Walton
Investing on Solid Ground®

VIA EMAIL

February 22, 2013

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

Dear Sir or Madam:

Re: CSA Consultation Paper 33-403

This letter is provided by Walton Capital Management Inc. ("**Walton**") in response to the Request for Comment by the Canadian Securities Administrators (the "**CSA**") in relation to the proposed adoption of a fiduciary standard of care for all Canadian financial advisors and securities dealers.

Walton is registered as an exempt market dealer under NI 31-103 in all provinces in Canada. Walton currently has 75 dealing representatives and offers for sale prospectus-exempt real estate investments manufactured by entities in the Walton Group of Companies to qualified investors resident in Canada. These investments include pre-development and development land securities products.

Walton has a number of concerns with the proposal described in Consultation Paper 33-403 (the "**Consultation Paper**"). Walton's key concerns are set out below in response to a number of the specific questions raised by the CSA.

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?

Walton disagrees with the imposition of a universal fiduciary best interest standard. Fiduciary relationships under Canadian common law arise in limited circumstances, and Canadian courts have developed a series of factors that must be in place before fiduciary obligations will be imposed. These indicia trigger these fiduciary obligations in equity, and define their content and the fiduciary's standard of conduct. Simply imposing fiduciary duties by regulation without consideration of the relevant context will result in a largely unworkable standard.

In addition, adopting a fiduciary standard that is to be governed exclusively by the courts, rather than providing a coherent set of detailed prescriptive rules, will add a considerable and

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disproportionate degree of uncertainty and risk to the day to day affairs of the affected advisers and dealers. Canadian courts are not necessarily familiar with the practical realities of the securities industry and indeed, in the course of a particular legal proceeding, will not take into account the impact a particular decision may have on the securities industry. This is not the job of the courts; it is the job of the securities regulators in Canada. Unpredictable decisions issued by the courts in the context of what is proposed by the CSA may impose unanticipated disproportionate burdens or affect entire business models in a manner not contemplated by the CSA and without any input from or consultation with the numerous affected parties. Simply put, the CSA will not have control over how the courts handle the imposition of fiduciary duties on dealers and advisors or how it impacts the securities industry as a whole.

Further, the equitable remedies available to the courts for the breach of a fiduciary duty will be inappropriate in circumstances where a fiduciary duty is imposed by regulation but would not have been imposed under common law. These equitable remedies were developed by the courts to address the circumstantial factors that give rise to a fiduciary relationship under common law, such as vulnerability, power or discretion over a beneficiary's affairs and an undertaking by the fiduciary to act in the beneficiary's best interests. The application of equitable obligations to parties who would not otherwise have been subject to such a standard will impose unduly harsh remedies on dealers. For instance, equity permits the recovery of windfall awards by unharmed plaintiffs in the event of a nominal fiduciary breach. Awards such as these will be inappropriate in many circumstances, and could be abused by sophisticated investors.

These grounds of objection are set out in greater detail below in response to selected questions raised by the CSA in the Consultation Paper.

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?

Provides a more principled foundation for client relationship

While certain relationships, such as that between a lawyer and client or a trustee and beneficiary, are always fiduciary relationships, Canadian common law requires a detailed analysis of other relationships before imposing fiduciary duties. In addition to the commonly referenced considerations of vulnerability, trust, reliance and discretion, equity contemplates that a given party will have agreed to act in utmost good faith in relation to another before their relationship can be considered a fiduciary one. Imposing a fiduciary obligation on all advisors and dealers without taking the circumstances of the particular client/dealer relationship in issue into account will not result in a principled foundation to such relationships. Such an approach will, in fact, be definitively unprincipled.

Equity considers a party's undertaking to act in utmost good faith towards another as integral to the imposition of fiduciary obligations. Absent such an undertaking, or absent the other hallmarks of a fiduciary relationship that are required under common law, there is no principled basis upon which to impose the equitable standard of utmost good faith. The Supreme Court of Canada made this precise point in *Hodgkinson v. Simms*, in the specific context of financial advisers and stock brokers, after citing the decision of Keenan J. in *Varcoe v. Sterling*, (1992), 7 OR (3d) 204 (Gen. Div.) for a summary of the law governing fiduciary relationships in this context:

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> 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 client's trust and confidence and undertakes to advise, the broker must do so fully, honestly and in good faith... It is the trust and reliance placed by the client which gives to 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.

