.pdf/\\$file/rg175-010411.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg175-010411.pdf/$file/rg175-010411.pdf)

¹¹⁰ In Australia, there are current rules setting out minimum investment (AUS\$500,000), income (AUS\$250,000) and net asset (AUS\$2.5 million) thresholds under which investors are considered “retail clients” (See Australian Government, *Wholesale and Retail Clients - Future of Financial Advice* (January 2011), online:

http://futureofadvice.treasury.gov.au/content/consultation/wholesale_retail_OP/downloads/Wholesale_and_Retail_Options_Paper.pdf at para. 2.3 and para. 2.5.)

¹¹¹ Corporations Act, s.961B(2).

¹¹² ASIC, *Consultation Paper 182: Future of Financial Advice: Best interests duty and related obligations—Update to RG 175* (August 2012), online: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/CP182-published-9-August-2012.pdf/\\$file/CP182-published-9-August-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/CP182-published-9-August-2012.pdf/$file/CP182-published-9-August-2012.pdf).

¹¹³ *Ibid.* at 37-38.

¹¹⁴ *Ibid.* at 39.

¹¹⁵ Australian Parliament, *Revised Explanatory Memorandum - Corporations Amendment (Further Future of Financial Advice Measures) Bill 2012*, online:

http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4739_ems_c1902f04-f76c-455d-87bf-763755860827/upload_pdf/368171rem.pdf;fileType=application%2Fpdf at para. 1.34 (**Revised Explanatory Memorandum**).

For additional explanation and guidance, see ASIC, *Consultation Paper 183: Giving information, general advice and scaled advice* (August 2012), online:

[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/CP183-published-9-August-2012.pdf/\\$file/CP183-published-9-August-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/CP183-published-9-August-2012.pdf/$file/CP183-published-9-August-2012.pdf).

¹¹⁶ Revised Explanatory Memorandum, *ibid.*

provider must (i) conduct a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client that would reasonably be considered as relevant to advice on that subject matter, and (ii) assess the information gathered in this investigation.¹¹⁷ This “reasonable investigation” does not require an investigation into every financial product available;¹¹⁸ however, it would include any specific financial products that the client requests the advice provider to consider in her or his advisory analysis.¹¹⁹

- **Prohibition on embedded commissions.** The Australian Reforms contain a broad, comprehensive ban on conflicted remuneration structures involving retail investors, including commissions and any form of volume based payment. In addition, percentage-based fees (known as assets under management fees) can be charged only on unleveraged products or investment amounts.
- **Investor payment to adviser.** The Australian Reforms include the introduction of an adviser payment regime, which retains a range of flexible options through which consumers can pay for advice and includes a requirement for retail clients to agree to the fees and to annually renew (by opting in) an adviser’s continued services.

Significant cost-benefit and market impact analysis of the Australian Reforms were conducted by ASIC and external consultants.¹²⁰

The Australian Reforms provide another example of how a foreign regulator has developed a qualified best interest standard applicable to intermediaries that provide advice:

- First, the best interest duty only applies to advisors when dealing with retail clients.
- Second, the standard is balanced with a statutory safe harbour that clarifies that the advisor does not need to provide perfect advice¹²¹ and does not need to canvass the whole universe of products.¹²²

The Australian government introduced the reform bills in the fall of 2011 and established a hard deadline of July 1, 2012, as its effective date. However, since the legislation only received royal

¹¹⁷ FoFA Bill 2, *supra* note 108 at para. 961B(2)(e).

¹¹⁸ Revised Explanatory Memorandum, *supra* note 115 at para. 1.41. The advice provider is expected to exercise professional judgement to determine whether this requires going beyond the provider’s approved product list (if the provider operates using such a list). This is will ultimately depend on the nature and range of products on their approved product list and the needs and objectives of the specific client: *ibid.*

¹¹⁹ FoFA Bill 2, *supra* note 108 at para. 961D(2).

¹²⁰ Rice Warner Actuaries, *The Financial Advice Industry Post FoFA*, study commissioned by Industry Super Network (January 2012), online:

<https://senate.aph.gov.au/submissions/comitees/viewdocument.aspx?id=72479870-5146-4b8e-9688-35734f9592d4>; see also Revised Explanatory Memorandum, *supra* note 115 at chapter 3.

¹²¹ *Supra* note 112 at para. 29.

¹²² *Supra* note 115 at para. 1.41.

assent on June 27, 2012, there is 12-month transition period, giving firms the option to voluntarily comply with the reforms before they are made mandatory on July 1, 2013.¹²³

European Union

Since November 2007, all firms based in E.U. member states (whether advising or dealing) have been subject to a statutory requirement to “act honestly, fairly and professionally in accordance with the best interests of its clients.”¹²⁴ This requirement was introduced as part of the E.U.’s *Markets in Financial Instruments Directive (MiFID)*.¹²⁵ MiFID has been in force since November 2007 and is the cornerstone of the E.U.’s regulation of financial markets.

On October 20, 2011, the European Commission adopted a legislative proposal for the revision of MiFID. The proposals take the form of a revised directive¹²⁶ and a new regulation¹²⁷ which together are commonly referred to as “MiFID II” (the **E.U. Reforms**). The new proposals are designed to take into account developments in the trading environment since the implementation of MiFID in 2007, including advances in technology and gaps in transparency to investors and regulators. Specific proposals involving a standard of conduct for intermediaries include:

- Firms providing investment advice will be required to disclose whether (i) the advice is provided on an independent basis, (ii) it is based on a broad or more restricted analysis of the market, and (iii) the firm will provide the client with an on-going assessment of the suitability of the recommended financial instruments.¹²⁸ In order to qualify as “advice provided on an independent basis”, the firm must meet certain requirements, such as:
 - assessing a sufficiently large number of financial instruments available in the market. The financial instruments should be diversified with regard to their type and issuers or product providers and should not be limited to financial instruments issued or provided by entities having close links with the investment firm,¹²⁹ and
 - not accepting or receiving fees, commissions or any monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients;¹³⁰

¹²³ FoFa Bill 1, *supra* note 108 at division 7; FOFA Bill 2, *supra* note 108 at part 10.18.

¹²⁴ Article 19(1) of MiFID, *infra* note 125 below.

¹²⁵ Directive on Markets and Financial Instruments, Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ (2004) L145/1 (April 30, 2004)), online: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

¹²⁶ European Commission, *Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council* (October 20, 2011), online : <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF>.

¹²⁷ European Commission, *Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories* (October 20, 2011), online : <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0652:FIN:EN:PDF>.

¹²⁸ MiFID II, *supra* note 126 at Article 24(3).

¹²⁹ *Ibid.* at Article 24(5).

