Why A Fiduciary Standard For Investment Advisers Is Urgent And Crucial

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In light of numerous instances of financial wrongdoing in Canada and elsewhere , there has been increased focus on the duties and obligations owed by investment dealers and so-called "advisers' to their clients especially retail investors. A fiduciary standard would help immeasurably, by forcing advisers to put the interests of investors they serve before their own. Lawmakers in Britain, the U.S. and Australia have recently introduced legislation to strengthen investors' legal rights and raise the professional bar for investment advisers. In Feb. 2012, the UK Financial Services Consumer Panel published a briefing paper http://www.fs-cp.org.uk/publications/pdf/position-paper-consumer-responsibility.pdf on consumer responsibility, which maintains that it's not reasonable to expect consumers to understand the detail of highly complex financial products and services, and the risks they create. In these and other jurisdictions, regulators are proposing changes that would impose a fiduciary standard on those entrusted with managing investor savings. The Small Investor Protection Association, FAIR Canada , the OSC Investor Advisory Panel and other investor advocates urge that similar initiatives should be undertaken here.

A fiduciary standard (already the norm for doctors, lawyers and some other professionals) makes it a legal requirement that an adviser must put a client's interests first. That includes avoiding conflicts-of-interest and making the best recommendations for the client even if it means lower fees for the adviser. The principles for damages in breach of fiduciary duty cases can often result in higher damages than would otherwise be the case. The Courts have identified five interrelated factors that are to be considered when determining whether financial advisers stand in a fiduciary relationship to their clients:

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

b) **Trust** – the degree of trust and confidence that a client reposes in the adviser and the extent to which the adviser accepts that trust.

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

d) **Discretion** – the extent to which the adviser has power or discretion over the client's account.

e) **Professional Rules or Codes of Conduct** – help to establish the duties of the adviser and the standards to which the adviser will be held.

The courts have clearly stated the client-dealer relationship is not presumptively fiduciary.

The legal concept of a fiduciary is highlighted by a agent-principal relationship. The agent has an obligation to act for the sole benefit of the principal (client). A high standard is imposed on the fiduciary because she/he often has discretion over key decisions- the client is reliant upon the fiduciary. A adviser owes clients a duty of care. However, a fiduciary relationship, and all the consequent duties, may or may not exist, depending on the circumstances of the specific relationship. The concept of a fiduciary relationship has been elusive of definition.

The Ontario Court (General Division) has fleshed out fiduciary duties in the context of the broker-client relationship (1992 ,Varcoe v. Sterling,). This description has been cited and used by the Supreme Court of Canada in describing the principles of fiduciaries in the context of advisory relationships. viz

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

A very insightful blog Fiduciary duty: will it make a difference? http://blog.moneymanagedproperly.com/?p=1077 by respected industry commentator Andrew Teasdale suggests that most retail investors are dependent on their "advisers". Teasdale observes that you cannot ascribe a fiduciary duty to a simple investor initiated transaction relationship, but that one can nevertheless not ignore the fact that many of the real world retail client-dealer relationships regulated by transaction based regulation operate well outside of such a context. In The Concept and Application of Fiduciary Duty in the Realm of Securities Brokers and their Client Relations, Law Firm Siskinds provide a readable overview of the fiduciary issue as it applies to financial advice at http://www.siskinds.com/getattachment/ec989f93-10fd-4d80-b5d9-b625716b087c/test.aspx Another interesting read is Liability and Damages in Unsuitable Investment Advice Cases http://www.investorvoice.ca/Research/LIABILITY_AND_DAMAGES.pdf APPENDIX A provides a summary of typical investor allegations and industry defences.

Suitability requirements are generally defined as any requirement that a financial firm, when advising a retail client to purchase a particular financial instrument, make a determination of whether that investment is "suitable" or appropriate for that particular client. Suitability or appropriateness are given a broad meaning -the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience. The "Know-Your-Client" (KYC) obligation is the obligation the "adviser" has to learn about the client, their personal financial situation, financial sophistication and investment experience, investment objectives and risk (and loss) tolerance. The term "disclosure" refers to any requirement that the firm disclose information to the retail client that could be material to the investment decision. The term "mis-selling" generally refers to the situation where the firm sells a product to a client that is not suitable for that client, whether or not a recommendation is made.

In Canada, the primary basis for advice is the "suitability" standard based on the KYC information. To understand the difference between a "suitability" and "client-first" standard, think of a investor seeking advice. A very common example would be if the "adviser" recommends a high -priced mutual fund with a deferred sales charge – a recommendation designed to generate the highest commission. The fund is suitable - it will satisfy the client's needs. It isn't necessarily the best solution and a disclosure obligation isn't likely to stand in the way of a commission-focused salesperson. If the "Adviser"had been bound by a "best-interest"/ fiduciary standard, he would recommend a better, cheaper fund, Index fund or ETF. Under a suitability standard, the investor, in a nondiscretionary account, has to make the purchase decisions with inadequate guidance and live with the results.

