Investor Protection -
Why I Would Bet on Courts over Regulators

Lecture by Edward Waitzer
Allard School of Law, University of British Columbia
November 10, 2016

I'm hoping to persuade you today of a somewhat provocative and lamentable proposition - that the Canadian Securities Administrators suffer from an increasingly prevalent form of democratic paralysis, the result of which is they have largely lost their ability to be responsive to the reasonable expectations of investors when it comes to substantive policy decision-making (i.e., where competing interests are at stake). By default, I predict, our courts will step into the breach. Not an optimal outcome, but one that highlights the challenge of legislative and regulatory processes responding to systemic risks. To illustrate, I will focus on a "current" initiative of the CSA to implement a "best interest" standard. To do so, I must digress.

In 1994, as Chair of the Ontario Securities Commission, I asked one of our Commissioners to undertake a review of regulatory issues facing what was then a rapidly growing investment fund industry. The initiative, opposed by the industry, was an attempt to anticipate and address regulatory concerns. Commissioner Stromberg's Report, released in January 1995, highlighted inherent conflicts of interest with respect to the structuring and management of investment funds and the sale of securities generally – all resulting in the interests of consumers not being placed first. She also noted the inadequacy of the training and proficiency of many of those who sell and management investment funds. Her proposals addressed these conflicts of interest and proficiency gaps.

More than twenty years later, the CSA is still studying these issues. Many in the industry continue to argue that it is the client's responsibility to do their homework.

Should caveat emptor apply when buyers think they are hiring a professional to help them do the shopping?

With the passage of time, the significance of the issues highlighted in the Stromberg Report has taken on systemic implications. For one, a strong financial-services sector depends on public trust. This has been seriously eroded and is unlikely to be restored (nor a sound regulatory framework built) unless investors are entitled to expect that the financial professionals they rely upon are proficient and will be held accountable to a uniform best-interest standard. As importantly, the lack of workplace pension coverage for the majority of Canadian workers, coupled with the on-going transfer of wealth from savers to the financial sector through high investment fees, have become challenges to the adequacy of retirement income savings. Asset management has become a significant, high margin business for the financial services sector. So, not surprisingly, regulatory reform remains in low gear and, at the systemic level, we continue to punt issues of intergenerational equity down the road.

The notion that financial professionals must act in the best interest of their clients and make full disclosure, particularly regarding conflicts of interest, is long overdue. The need for such core principles has been recognized in most other mature market economies. The suggestion by some Canadian securities regulators (responding to pressure from the financial sector) is that incremental rules, in the absence of strong foundational principles, may be sufficient. The result, if this approach is taken, will defer practical solutions and raise expectations, which will inevitably be disappointed.

Why has this issue remained in "spin cycle" for over twenty years, even as the logic of regulatory reform becomes increasingly compelling? When it comes to issues of investor protection there are many analogs. Consider, for example, the recent request by Senator Warren that President Obama remove the Chair of the U.S.

Securities and Exchange Commission who, since her appointment, has resisted instructions to develop a political spending disclosure rule, despite her clear authority to do so. The need for such a rule resulted from the U.S. Supreme Court's Citizens United decision in 2010, which facilitated unlimited political spending by corporations. Even the majority of the Court which gave effect to that result expressed strong support for public disclosure of such corporate spending. Yet, in the face of narrow but powerful interests, transparency with respect to political spending has been frustrated.

My fundamental argument to you today is that in a time of "thin" political markets – where governments appear increasingly incapable of tackling long-term, systemic policy issues because of the short-term incentives that motivate political processes – the tension between public expectations and legislative (and regulatory) responsiveness becomes more severe and a growing role emerges for our courts to use the open-ended concept of "reasonable expectations" to create and modify legal standards and forge new and often radical legal pathways. Hence my prediction that judicial activism will likely trump securities regulation (and traditional notions of contract law) in addressing the "best interest" challenge that seems to continue to vex the CSA.