¹³⁰ *Ibid.*

- Municipalities and other local authorities do not qualify as professional investors and thus would be afforded more protection,¹³¹ and
- The exception to the know-your-customer requirement for execution-only business will be narrowed with respect to the categories of qualifying financial instruments.¹³²

Significant cost-benefit and market impact analysis of the E.U. Reforms were conducted by the European Commission and external consultants.¹³³

The E.U. Reforms are now with the European Parliament and the Council of the European Union for discussion. Although a final agreement between the legislative bodies on the Level I proposals is expected by the end of 2012, implementation of MiFID II is not expected until at least 2015.¹³⁴

6) KEY INVESTOR PROTECTION CONCERNS WITH THE CURRENT STANDARD OF CONDUCT IN CANADA

CSA staff has identified the following five key investor protection concerns with the current standard of conduct applicable to advisers and dealers in Canada. The applicability and significance of each concern in each CSA jurisdiction likely depends on the existing standard of conduct existing in each CSA jurisdiction.

Concerns At-a-Glance

- 1) There may be an inadequate principled foundation for the standard of conduct owed to clients.
- 2) The current standard of conduct may not fully account for the information and financial literacy asymmetry between advisers and dealers and their retail clients.
- 3) There is an expectation gap because investors incorrectly assume that their adviser/dealer must always give advice that is in their best interests.
- 4) Advisers/dealers must recommend suitable investments but not necessarily investments that are in the client's best interests.
- 5) The application in practice of the current conflicts of interest rules might be less effective than intended.

These concerns are more fully discussed below.

¹³¹ *Ibid.* at 3.4.8.

¹³² *Ibid.* at Article 25(3).

¹³³ *Supra* note 127 at pages 4-5.

¹³⁴ See, generally, <http://www.fsa.gov.uk/about/what/international/mifid>.

- **Concern 1: Principled foundation**

This concern is whether the current standard of conduct of advisers and dealers in respect of their clients is based on the most principled foundation. Some commentators believe that the principle underlying the current statutory standard of conduct is that advisory services are just like any other business transaction or interaction where the principles of “buyer beware”, supported by prescriptive prohibitions and key disclosure requirements, are sufficient.

However, advice for investing in securities is arguably *not* just like any other business transaction or interaction (certainly when advisers and dealers are advising retail investors) because:

- many investors place substantial trust, confidence and reliance on the financial advice they receive (see further discussion below on this point),
- there is often information and financial literacy asymmetry between advisers/dealers and their clients (see further discussion below on this point),
- these issues are compounded by the increasing complexity of financial products and the fact that many financial products must be “sold” to, not “bought” by, investors,¹³⁵
- adviser and dealer compensation arrangements can create a conflict of interest between the interests of advisers and dealers and their clients, and
- amounts invested often constitute a major portion of investors’ wealth and responsibility for funding the costs of living during old age is shifting more to investors.¹³⁶

- **Concern 2: Information and financial literacy asymmetry**

Despite the CSA’s new and proposed rules around disclosure to investors (such as the new “fund facts” disclosure document for mutual funds¹³⁷ and, as part of CRM, the cost

¹³⁵ See, e.g., Henry T.C. Hu, “Too Complex to Depict? Innovation, 'Pure Information,' and the SEC Disclosure Paradigm”, *Texas Law Review*, Vol. 90, No. 7, 2012, online:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2083708&download=yes; see also Stephen Lumpkin, “Innovation: A Few Basic Propositions”, *OECD Journal: Financial Market Trends*, vol 2010:1, online: <http://www.oecd.org/finance/financialeducation/46010844.pdf>.

¹³⁶ See, e.g., BMO Retirement Institute, *Report - Perfecting the workplace pension: The quest continues* (January 2012), online: http://www.bmo.com/pdf/11-1832%20BMO%20Retirement%20Institute%20Report_E_FINAL.pdf. In a related news release

(<http://newsroom.bmo.com/press-releases/bmo-retirement-institute-report-are-employer-pens-tsx-bmo-201201310762221001>), the authors state that this report “explores the shift in Canada from the traditional defined benefit model to the defined contribution model. As a result of this change, the responsibility for properly managing one’s pension now lies primarily with the employee rather than the employer.”

¹³⁷ http://www.osc.gov.on.ca/en/InvestmentFunds_point-of-sale_index.htm

disclosure and performance reporting initiative¹³⁸), advisers and dealers usually have more knowledge and information about the financial products they recommend to their clients.

Furthermore, the latest research available suggests that the poor financial literacy of investors remains a stubborn problem in Canada¹³⁹ even though investors themselves want to improve in this area.¹⁴⁰ This concern is not unique to Canada; securities regulators in other jurisdictions have also noted similar concerns about the poor financial literacy or capabilities of their investors.¹⁴¹

Although financial literacy is a problem in and of itself, it becomes of greater concern when combined with (i) the information asymmetry referred to above, (ii) a general conflict of interest regime that relies heavily on disclosure, (iii) tacit approval by investors of compensation practices based on disclosure, (iv) the explicit or implicit suggestion by some advisers and dealers that they act in their client's best interests when they may not have a legal obligation to do so, and (v) cognitive biases on the part of investors that impair rational decision making.¹⁴²

¹³⁸ http://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20110622_31-103_rfc-pro-amd.htm

¹³⁹ See, for example, The Brondesbury Group, *Report: Performance Reporting and Cost Disclosure* (September 17, 2010), online: http://www.osc.gov.on.ca/documents/en/Securities-Category3/rpt_20110622_31-103_performance-rpt-cost-disclosure.pdf; The Brondesbury Group, *Focus Groups with Retail Investors on Investor Rights and Protection* (April 7, 2011), online: http://www.osc.gov.on.ca/en/SecuritiesLaw_com_20110427_11-765_ananda.htm; CSA Investor Index (2009), online: <http://www.getsmarteraboutmoney.ca/Investor-research/Related-research/Pages/2009-CSA-Investor-Study.aspx>, Investor Education Fund, *Investor knowledge: A study of financial literacy* (2011), online: <http://www.getsmarteraboutmoney.ca/Investor-research/Our-research/Pages/financial-literacy-research.aspx>; The Investment Funds Institute of Canada, *The Value of Advice: Report* (July 2010), online: <https://www.ific.ca/Content/Document.aspx?id=5906>. SEC staff has recently published a study on U.S. investor financial literacy that concludes that, among other things, U.S retail investors lack basic financial literacy (SEC Staff, *Study Regarding Financial Literacy Among Investors* (August 2012), online: <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf> at iii).

¹⁴⁰ See Editorial, "Canadians bothered by their level of financial literacy" *Investment News* (November 9, 2011), online: http://www.investmentexecutive.com/-/canadians-bothered-by-their-level-of-financial-literacy?utm_source=newsletter&utm_medium=nl&utm_content=investmentexecutive&utm_campaign=INT-EN-morning.