Retail investors, especially seniors, are very trusting. A number of polls and studies have concluded that financial literacy is sorely lacking. The New Accounting Application Form (NAAF) has been criticized for its legalese, inconsistency and poorly defined terminology. This of course leads to defective KYC information. NAAF's have also been subject to post -signature additions or changes. Investors do not receive their KYC forms and even if they did, they likely would not grasp the legal implications of the material. The financial services industry tends to encourage clients to "Trust Us" until the moment a dispute arises when they usually call in their lawyers to deal with investors who do not have similar resources. Many so-called advisers are masquerading as qualified professionals when in fact their training is limited, particularly in the mutual fund sector. Investment industry ads promote the idea that the industry can and should be trusted. Of course, "advisers" dependent on commissions have many conflicts-of interest, almost always not clearly disclosed to trusting clients ."Advisor" titles on business cards are inflated ,creating an illusion of competency and professionalism without regard to their true capabilities, constraints and registration. The result? A situation where the investor is ignorant of the true relationship and is led to believe that the relationship is one in which the adviser is responsible for the suitability processes and the integrity of the advice.

The research paper"It's Regulated, Right?" confirms Canadians are in the dark regarding the Qualifications and Ethical Obligations of Financial Planners and Advisers https://www.fpsc.ca/newsroom/post/its-regulated-right-research-reveals-canadians-dark-regarding-qualifications-ethical According to research conducted by The Strategic Counsel on behalf of Financial Planning Standards Council (FPSC), far too many Canadians are misinformed about the required qualifications and ethical obligations of their planners. Many Canadians operate on blind trust when choosing whom to engage for this assistance. For instance, an overwhelming majority (70%) of survey respondents falsely believe that individuals must be licensed in order to call themselves a financial planner. More than half (54%) of respondents falsely believe "All financial advisers are accountable to an oversight body which ensures they provide ethical and competent service to their clients." to be true. Nearly one third (29%) are 'not sure' and fewer than 1 in 5 (17%) respondents disagreed with this statement. Cary List, President & CEO, FPSC says "With the exception of Quebec, anyone in any province can call themselves a financial planner without meeting any minimum qualifications or standards".

" Advisers " are the key influence on investors' decision-making, according to a study Investor Behaviour and Beliefs: Advisor Relationships and Investor Decision-Making released March 1st by the Investor Education Fund (IEF), an Ontario Securities Commission (OSC) funded education entity. The study found that Canadian investors most commonly look to their advisers for advice on asset mix and specific types of investments to buy. The study found that investors' trust in their adviser's opinions dominates all other factors in the decision to buy investments. In addition, the study revealed that investor knowledge of mutual fund fees and what affects them is weak, and investors are unaware of potential conflicts-of- interest . Most retail investors incorrectly believe their adviser has a legal duty to put their interest ahead of his or her own. According to the study, most retail investors are not aware of what products their advisers are licensed or registered to sell. Such blind trust can be hazardous to the financial health of investors. A summary of the IEF report is available online at http://www.getsmarteraboutmoney.ca/en/research/Our-research/Pages/Investor-behaviour-and-beliefs.aspx

Besides civil law, there are regulatory requirements that a registered individual deal fairly, honestly and in good faith with his or her clients. Self-regulatory organizations (SROs) such as the Mutual Fund Dealers Association (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) require that investment professionals observe high standards of ethics and not engage in any business conduct which is unbecoming or detrimental to the public interest; and be of such character and business repute as is consistent with the standards of the rule. In March this year, IIROC announced several incremental changes under its Client Relationship Model. The enhancements aim to increase transparency for investors surrounding the fees they pay, the services they receive, potential conflicts-of- interest and the performance of their accounts. Some of the new requirements take effect immediately, while others will be phased in over the next two years. To the dismay of investor advocates, IIROC, at the request of the Canadian securities regulators, has suspended the implementation of the performance-reporting requirements, one of the most important of the changes. With all this wonderful protective legal and regulatory infrastructure in place, it is posited that a fiduciary standard is redundant.

Indeed, industry participants argue that their industry is heavily regulated and that investor protection is already robust. Fund industry lobbyist IFIC publishes survey data suggesting mutual fund investors are a satisfied lot (despite paying the highest fund fees in the world). Firms argue that under a nondiscretionary account, it's the client's responsibility to do due diligence and shop around for the best price. Dealers claim to provide lower-cost advisory services, offset by transaction fees, for customers who do not wish to pay, or cannot afford to pay, the higher direct fees charged by qualified fee-paid advisers. It's argued that mandated disclosures are doing the job. It's posited that the application of a standard of care that assumes a fiduciary relationship between registered representative and clients may constrain the ability to make product recommendations and limit the range of available financial products. Financial literacy initiatives by Government are really what's needed say industry leaders. In any event, they argue a fiduciary obligation won't protect investors from fraudsters and Ponzi schemers. - Firms say regulators should focus on tackling the unregistered scammers who have caused big investment fraud scandals in recent years.