To help convince you of my prediction (and that it is not a particularly novel idea), I propose to consider several cases that span over a century of jurisprudence. I'll start though by briefly framing the animating principles which, I believe, predict the trajectory of the law. Again, I'm going to be selective and provocative, and am hoping that some of you will take a different view, so that we can have a good discussion.

Protecting reasonable expectations is a central organizing principle for many (if not most) legal rules in common law systems. The standard is applied unevenly – private law generally emphasizes the more subjective aspect of expectations (i.e., the

expectations of particular stakeholders), while public law tends to focus more on objective "reasonableness" (viewed from the perspective of society as a whole).

By definition, reasonable expectations mean more than the current law. As the Supreme Court of Canada stated in its BCE decision, the doctrine "looks beyond legality to what is fair, given all of the interests at play" to address conduct that is "wrongful, even if it is not actually unlawful". Contextual and dynamic, reasonable expectations can be thought of as legal polly filla – moulding around other structures to plug the gaps. This engenders reasonable expectations in and of itself!

While there is a wide range of contexts in which courts make use of reasonable expectations, I have suggested elsewhere that the doctrine has been used to achieve objectives that are remarkably consistent. First, to require powerful public and private actors to treat others fairly – i.e., with honesty and avoiding actions that would impose unnecessary or disproportionate costs on others. Second, to uphold the integrity of legal regimes (and, through them, social institutions) – i.e., sanctioning tactics that frustrate the purpose of a legal, regulatory or social norm by allowing an actor to avoid obligations associate with that norm.

With that context in mind, let's begin our case law journey with a classic contract dispute, the Supreme Court of Canada's decision in *Hobbs v Esquimalt and Nanaimo Railway Co.* (1889). Hobbs had entered into a contract to buy certain lands from the Railway. The agreement was for an unconditional sale but the Railway subsequently contended that its conveyance was intended to apply only to the land, and not to the underlying mineral rights. Hobbs' claim for specific performance was upheld, with the Court rejecting the Railway's argument that the contract should have been void by virtue of mistake. The test applied was what would a reasonable person in Hobbs' position think the terms meant. Given that the alleged mistake was unreasonable and careless, the Court was prepared to enforce specific performance as a matter of fairness. That is contract law in a nutshell!

For a tort law analog, let me jump ahead to a 1932 decision of Justice Learned Hand in the U.S. 2nd Circuit, which provides another example of how reasonable expectations have been used to prevent the imposition of unnecessary costs on others. In *The T.J. Hooper* case, tugboat owners were found liable for loss of cargos in a nor'easter because they hadn't issued to operators what were then newly developed short-wave receivers. At the time, this device was a rarity on tugs. However, had the operators possessed them, they surely would have picked up weather reports warning of a storm and sought refuge on the inland waterway. Here is the crucial finding of that great jurist:

> *"Indeed, in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It may never set its own tests, however persuasive be its usages.* ***Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission."***

In addition to imposing a duty to minimize the costs one imposes on others, fair treatment also entails standards of honest conduct. Consider, for example, the 1994 Supreme Court of Canada decision in *Hodgkinson v. Simms*. There, La Forest J. observed that "until recently the fiduciary duty could be described as a legal obligation in search of a principle". To the extent that may have been the case, our Supreme Court (largely as a result of its role in determining the legal relationship between the Crown and First Nations) has certainly not shied away from articulating dominant themes in fiduciary law over the last several decades.

In *Hodgkinson*, a successful Vancouver stockbroker sought tax-planning advice from his accountant, who specialized in such matters. The accountant invested on his behalf in a series of tax-sheltered residential developments, without disclosing to

Hodgkinson the fact that he received commissions from the developer for every investment made. Hodgkinson lost heavily in the real estate crash of the early 1980s. In deciding in Hodgkinson's favour, La Forest said the question is whether one party could reasonably have expected that the other party would act in the former's best interest with respect to the subject matter at issue. In other words, a party who expects the other to act in its best interest can be excused from the responsibility of taking measures to protect itself from harm. Hodgkinson's reliance on Simms created a fiduciary relationship and imposed on Simms the duty of loyalty. It was a breach of that duty not to disclose his relationship with the developers.