¹⁴¹ See, e.g., Securities and Exchange Commission (Staff), *Study Regarding Financial Literacy Among Investors – As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (August 2012), online: <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>; Financial Services Authority, *Feedback Statement: Retail Distribution Review - Including feedback on DP07/1 and the Interim Report* (November 2008), online: http://www.fsa.gov.uk/pubs/discussion/fs08_06.pdf, at para. 5.1; Australian Securities & Investments Commission, *Financial literacy and behavioural change* (March 2011), online: <http://www.financialliteracy.gov.au/media/218309/financial-literacy-and-behavioural-change.pdf>.

¹⁴² For an interesting discussion of the weaknesses that behavioural psychology identifies in the reliance on disclosure generally, and the treatment of conflicts of interest in particular, in the broader fiduciary duty debate, see Robert A. Prentice, "Moral Equilibrium: Stock Brokers and the Limits of Disclosure" *Wisconsin Law Review* 2011:1059, online: <http://wisconsinlawreview.org/wp-content/files/I-Prentice.pdf>. See also Steven J. Choi & A.C. Pritchard, "Behavioral Economics and the SEC", 56 *Stanford Law Review* 1, 22 (2003), online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=500203; Onnig H. Dombalagian, "Investment Recommendations and the Essence of Duty", *American University Law Review*, 2011, Vol 60, Issue 5 at 1279 (and footnotes 61 and 64), online: <http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1627&context=aulr>.

- **Concern 3: Standard of conduct expectation gap**

The Investor Education Fund (**IEF**) recently completed an extensive study of approximately 2,000 Canadian investors that receive investment advice in respect of a non-discretionary account from an adviser or dealer (the **IEF Study**).¹⁴³ The IEF identified a number of issues that are important for understanding the expectations and needs of investors in an advisory relationship.

The IEF Study provides strong evidence that most investors already believe that their adviser or dealer is required to act in their best interests. In the IEF Study, 70% of investors surveyed indicated that they believed that their adviser or dealer has a legal duty to put the client's best interests ahead of their own. Further, 76% of investors surveyed stated that they can trust their adviser or dealer to give them the best possible advice they can, with most investors believing that their adviser or dealer would identify the investments that are best for them. Finally, 62% of investors surveyed believed that their adviser or dealer would recommend the product that is best for the investor even if it resulted in less compensation for the adviser or dealer.

These findings are of concern because, as discussed above, advisers and dealers are not always legally required to act in their clients' best interests. These results indicate a significant gap between the expectations of investors and the actual legal protection that exists. Further, these expectations of investors are often created and reinforced by the advertising and promotional statements made by some advisers and dealers.

- **Concern 4: Recommendation of suitable investments versus investments in the client's best interests**

As noted above, under the current securities regime, advisers and dealers must ensure that, when they advise their clients about investing in securities, the investments are suitable. This is a lower standard than having to ensure that a purchase or sale of securities is in the client's best interests.

In practice, an adviser or dealer can often reasonably conclude that a large number of investment products are suitable for her client. In the face of so many "suitable" options, the adviser or dealer may be tempted to select a "suitable" product that is not necessarily the best one for the client.

This may result in investors acquiring a "suitable" investment but at an inflated price. Even slightly higher fees can have a significant negative impact on the value of a client's investment portfolio over the long term.¹⁴⁴ Similarly, a suitability standard could have the

¹⁴³ The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study* (March 2012), online: <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>.

¹⁴⁴ See, e.g., Financial Consumer Agency of Canada, *Frequently Asked Questions – What is a Management Expense Ratio*, online: <http://www.fcac-acfc.gc.ca/eng/resources/faq/qaview-eng.asp?id=342>.

effect of the client acquiring an investment that may be suitable but in circumstances in which another investment at the same price may be a better investment for the investor.

- **Concern 5: The application in practice of the current conflicts of interest rules might be less effective than intended**

The intention of Canadian securities regulators in adopting the current principle-based rules in NI 31-103 regarding conflicts of interest was to ensure that clients receive meaningful disclosure about conflicts of interest without imposing unnecessary regulatory burdens on registrants. CSA staff have the following concerns with the effect of these rules on retail investors in practice:

- a) First, CSA staff in certain jurisdictions have identified (in normal course compliance reviews) certain concerns with how the conflict rules are interpreted by some advisers and dealers in practice. For example, some firms narrowly interpret the current principles-based regulatory approach for dealing with conflicts of interest such that they (i) fail to appropriately identify and respond to conflicts or (ii) rely too heavily on disclosure (especially where the disclosure may be meaningless for the client). Further, some firms take the position that once disclosure is provided, the adviser or dealer need not comply with the general standard of conduct that would otherwise apply. This in turn can lead to situations where the interests of advisers and dealers are not aligned with the interests of their clients.
- b) Second, commissions paid by issuers (or their agents) to advisers and dealers for recommending the issuer's securities may constitute such a fundamental conflict of interest that regulators should consider how best to mitigate this risk (e.g. prohibiting some or all "embedded" commissions; requiring more effective disclosure). The UK and Australia have directly addressed this issue in their reforms described above.¹⁴⁵ The CSA is currently considering fee arrangements in the mutual fund industry as a separate policy initiative.
- c) Third, how advisers and dealers respond to conflicts of interest involving their recommendations to buy, hold or sell securities in related or connected issuers could be strengthened. For example, a common business model for exempt market dealers is that they exclusively distribute the securities of related or connected issuers. Another example is the common practice of advisers and dealers recommending the purchase of securities of mutual funds that are related or connected. While NI 31-103 does currently include rules in this regard,¹⁴⁶ these rules only apply to clients in managed accounts and/or rely on disclosure to

¹⁴⁵ ASIC has also published draft guidance on (i) incentive scheme features that increase the risk of mis-selling, and (ii) managing the risks and governance of incentive schemes (ASIC, *Guidance Consultation: Risks to customers from financial incentives* (September 2012), online: <http://www.fsa.gov.uk/static/pubs/guidance/gc12-11.pdf>).

¹⁴⁶ NI 31-103, *supra* note 4 at s. 13.5.

manage the conflict. Further consideration is required to determine whether a stronger, more prescriptive approach is appropriate.

Consultation Questions on Investor Protection Concerns

Question 1: Do you agree, or disagree, with each of the key investor protection concerns discussed above with the current standards applicable to advisers and dealers in Canada? Please explain and, if you disagree, please provide specific reasons for your position.

Question 2: Are there any other key investor protection concerns that have not been identified?