Investor advocates counter that complex, high-priced products are eroding retirement savings. When salespeople are called - and viewed as - "advisers," the public can be led into thinking they are being told what is best for them when in fact that is not the case. Abuses ranging from unsuitable investments (the #1 cause of complaints) and excessive leveraging to account churning are not uncommon. Advocates see lax enforcement of weak regulations. Industry opposition and stonewalling to proposed pro-investor regulatory reforms are evident at every turn. Advocates see wrist-slap penalties imposed on advisers with little in fines imposed actually collected. Numerous studies are cited that show that disclosure alone is not adequate protection for retail investors. A number of investor advocates believe that it is unethical to lead customers into a false sense of trust and confidence, using a false license (labelling oneself with a title for which no actual license exists) , and false pretences of what the business relationship truly is (seller-buyer) while purporting to deliver some kind of professional advice. The very public attack on the Ombudsman for Banking Services and Investments highlights the knee jerk anti-investor behaviour of the financial services industry. In a climate like this, caveat emptor (buyer beware) is the only defense for the investor but, as we have seen, most retail investors are not qualified by themselves to manage their investments. That's why they seek advice!

To address the obvious problems, the OSC published a concept paper, the "Fair Dealing Model." (FDM), way back in 2004 for comment .The paper publicly acknowledged that the prevailing regulatory framework - regulating dealers and their advisers through the products they sell - was based on the outdated notion that transaction execution is the primary reason Canadians seek financial services. The FDM approach proposed reforming the regulatory framework to focus on the advisory relationship. Under the current distribution system, few "advisers "are compensated directly for advice provided. In the case of mutual funds, a $700 billion industry, sales commissions are embedded in the price- commissions are paid only if "advisers "sell specific funds. Addressing the inherent conflicts- of -interest that arise from commission-based compensation, the FDM proposed that retail clients should be entitled to rely on objective advice that is in their best interest and, when there are conflicts-of- interest, they should be clearly disclosed so that the client is aware of the conflicts and how they may impact the recommendations provided. One of the obvious recommendations (regarded as extreme by advisers!) Was that investors should be provided their personal rates of return. Strong industry objections and a cool reception from other regulators killed the "Client First" reforms stillborn. Over the years the FDM has fragmented into solo efforts undertaken by the OSC, the IIROC, the MFDA and the Canadian Securities Administrators (CSA), the umbrella group for Canada's 13 provincial and territorial securities regulators. The multi-pronged effort has so far delivered diluted results and continued dismay among those trying to protect the interests of investors.

Recognizing this, the OSC announced on March 30th, this year that --after more than a decade of abundant evidence supporting the need for a fiduciary standard, a decade in which many investors' dreams were destroyed by bad financial advice – that it intends yet again to re-evaluate the adviser-client relationship. The OSC promises to consider again whether an explicit statutory fiduciary duty or other standards should apply to all advisers and dealers in Ontario.

There is overwhelming evidence that regulatory reforms are needed. As the Canadian Association of Retired Persons outlined in their 2011 Annual Report, for many of the older Canadians who come to them, the financial harm suffered when a bank or investment firm makes a mistake is magnified by having fewer years to make up the losses and fewer income or job opportunities. The issues have been known for years. Given Canadian demographics, the skewed "advice" problem is expected to grow exponentially over the next decade. Investor protection is not sufficiently robust under the suitability standard. Products are increasingly complex and not understood by most investors. Financial contracts are often unintelligible, preprinted and nonnegotiable, exacerbating the investor disadvantage.

In a commission-focused transaction (with only the suitability rules in play), the client often comes out on the short end of the "conflict-of- interest" stick. Note though that factors other than remuneration are the financial literacy of clients, cost transparency, handling of complex products, adviser qualifications and other internal incentive systems can also influence outcomes. The high level of unsubstantiated trust and a misunderstanding of the client- adviser relationship make retail investors, especially seniors, vulnerable to an array of sophisticated marketing and sales ploys.

Workplace pensions are no longer the norm in the private sector as companies continue to scrap predictable Defined Benefit plans. Ottawa has essentially pushed a trusting aging population into the—frequently untrustworthy—arms of the financial services industry. RRSPs, TFSAs, RESPs as well as the newly created pooled registered pension plans (for employees of small businesses) all encourage private savings, typically managed by financial advisers. People are living longer. If the current exploitative situation prevails, there will inevitably be a tremendous call on already burdened government social/pension programs. That's why there needs to be a very urgent push for a fiduciary standard —or at the very least—a "Best Interest" standard to protect investors.

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