Of interest is the effort made by La Forest J. to justify this principle by reference to considerations of social policy. He said:

> *"The desire to protect and reinforce the integrity of social institutions and enterprises is prevalent throughout fiduciary law. The reason for this desire is that the law has recognized the importance of instilling in our social institutions and enterprises some recognition that not all [business] relationships are characterized by a duty of mutual autonomy, and that the marketplace cannot always set the rules."*

I would be remiss if I didn't also point out that the concurring decision of Sopinka J. and McLachlin J. questioned whether advice as to how to add to one's personal wealth while paying the least amount of tax invokes a legitimate public policy concern. That said, the analogy between the facts in *Hodgkinson* and the policy concerns underlying a "best-interest" standard for investors is striking.

In *Cabell v. Personal Insurance Co.*, the Ontario Court of Appeal (2011) noted that, where the plain terms of an exclusion within an insurance policy operate in such a way as to nullify the type of coverage that the parties reasonably expected would

have flowed from the policy, the contractual terms will yield to the reasonable expectations of the parties. Because the disclaimer in the policy covered the most obvious risks that could result in damage to an outdoor swimming pool, giving effect to it would have frustrated the purpose for which the insurance policy was purchased. The Court refused to do so, and required the insurer to compensate the insured for the damage. More recently, legislative reforms in British Columbia and Alberta have explicitly authorized courts to set aside insurance policy exclusions, in whole or in part, where these exclusions are unreasonable or contrary to public policy.

Again, the analogy to the sale of "hazardous" financial products and services is striking.

A more recent contract case addressing the duty of fair treatment is the Supreme Court of Canada's decision in *Bhasin v. Hrynew*. Here the Court, citing the "reasonable expectations" of commercial parties, recognized a "general duty of honest contractual performance". The Court was careful to explain that this duty does not require contracting parties to "put the interests of the other contracting party first" or to "forego advantages flowing from the contract". Rather, it simply requires that that the party to a contract not "lie or otherwise knowingly mislead [the other party] about matters directly linked to the performance of the contract".

While *Bhasin* is regarded as a landmark case in Canada, the principles it enunciates would hardly be viewed as controversial in the United States or Europe, where a duty of honest contractual performance has long been recognized. Indeed, the concept of "good faith" which is central to the interpretation of contracts in Quebec, has long been instrumental in preventing contractual parties from avoiding obligations that flow from the purpose of their contract.

I have been involved in such a case, where Churchill Falls (a Newfoundland crown corporation) is currently seeking leave to appeal to the Supreme Court of Canada.

In the 1960s, Churchill Falls joined forces with Hydro Quebec to build the then largest power plant in North America on the Upper Churchill River in Labrador. To do so, the parties entered into a long-term contract under which Hydro Quebec committed to purchase in excess of 85% of the power produced by Churchill Falls. At the time, the value of energy was solely a function of its cost to produce, which was the basis on which the contract was priced through 2041. While no windfalls were intended (the rate was to be adjusted up or down based on actual costs), the cost-base paradigm gave way to competitive markets after the oil price shocks in the '70s. As a result, by 1989, Hydro Quebec estimated that for the $5.8 billion it would pay for energy over the life of the contract, it would obtain a value of $450 billion (in 1989 dollars). While the original contract contemplated that this energy was to satisfy Quebec's requirements, most of this electricity is now being exported by Hydro Quebec to the U.S. for significant profit.

Churchill Falls has argued that there is a heightened duty to cooperate in long-term, interdependent "relational" contracts under Quebec civil law; that the duty of good faith articulated in the Bhasin judgment is, in civil law, more than just an organizing principle but, rather, a general legal obligation in its own right. Hundreds of billions of dollars and significant political relationships are at stake.