Question 3: Is imposing a statutory best interest standard on advisers and dealers the most effective way of addressing these concerns? If not, would another policy solution (e.g., changes to one or more of the existing statutory standard of conduct requirements) offer a more effective solution?

Question 4: Do you believe that some or all of these concerns are inapplicable (or less significant) in any CSA jurisdiction as a result of its current standard of conduct for advisers and dealers?

7) CONSULTATION ON THE APPROPRIATENESS OF INTRODUCING A STATUTORY BEST INTEREST DUTY WHEN ADVICE IS PROVIDED TO RETAIL CLIENTS

Why a statutory best interest standard?

Having considered all of the issues discussed above in this Consultation Paper, CSA staff has decided to undertake a formal consultation on the desirability and feasibility of imposing a statutory best interest standard on advisers and dealers that provide investment advice to retail investors.

Our rationale for considering the imposition of a fiduciary duty at this stage, rather than another policy tool, is that a statutory best interest standard may be the best way to address the five investor protection concerns identified in Part 6 above and appears to offer the benefits, and may be flexible enough to address most or all of the competing considerations, identified in Part 8 below.

We note that each of the foreign jurisdictions that we have reviewed (U.S., U.K., Australia and the E.U.) have identified similar policy concerns and have either adopted a qualified statutory best interest standard (i.e., in the U.K., E.U. and Australia) or are considering adopting one (i.e., in the U.S.). Further, international bodies such as the International Organization of Securities Commissions (IOSCO) and the Organisation for Economic Co-operation and Development (OECD) are clear that financial intermediaries, such as advisers and dealers providing advice,

should act in their clients' best interest.¹⁴⁷ While these international developments should not determine Canada's policy direction in this matter, they do support the conclusion that it is time to revisit the standard of conduct framework currently in place for advisers and dealers providing advice to retail investors and determine whether changes are required.

Possible Statutory Best Interest Standard for Consultation Purposes

CSA staff is seeking comment on the desirability and feasibility of introducing a statutory best interest standard for advisers and dealers when providing investment advice to retail investors. For consultation purposes, one possible articulation of this standard would be as follows:

Every adviser 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.¹⁴⁸

Although other articulations of statutory "best interest" duties already exist in certain CSA jurisdictions, as in Québec, we are exploring the possibility of harmonizing the appropriate standard of conduct for advisers and dealers that should apply across Canada. Common law and civil law remain distinct legal regimes, but both cover the same advisory services provided by advisers and dealers to their clients. If such a new harmonized standard of conduct for advisers and dealers in Canada is identified by the CSA, further work would be required, as necessary, to reflect it appropriately in each CSA jurisdiction (including in Québec).

We note that while no decision has been made whether a statutory best interest standard should be adopted, whether another policy solution is preferable, or whether the current regulatory regime is adequate, we believe that a public consultation will be more productive if that consultation focuses on and addresses a specific articulation of a best interest standard. Accordingly, the balance of this Consultation Paper will address the implications of a best interest standard as described above.

¹⁴⁷ See IOSCO, *International Conduct of Business Principles* (July 9, 1990), online: <http://riskinstitute.ch/19900701.htm>; OECD, *G20 High-Level Principles On Financial Consumer Protection* (October 2011), online: <http://www.oecd.org/dataoecd/58/26/48892010.pdf> at 6.

¹⁴⁸ This best interest standard is drafted with certain qualifiers. However, no qualifiers have been included that might address concerns about the negative impact on certain business models and compensation practices. Further, no qualifiers have been included that overcome the common law prohibition that a fiduciary cannot take advantage of opportunities learned of as a fiduciary, which CSA Staff recognize may need to be qualified in this context. We ask specific questions below intended to assist us in determining what additional qualifiers may be necessary or appropriate.

General Scope

For the purpose of this Consultation Paper, we will assume that the best interest standard articulated above would have the following terms:

- (i) a “retail client” would mean any person or company that is not a “permitted client” (as such term is defined in section 1.1 of NI 31-103). As a result, a “retail client” would include individuals that have net financial assets of \$5 million or less and companies that have net assets of less than \$25 million;
- (ii) a retail client would retain complete discretion whether to follow any advice received; an adviser or dealer who disagrees with the investment decision of a retail client and who has so advised the client, would have no further obligation to dissuade the client or to refuse to facilitate an order;¹⁴⁹
- (iii) the duty would apply only when an adviser or dealer gives advice to a retail investor with respect to investing in securities. Thus, for instance, the duty would not apply to discount brokers who act as mere order takers;
- (iv) the duty would be an on-going duty in the case of advisers and dealers other than exempt market dealers and scholarship plan dealers. The duty would terminate only upon the termination of the client relationship;
- (v) the best interest standard could not be waived by a retail client as a contractual matter if advice is given to that client;¹⁵⁰
- (vi) a common law retail client would be entitled to enforce the best interest standard as a private law right of action;
- (vii) a non retail client would still be entitled to pursue a private law right of action based on the common law (in all Canadian jurisdictions except Québec) and the Civil Code of Québec would not be amended to deprive non retail clients of a right of action; and
- (viii) the existing suitability requirement would continue to apply to advisers and dealers (and their representatives).

Consultation Questions on the Statutory Best Interest Standard Described Above

Question 5: Should securities regulators impose a best interest standard applicable to advisers and dealers that give advice to retail clients? Why or why not?

¹⁴⁹ This is consistent with the current suitability requirement set out in subsection 13.3(2) of NI 31-103, *supra* note 4.

¹⁵⁰ We note that this is consistent with the duty as it applies to directors under the *Canada Business Corporations Act* in that the best interest duty and duty of care cannot be contracted out of (see s.122(3) of the CBCA).

Question 6: If such a duty is imposed, are the terms of the best interest duty described above appropriate (for example, should there also be an on-going obligation regarding the suitability of advice previously given or investments held by a client)? What changes, if any, would you suggest to the terms of the best interest duty described above?

Question 7: Are there other general issues related to imposing the best interest standard described above that should be addressed?

We note that there are further consultation questions set out below with respect to the potential benefits and competing considerations in imposing a statutory best interest standard.

8) POTENTIAL BENEFITS AND COMPETING CONSIDERATIONS IN IMPOSING A STATUTORY BEST INTEREST STANDARD

This section of the Consultation Paper identifies the potential benefits and competing considerations related to the imposition of the statutory best interest standard described above. The following chart summarizes these elements and each one will be discussed in more detail below.