...

In my view, this passage represents an accurate statement of fiduciary law in the context of independent professional advisory relationships, whether the advisers be accountants, stockbrokers, bankers or investment counselors. <u>Moreover, it states a principled and workable doctrinal approach. Thus, where a fiduciary duty is claimed in the context of a financial advisory relationship, it is at all events a question of fact as to whether the parties' relationship was such as to give rise to a fiduciary duty on the part of the advisor</u> (Emphasis added).

- *Hodgkinson v. Simms*, [1994] 3 SCR 377 at para. 44.

Accordingly, the unilateral application of a fiduciary duty to all financial advisors or brokers, regardless of the particular circumstances of a given relationship, and in situations in which no power or discretion is given to the broker does not give rise to a "principled foundation" to the client relationship. In fact, imposing such responsibilities in the absence of these considerations makes the contents of the duty difficult to articulate and apply and, in many cases, makes the remedies available against the registered dealer inappropriate, harsh and disproportionate.

Eliminates any legal uncertainty whether a fiduciary duty exists

The circumstances and factors considered under common law in determining whether or not a fiduciary duty exists serve to both trigger fiduciary obligations and to define their scope and content. It is, consequently, not obvious that the elimination of the "legal uncertainty" as to whether a fiduciary duty exists in a given instance could be said to be a "benefit" of the proposed standard. If anything, the universal application of a fiduciary duty without consideration of the relevant circumstances will likely lead to significant difficulties in defining and applying the content of the applicable standard of care and, as a result, cause significant uncertainty in the Canadian capital markets.

The above-stated benefit presupposes that the current state of the law creates uncertainy as to when a fiduciary duty exists. Under Canadian common law, the considerations and factors that properly give rise to a fiduciary duty in the context of brokers and financial advisors have been widely canvassed. These requirements, when present, already provide a consistent and reasonably certain basis for the imposition of a fiduciary duty and define its contents. The test has been canvassed in numerous decisions. As stated by the Ontario Superior Court, a fiduciary relationship requires, among other things, trust and reliance:

> The relationship of a broker and client is not *per se* a fiduciary relationship. Where the elements of trust, confidence, reliance on skill and knowledge and advice are present, the relationship is fiduciary...

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- *Davidson v. Noram Capital Management Inc.* (2005), 13 BLR (4th) 35 (ONSC) at para. 47.

Further, fiduciary law is primarily concerned with circumstances where a beneficiary grants a discretionary power over his or her interests or affairs to another party. The Supreme Court of Canada has expressly ruled that the absence of such a grant negates the possibility of a fiduciary duty existing under Canadian law:

> It is fundamental to the existence of any fiduciary obligation that the fiduciary has a discretionary power to affect the other party's legal or practical interests…
>
> …
>
> While what is sufficient to constitute power in the hands of the fiduciary may be controversial in some cases, the requirement for the existence of such power in the fiduciary's hands is not. The presence of this sort of power will not necessarily on its own support the existence of an *ad hoc* fiduciary duty; its absence, however, negates the existence of such a duty. (Emphasis added).

- *Galambos v. Perez*, [2009] 3 SCR 247 at paras. 83, 84.

In addition, fiduciary obligations in this context are contingent upon an undertaking by the broker or advisor to accept the client's trust and to advise the client fully, honestly and in utmost good faith:

> 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 client's trust and confidence and undertakes to advise, the broker must do so fully, honestly and in good faith... It is the trust and reliance placed by the client which gives to 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 the broker fails to honour that trust or betrays the trust by taking advantage of the client, the broker has breached that fiduciary duty.

- *Srdarev v. McLeod Young Weir Ltd.* (1992) O.J. No. 70 p 8-10.