Likewise when it comes to a "best interest" standard for consumers of financial products and services. The difference being the Supreme Court will now decide whether to hear the appeal and, if so, determine the dispute (and make law), all in a fixed time frame.

Back then, to the "best interest" standard still being mooted by certain of the CSA. As I alluded to at the outset of my remarks, British Columbia Securities Commission and certain other provincial regulators have taken the view that such a standard remains "a bridge too far" and, instead, have proposed "targeted reforms" with respect to conflicts of interest, suitability and proficiency requirements. Their

suggestion is that the proposed targeted reforms be implemented first and a best interest standard be left for a later date.

Best interest standards have been adopted in the U.K., Australia, Europe and the U.S. All recognize that we are shifting from being a “contract society” – which values economic independence and bargaining between equal parties – to a “fiduciary society” – which values interdependence and reliance on the services of specialists. In the latter, legal regimes **must**, in the absence of any practical mechanisms by which lay persons can supervise the work of the specialists they hire, provide protections that encourage individuals to trust that the specialists they rely upon will keep their best interest at heart.

Ironically, even securities regulators themselves have increasingly resorted to favouring “judicial activism” over rule-making. Consider their use of “public interest” powers over the last thirty years. In *Canadian Tire*, the Ontario Securities Commission noted that a breach of securities laws is not a precondition to a public interest order and characterized as “facts that demand some relief” cases involving “an abusive transaction that will have a deleterious effect on a class of investors in particular, or on capital markets in general”, or “a transaction that is clearly abusive of investors and of the capital markets, whether or not that transaction constitutes a breach of the act, the regulations or policy statement”. Since then, the OSC has exercised its public interest jurisdiction in a wide range of take-over and enforcement decisions. The Commission has even been prepared to invoke the “public interest” to make determinations with respect to the exercise by directors of their statutory duties under corporate law – a subject not addressed in securities legislation and, arguably, beyond their jurisdictional remit! The exercise of such jurisdiction has been premised on the “justifiable expectations” of investors and the marketplace.

So, let's take stock. It has become challenging, if not impossible, to advance substantive regulatory initiatives within a reasonable timeframe in the face of concentrated opposition. When it comes to securities regulation, the "best interest" standard isn't an isolated example. Consider, for example, point of sale disclosure – a proposal that was relatively uncontroversial but took ten years to implement. Or disclosure by fund managers of holdings in their own funds – mandated in the U.S. over a decade ago and a direct indication of a manager's alignment with the interest of investors.. Just two weeks ago an OSC spokesperson suggested in the Globe & Mail that such a requirement was barred by privacy laws?

Or consider various proposals for a national securities regulator – again, a project, the merits of which are intuitively obvious but that I've been involved with since the beginning my legal career forty years ago. Indeed, the lack of a national regulator is, itself, a barrier to timely and coordinated rule-making.

By the time substantive regulatory initiatives are implemented, many are no longer relevant or responsive to current market challenges. We're left with outmoded regulatory instruments and frameworks. Often it's not even a matter of playing catch-up but, rather, of playing make believe. The overwhelming sense with respect to many regulatory initiatives has become one of maintaining appearances.

Hopefully you now see my argument that, absent some mechanism to accelerate regulatory reform and responsiveness, judicial activism is likely to carry the day. To be clear, it is not without challenges – consider, for example, the costs of seeking judicial relief, the lack of specialized judicial expertise or accountability, the lack of due process that is the hallmark of legislative and administrative policy-making and the tendency of "bad facts" make "bad law".

On the other hand, courts are attuned to reasonable expectations. That is something our regulatory and legislative processes appear increasingly incapable of doing.

Hence my bet that, when it comes to systemic issues, judicial activism will increasingly trump legislative or regulatory reforms.