<u>POTENTIAL BENEFITS</u>	<u>POTENTIAL COMPETING CONSIDERATIONS</u>
<ul style="list-style-type: none"> • Provides a more principled foundation for client relationship 	<ul style="list-style-type: none"> • Current regime may be functionally equivalent to a fiduciary duty
<ul style="list-style-type: none"> • Principle-based approach alleviates need for detailed prescriptive rules 	<ul style="list-style-type: none"> • May impose greater costs on providing advice
<ul style="list-style-type: none"> • Retail clients expect that their adviser or dealer already has a duty to act in their best interest 	<ul style="list-style-type: none"> • Possible negative impact on investor access to, and choice and affordability of, advisory services
<ul style="list-style-type: none"> • Recommended products that are in the client’s best interest rather than just suitable 	<ul style="list-style-type: none"> • Possible negative impact on certain business models
<ul style="list-style-type: none"> • Further mitigates information and financial literacy asymmetry 	<ul style="list-style-type: none"> • Uncertain impact on capital raising
<ul style="list-style-type: none"> • Eliminates any legal uncertainty whether a fiduciary duty exists 	<ul style="list-style-type: none"> • Uncertain effect on compensation practices
<ul style="list-style-type: none"> • Strengthens legal remedy to retail clients for breach of fiduciary duty 	<ul style="list-style-type: none"> • May require more guidance with respect to its application and operation in specific circumstances

<ul style="list-style-type: none"> Limited application of a statutory duty 	<ul style="list-style-type: none"> Whether duty should only apply to retail clients
	<ul style="list-style-type: none"> How the duty applies to “advice”

Consultation Question on Potential Benefits and Competing Considerations Generally

Question 8: Do you agree, or disagree, with each of the potential benefits and competing considerations of the statutory best interest standard described above? Please explain and, if you disagree, please provide reasons for your position. Are there any other key potential benefits or competing considerations that have not been identified?

(a) Potential Benefits

Provides a more principled foundation for client relationship

The introduction of a statutory best interest duty may establish a more principled foundation for the advisor-client relationship by requiring that the adviser or dealer must always act in the client’s best interests and put the client’s interest ahead of their own. It seems to address the issues discussed under “Concern 1: Principled foundation” in Part 6 above and could assist in reversing any deterioration of client trust with their financial adviser or dealer (whether such deterioration of trust is deserved or not).¹⁵¹

Principle-based approach alleviates need for detailed prescriptive rules

The imposition of a statutory best interest standard constitutes a principle-based approach to the concerns identified in this Consultation Paper. The advantage of any principle-based approach to regulation is that regulators do not have to introduce detailed rules for every element of a relationship being regulated. This advantage is magnified by the inherent flexibility and fluidity of the fiduciary duty doctrine at common law,¹⁵² which is why it is applied so often by judges in various circumstances.¹⁵³ An over-arching best interest standard would be a principled foundation that could support the existing body of regulatory rules while at the same time addressing behaviour that may not be in the client’s best interest but that falls outside specific

¹⁵¹ See, e.g., Editorial, “The business of trust” *Investment Executive* (August 2012), online: http://www.investmentexecutive.com/-/the-business-of-trust?redirect=%2Fsearch%3Fp_p_id%3Dsearch_WAR_search10%26p_p_lifecycle%3D0%26p_p_state%3Dnormal%26p_p_mode%3Dview%26p_p_col_id%3Dcolumn-1%26p_p_col_count%3D1%26_search_WAR_search10_search%3Dgeneric; see also Ian Russell, “Should advisors become fiduciaries?” *Investment Executive* (April 6, 2010), online: <http://www.iiac.ca/resources/1262/should%20advisors%20become%20fiduciaries.%20investment%20executive%20-%202004-01-2010.pdf>.

¹⁵² See Ellis, *supra* note 8 at Chapter 1, s.4(2).

¹⁵³ See, e.g., Rotman, *supra* note 5 at 37.

rules. Any such principle-based approach may bring with it, however, the need for regulators to provide appropriate guidance as to the application of the standard.

Retail clients expect that their adviser or dealer already has a duty to act in their best interest

The adoption of a best interest duty for advisors and dealers would likely align an adviser's or dealer's standard of conduct with most investors' current understanding that an adviser or dealer already has a duty to act in the client's best interests and to provide advice that is in the investor's best interests. That understanding may not be unreasonable for some investors given that some advisers and dealers market their services on the explicit or implicit basis that the advice they are providing is in the client's best interests.

Recommended products that are in the client's best interest rather than just suitable

A best interest standard may result in advisers and dealers recommending investments that are in a client's best interests, not only investments that are suitable. This may have the effect of investors acquiring an appropriate investment at a lower price or acquiring a better investment at the same price. This does not mean that there is necessarily only one "best" investment for a client. Nor does it mean that advisers or dealers would assume liability for the success of the investment; they would not. Stakeholder consultation will be important to explore the benefits, costs and challenges of shifting the suitability standard to a best interest standard.

Further mitigates information and financial literacy asymmetry

The adoption of a best interest standard may help to further mitigate concerns with information asymmetry and financial literacy by ensuring that the adviser has the obligation to act in the best interests of the client. This places an appropriate obligation on the party to the relationship that is arguably the most knowledgeable and financially literate, namely the adviser or dealer.

Eliminates any legal uncertainty whether a fiduciary duty exists

Currently, a fiduciary duty arises at common law only in certain circumstances (see Part 3 above for further discussion). Determining whether that duty exists requires an analysis of the particular circumstances and, in any event, it may be unclear whether such a duty arises. A statutory best interest standard may clarify that such a duty applies in most instances when an adviser or dealer provides advice to a retail investor. This may help clarify some of the uncertainty currently experienced by both clients and their advisers and dealers regarding what standard of conduct the adviser or dealer will be held to. The statutory best interest standard described above makes clear that the duty cannot be waived as a contractual matter.

Strengthens legal remedy to retail clients for breach of fiduciary duty

Although Securities Legislation contains express civil liability for misrepresentations in a variety of distribution-related and secondary market disclosure documents, there is no express statutory civil right of action for breach of Securities Legislation for most requirements. However, because a best interest standard would establish the nature of the relationship between an adviser or dealer with the client to whom advice is given, the best interest standard described in this

Consultation Paper contemplates that breach of a best interest standard may strengthen civil liability at common law without creating a separate statutory right of action. Eliminating the need to prove the existence of a fiduciary duty between a retail client and her adviser or dealer would likely strengthen the recourse that the client has if she wishes to pursue private law recourse for a breach of that duty. A statutory best interest standard could be directly enforced by an investor as a private law matter. There would seem to be limited benefit in establishing a best interest standard if it does not give rise to any such civil liability on the part of the adviser or dealer. Most advocates for imposing a best interest standard assume that it would give rise to such liability.

Limited application of a statutory duty

A statutory best interest standard does not have to impose an unqualified common law fiduciary duty on all advisers and dealers in respect of all facets of the client relationship. Distinctions can be made among the constituent elements of a fiduciary duty and addressed in different ways to meet the needs of all stakeholders. That is to say, the elements of a statutory fiduciary duty can be qualified to accommodate specific circumstances including the particular circumstances and business model of the adviser or dealer. It could be made explicit, for example, that conflicts of interest can be addressed as currently provided in Securities Legislation (including NI 31-103). Similarly, it could be made clear that the principle that an adviser or dealer cannot take advantage of an opportunity learned of as a fiduciary should have limited application; that common law concept may not be appropriate in the context of the advice of an adviser or dealer.

The benefits set out above represent CSA staff's observations in the context of the possible statutory best interest standard described in this Consultation Paper. Additional benefits, or variations to the benefits referred to above, may emerge as part of this consultation.

Consultation Questions on the Potential Benefits of a Statutory Best Interest Standard

Question 9: What are the criteria that should be used to identify an investment that is in a client's best interest?

Question 10: Should breaches of a best interest standard give rise to civil liability at common law?

Question 11: If so, is it necessary to state expressly that a best interest duty will give rise to civil liability on the part of the adviser or dealer or is it sufficient if that standard is a statutory duty?

(b) Potential Competing Considerations

Current regime may be functionally equivalent to a fiduciary duty

As discussed above, some commentators argue that the duty of an adviser or dealer to act fairly, honestly and in good faith when dealing with clients, coupled with the existing rules related to suitability and conflicts of interest, may already impose a standard of conduct

that is functionally equivalent to a fiduciary duty.¹⁵⁴ As a result, the introduction of a best interest standard could be unnecessary and could lead to additional complexity and/or uncertainty.

Consultation Questions on Functional Equivalency

Question 12: Does the duty of an adviser or dealer to act fairly, honestly and in good faith when dealing with clients, coupled with the existing rules related to suitability and conflicts of interest, already impose a standard of conduct that is functionally equivalent to a fiduciary duty?

Question 13: If so, should it be made clear that investors can enforce that duty as a private law matter?

Question 14: If you believe that the existing standard of conduct for advisers and dealers already imposes a standard of conduct that is functionally equivalent to a fiduciary duty, what impact (if any) would the introduction of a statutory best interest standard have? For example, would it be desirable for investors to have the benefit of a statutory best interest standard that has long been recognized and interpreted under fiduciary duty common law principles?

Question 15: Do you think the investor protection concerns raised in this Consultation Paper could be addressed by issuing guidance about current business conduct requirements, including the duty to deal fairly, honestly and in good faith with clients? Please provide specifics about the type of enhanced guidance that would be most effective.

Question 16: Do you think that the concerns raised in this paper could be addressed by increased enforcement of current business conduct rules, including fair dealing, suitability and conflict of interest requirements?

May impose greater costs on providing advice

Some industry stakeholders have suggested that the introduction of a statutory best interest standard would result in increased costs for advisers and dealers providing advice to retail clients. This is a significant concern of advocates against imposing a statutory best interest standard.

¹⁵⁴ It is interesting to note that in one of the leading Canadian cases on the content of a fiduciary duty in the client-advisor context, the court stated that when an adviser or dealer undertakes to advise the client, he or she must “do so fully, honestly and in good faith”: *Varcoe*, *supra* note 17 at para. 86. This is very similar to the existing statutory requirement for advisers and dealers to “deal fairly, honestly and in good faith” with their clients. See also *Davidson v. Noram Capital Management Inc.* (2005), 2005 CarswellOnt 7243, 13 B.L.R. (4th) 35 at paras. 49-50.

Although CSA staff is mindful that potential cost increases for such advisers and dealers may occur, the extent of any such cost increases would depend on a number of factors, including:

- the scope of the standard that is eventually adopted (if any),
- the way advisers and dealers respond to the new standard, and
- the extent to which any of these costs are passed on to retail clients (which is discussed in the next item below, “Possible negative impact on investor access to, and choice and affordability of, advisory services”).

Although the Consultation Paper is not making a policy recommendation, if the CSA were to make a policy recommendation to introduce a statutory best interest standard, the consultation process will provide the opportunity for the CSA to seek comment on potential costs and benefits associated with such specific proposal. Although a precise cost-benefit analysis is not feasible at this stage, we believe it is still worthwhile to gather input on potential costs if the statutory best interest standard described above were introduced. Ultimately, the costs to introduce a statutory best interest standard should be proportionate to the regulatory objectives to be achieved as a result of any change.

Consultation Questions on Potential Increased Costs

Question 17: Would the statutory best interest standard described above increase ongoing costs for advisers and dealers in Canada? If so, please identify the areas in which you believe there would be increased costs for advisers and dealers and provide any relevant qualitative arguments or quantitative data. In responding, please consider potential costs in the following areas:

- (i) regulatory assessment (client information required to meet standard)
- (ii) compliance/IT systems
- (iii) supervision
- (iv) ensuring representative proficiency
- (v) client documentation/disclosures
- (vi) insurance
- (vii) litigation/complaint handling
- (viii) other (please identify)

Question 18: If yes, given that a fiduciary duty is already owed to a client in certain circumstances, why do you think that clarifying the circumstances in which such a duty is owed will affect ongoing costs of advisers and dealers in Canada?

Question 19: Are the computer systems advisers and dealers use today to support their compliance mandate able to support a statutory best interest standard? If no, what types of investment do advisers and dealers anticipate needing to

make to improve their IT systems in order to ensure compliance with a best interest standard?

Question 20: We note that cost-benefit and/or market impact analysis has been conducted to varying extents on the proposed reforms in each of the U.S., U.K., Australia and E.U. Do you believe that this international analysis is relevant to the possible introduction of a statutory best interest standard for advisers and dealers in Canada? If so, please explain.

Possible negative impact on investor access to, and choice and affordability of, advisory services

A concern raised by industry stakeholders in the adoption of a statutory best interest standard is that there could be a negative impact on the choice, access and/or affordability of advisory services for investors to whom the standard applies. As noted above, two U.S. focused studies seem to reach opposite conclusions on this question.

It is unclear whether a qualified best interest standard would have these negative consequences in Canada, given that in many cases a fiduciary duty may exist as a common law matter in any event and given the current standard of conduct imposed on advisers and dealers as well as suitability requirements.

Consultation Question on Investor Choice, Access and Affordability

Question 21: Do you believe that the statutory best interest duty described above would have a negative, positive or neutral impact on retail clients across each of the following dimensions: choice, product access, and affordability of advisory services?

Possible negative impact on certain business models

The introduction of an unqualified statutory best interest duty could have a significantly negative impact on advisers and dealers whose business involves advice that is specialized or restricted in some way (e.g., some mutual fund dealers, exempt market dealers and scholarship plan dealers). The concern is that there may be practical difficulties in implementing a strict “one size fits all” standard of conduct for all advisers and dealers. We note that this concern may be addressed by customizing the nature of a best interest standard as it applies to different business models.

The introduction of a statutory best interest standard would likely require tailoring of any duty to relevant business models. For example, the application of a statutory best interest standard to a typical mutual fund dealer, exempt market dealer or scholarship plan dealer raises different issues. In each case, the dealer’s advice is restricted in two ways. First, it is restricted because legally such dealers are only allowed to advise on the financial products for which they are registered. Second, many of these dealers only advise on products of

related or connected entities. We note that a statutory best interest standard would not apply to discount brokers who, by definition, do not offer advice on which investments their clients should invest in.

Both the UK Reforms and the Australian Reforms were specifically developed with the intention of allowing restricted advice and scaled advice, respectively.

Consultation Questions on Impact on Certain Business Models

Question 22: How should a statutory best interest standard apply to mutual fund dealers, exempt market dealers and scholarship plan dealers?

Question 23: Are there any adviser or dealer business models that could not continue if the best interest standard described above was adopted?

Question 24: Do you agree with the approach reflected in the Australian Reforms or UK Reforms to accommodate restricted advice and scaled advice, respectively?

Question 25: What specific qualifications to the best interest standard described in this Consultation Paper are required (please provide proposed statutory language where possible)?

Question 26: Will the qualifications required to make a best interest standard work in Canada result in retail clients receiving only advice on a narrow range of investment products?

Uncertain impact on capital raising

One of the areas that has not generated much commentary in Canada has been what impact a statutory best interest duty to retail clients may have on capital raising. There is, for instance, a question of what effect a statutory best interest standard would have on exempt market dealers and their role in raising venture capital for smaller Canadian issuers. That issue may be addressed in formulating a best interest standard that is qualified to take into account the business model of exempt market dealers.

Consultation Question on Impact on Capital Raising

Question 27: Would imposing a statutory best interest standard as described above affect capital raising?

Uncertain effect on compensation practices

The statutory best interest duty described above could have an uncertain impact on current compensation structures, especially those involving embedded commissions paid by third parties to advisers and dealers. This area has been considered by Canadian securities regulators before, including in the Fair Dealing Model published by the OSC in 2004.

The U.K. and Australia are moving towards models where most of the embedded commissions payable by third parties to firms providing advice to retail clients will be banned. As a result, firms that offer advisory services will be compensated by their retail clients directly.

The direction the SEC seems to be taking is that it will evaluate any broker-dealer compensation practice on its merits to determine whether or not it meets the proposed fiduciary standard. The SEC Study states that “[w]hile the duty of loyalty requires a firm to eliminate or disclose material conflicts of interest, it does not mandate the absolute elimination of any particular conflicts, absent another requirement to do so”.¹⁵⁵ The SEC Study concludes by stating that “Staff’s recommendations are intended to minimize cost and disruption and assure that retail investors continue to have access to various investment products and *choice among compensation schemes to pay for advice.*”¹⁵⁶ (italics added) In addition, Chairman Schapiro has stated that the SEC’s fiduciary rule would be business-model neutral and would allow brokers working with retail investors to sell proprietary products and *charge commissions.*¹⁵⁷ (italics added)

Interestingly, lawmakers in the U.S.¹⁵⁸ and Australia¹⁵⁹ have both stated that any particular compensation structure does not, in and of itself, necessarily need to be abandoned as a result of the introduction of a best interest standard. This position seems to be supported by the Academic Study¹⁶⁰ in the U.S. that concluded that the existence of such a duty did not affect compensation arrangements.

Accordingly, imposing a best interest duty does not necessarily mean a change must be made in compensation structures.

Consultation Questions on Effect on Compensation Practices

Question 28: Do you believe that the statutory best interest duty described above would affect the current compensation practices of advisers and dealers? If so, in what way?

Question 29: Should a best interest duty expressly address adviser and dealer compensation practices? If so, in what way?

Question 30: Could volume based payments or embedded commissions continue if the statutory best interest standard described in this paper is introduced? If so, should such compensation structures be specifically prohibited?

¹⁵⁵ SEC Study, *supra* note 67 at 113.

¹⁵⁶ *Ibid.* at 166.

¹⁵⁷ See Melanie Waddell, “Reaction to Schapiro Comments on Fiduciary Rule Are Quick and Varied” (December 9, 2011), *AdvisorOne*, online: <http://www.advisorone.com/2011/12/09/reaction-to-schapiro-comments-on-fiduciary-rule-ar>.

¹⁵⁸ See *Dodd-Frank Act*, *supra* note 63 at section 913.

¹⁵⁹ Revised Explanatory Memorandum, *supra* note 115 at para. 1.47.

¹⁶⁰ *Supra* note 89.

Question 31: What compensation structures that exist today among advisers and dealers do you think would be prohibited by the statutory best interest standard articulated in this Consultation Paper? Please consider compensation received by advisers and dealers both from clients and from product manufacturers. For each structure you mention, please provide your reasons.

Question 32: Should any statutory best interest standard be modified in any way to preserve various compensation structures?

May require more guidance with respect to its application and operation in specific circumstances

Although there are benefits to a principle-based approach, such principles may not provide enough guidance to advisers and dealers. As a result, if the best interest standard described above was adopted, securities regulators may need to provide qualification in securities legislation or issue guidance setting out their expectations as to specific adviser and dealer behaviour under such a duty. This would assist advisers and dealers in determining how they should operationalize their obligation in practice and how it would apply in different circumstances. Although some of these topics are discussed in this Consultation Paper, other topics may not be explicitly covered.

Consultation Questions on Required Guidance

Question 33: If the statutory best interest duty described above is introduced, what areas of guidance would be most useful to advisers and dealers?

Question 34: Are there specific circumstances or activities, such as principal trading, that should be addressed?

Question 35: Are there any categories of registrants today whose minimum proficiency requirements would need to change in order to comply with the statutory best interest standard described in this Consultation Paper?

Current rules applicable to advisers and dealers should be reviewed to determine whether they are consistent with the best interest duty described above. If they are consistent, no change is required. While it is unlikely that current rules would be inconsistent with the statutory best interest duty described in this paper, if there are any such rules, we should consider how they should be addressed. We should also consider whether any new rules are required or whether any existing rules will be unnecessary if a best interest standard is introduced. As discussed above, if a best interest standard is imposed, we can apply some or all of the constituent elements of a fiduciary duty in a qualified way that still meets regulatory objectives.

Consultation Questions on Interaction with Existing Regulatory Regime

Question 36: Are there any advisory relationships between an adviser or dealer and a retail client where a fiduciary duty would not be appropriate?

Question 37: Would the introduction of a best interest duty as described above require the introduction of any new rules?

Question 38: Would the introduction of a best interest duty as described above require any existing rules be revised or repealed?

Question 39: Are any existing regulatory rules inconsistent with the best interest standard described above?

Under traditional fiduciary principles, fiduciaries must scrupulously avoid all actual or potential conflicts of interest involving their beneficiaries.¹⁶¹ The possible introduction of a statutory best interest standard raises the question of whether changes should be made to the current regulatory regime regarding conflicts of interest or whether there should be new rules addressing conflicts (e.g. how disclosure is made, when disclosure is appropriate, and, if required, the nature of informed consent).

Consultation Questions on Implications for Rules on Conflict of Interest

Question 40: Would the statutory best interest duty described above require revisions to the rules that govern how firms address conflicts of interest with their clients?

Question 41: If changes are required to the rules on conflicts of interest, what changes do you recommend?

Consultation Questions on Targeted Best Interest Standard

Question 42: Should the CSA consider only imposing a best interest standard in respect of certain requirements, such as conflicts of interest or suitability requirements?

Question 43: If so, how would more targeted best interest standards address the key investor protection concerns raised in this paper? Please provide specifics.

¹⁶¹ Ellis, *supra* note 8 at paragraph 4(2)(a) of Chapter 1.

Whether duty should only apply to retail clients

For purposes of this consultation, the best interest standard described above applies only when advice is being given to retail clients. A “retail client” would be defined as a person or company that is not a “permitted client” as that term is defined in NI 31-103. As a result, a retail client would include individuals that have net financial assets of \$5 million or less and companies with that have net assets of less than \$25 million.

As discussed above, in the U.S. and Australia, the proposed best interest standard only applies when a firm is dealing with retail customers and retail clients. The SEC defines a “retail customer” as “a natural person, or the legal representative of a natural person, who – (i) receives personalized investment advice about securities from a broker, dealer, or investment adviser, and (ii) uses such advice primarily for personal, family or household purposes.”¹⁶² In Australia, although there are currently rules setting out minimum investment (AUS\$500,000), income (AUS\$250,000) and net asset (AUS\$2.5 million) thresholds under which investors are considered “retail clients”,¹⁶³ the Australian government is currently reviewing the definitions of retail client and wholesale client in conjunction with the Australian Reforms.¹⁶⁴

Currently under Securities Legislation, there is no definition of what constitutes a “retail client”. There are, however, certain threshold criteria that classify different kinds of clients for Securities Legislation purposes. One of the most well known is the “accredited investor” definition. Accredited investors include individuals with financial assets of \$1,000,000 or more or incomes of at least \$200,000 per year. Our intention is to include in the definition of retail clients all individuals including accredited investors who are not permitted clients. We note that the CSA is currently conducting a policy review of the accredited investor exemption.¹⁶⁵ We will consider the outcomes of that review on the issues and questions posed in this Consultation Paper.

Consultation Questions on Application of Duty on Retail Clients

Question 44: Should a best interest standard apply only to advisers and dealers when dealing with “retail clients”?

Question 45: If so, is the definition of a “retail client” appropriate? Should any such duty apply to other clients in addition to retail clients?

Question 46: Should certain kinds of permitted clients (e.g., municipalities) have the benefit of a statutory best interest standard?

¹⁶² Dodd-Frank Act, *supra* note 63 at s.913(g).

¹⁶³ *Supra* note 110 at para. 2.3 and para. 2.5.

¹⁶⁴ *Ibid.*

¹⁶⁵ Canadian Securities Administrators, *CSA Staff Consultation Note 45-401 - Review of Minimum Amount and Accredited Investor Exemptions* (November 10, 2011), online: <http://www.osc.gov.on.ca/en/33950.htm>.

Question 47: Are there certain kinds of retail clients that do not require the benefit of a statutory best interest standard?

Question 48: If the best interest standard described above was introduced, should advisers and dealers be permitted to modify or negate the standard by contract with their clients? If so, what limitations (if any) should be placed on that ability?

Question 49: If a best interest standard is introduced, should the existing duty on advisers and dealers to deal with their clients fairly, honestly and in good faith continue to apply whenever the best interest standard does not?

How the duty applies to “advice”

For purposes of the consultation, the best interest standard would apply when an adviser or dealer provides *advice* to a retail client. The meaning of “advice” would be quite broad and would include any advice relating to the investing in or the buying or selling of securities or derivatives.

Other jurisdictions have taken a narrower approach. The fiduciary duty proposals in the U.S. and Australia are restricted to “personalized investment advice” and “personal advice”, respectively.

In the U.S., personalized investment advice has not yet been defined by the SEC. As stated in the SEC Study, SEC staff believes that such a definition at a minimum should encompass the making of a “recommendation”, as developed under applicable broker-dealer regulation, and should not include “impersonal investment advice” as developed under the Advisers Act. Beyond that, SEC staff believes that the term also could include any other actions or communications that would be considered investment advice about securities under the Advisers Act (such as comparisons of securities or asset allocation strategies), except for “impersonal investment advice” as developed under the Advisers Act.

In Australia, “personal advice” means financial product advice that is given or directed to a person in circumstances where (a) the provider of the advice has considered one or more of the person’s objectives, financial situation and needs (otherwise than for anti-money laundering rules purposes) or (b) a reasonable person might expect the provider to have considered one or more of those matters.

Consultation Questions on Duty Applying to Advice

Question 50: Should the best interest duty described above apply when any advice is provided to a retail client or only when personalized advice is provided to a retail client?

Question 51: If a best interest duty should apply only when personalized advice is provided to a retail client, what should “personalized advice” mean in this context?

Question 52: Should it be triggered in the same circumstances in which the suitability requirement arises? Does this include advice to *hold* securities (as opposed to buying or selling securities)?

The competing considerations described above represent CSA staff’s observations in the context of the possible statutory best interest standard articulated in this Consultation Paper. Additional competing considerations, or variations to those above, may emerge as part of this consultation.

9) REQUEST FOR COMMENTS

The CSA is publishing this Consultation Paper for a 120-day comment period. Please send your comments in writing on or before February 22, 2013. All submissions should refer to “CSA Consultation Paper 33-403”. This reference should be included in the subject line if the submission is sent by e-mail. Regardless of whether you are sending your comments by email, you should also send or attach your submissions in an electronic file in Microsoft Word format.

Please address your submission to the following securities regulators:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Please send your comments **only** to the address below. Your comments will be forwarded to the other CSA member jurisdictions.

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All comments will be posted on the OSC website at www.osc.gov.on.ca and the websites of the other CSA jurisdictions. We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period.

Questions

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