The factors and considerations set out above not only trigger the imposition of fiduciary obligations in equity, but also define the content the resulting duty. Where an advisor has been granted a degree of power or discretion over a client in relation to a specific decision or matter, the exercise of that power is subsequently subject to a duty of utmost good faith. Applying a fiduciary duty in relation to a broker's exercise of power or discretion over a client's affairs is consequently a relatively straightforward matter, and fiduciary law in Canada has evolved to define and clarify the nature and limits of the duty in those circumstances. However, where no such power has been granted, and the broker in issue has no discretion or power in relation to the client's affairs, fiduciary law cannot offer any guidance on the contents of the duty: equity would simply never have imposed such obligations. As a consequence, attempts to define the scope of the duty in the context of inappropriate circumstances will most likely lead to unprincipled and unpredictable results.

In the absence of the required hallmarks of a fiduciary relationship, the precise content of a given fiduciary duty under the proposed standard will be unclear. For instance, when a fiduciary

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duty is imposed specifically because a vulnerable client has given discretion over his or her financial affairs to an advisor, who has agreed to act in that capacity, it is clear that the advisor then owes a duty of utmost good faith in relation to the exercise of that discretion. If, by way of contrast, a sophisticated investor approaches and purchases the sole product currently being offered by an exempt market dealer, what is the scope of the duty owed by the dealer? Is the duty simply akin to a heightened suitability analysis in relation to that sole product? Or does the dealer have an obligation to advise the investor that other products available in the marketplace may better suit the investor's "best interests"? As a corollary, will such a dealer be obligated, as a fiduciary, to investigate the alternative products available on the market, although the dealing representative is not permitted to sell those other products or licensed to provide such advice? As the role currently performed by such a dealer is with respect to the particulars of a single investment product, it is difficult, if not impossible, to articulate the content of a fiduciary duty imposed in those circumstances. In many such cases, the imposition of an unprincipled fiduciary duty will render the nature and content of the duty unclear or entirely unworkable.

Principle-based approach alleviates need for detailed prescriptive rules

As discussed above, a statutory best interest standard in the circumstances where one would not have been imposed under common law is not a principle-based approach. In fact, the unprincipled nature of such a standard would inevitably increase the need for detailed prescriptive rules, as an otherwise unclear duty will need to be defined and articulated in cases where a fiduciary duty would not otherwise have applied. While the Consultation Paper suggests that "the inherent flexibility and fluidity of the fiduciary duty doctrine" which is "applied so often by judges in various circumstances" would alleviate the need for such detailed rules, Canadian jurisprudence has simply not considered the scope of a "universal" fiduciary duty in an otherwise inappropriate context. Existing court decisions may provide little or no assistance and may lead to significant uncertainty as to what is required by the broker to comply with the standard.

Further, it is difficult to perceive how the delegation of such a large area of regulatory responsibility by the securities commissions to the courts can be said to be a "benefit" to any of the parties involved. As indicated above, the courts may inconsistently apply a given rule or standard, and behavior regulated solely by the courts will inevitably be subject to a significant degree of uncertainty. Rather than relying on guidance provided by a codified set of rules designed by a well-informed regulator, advisors and clients will likely be required to obtain legal advice in relation to any and all conduct subject to the new standard. Requiring every broker, dealer and advisor to become intimately familiar with the evolving principles of Canadian fiduciary law will in many cases impose a significant burden.

As indicated above, adopting a standard governed entirely by the courts may have unintended consequences should a given court reach an unanticipated decision in relation to the proposed standard. There is no obligation on the courts to consider, or even be familiar with, the practical realities or business models employed within the Canadian securities industry. It is conceivable that an overreaching decision by the Court of Appeal in a given province, for instance, could substantially prejudice the securities industry as a whole, which could only be remedied by the drafting and implementation of new legislation, which could take years. The likelihood of such a decision is actually significantly increased by the proposed standard, which requires the courts to interpret and apply equitable obligations to factual situations which would not have given rise to fiduciary obligations under common law.

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Strengthens legal remedy to retail clients for breach of fiduciary duty

Equity provides for a wide range of remedies for the breach of a fiduciary duty. Many of these remedies are highly advantageous for a plaintiff beneficiary, and are specifically intended to punish and deter a fiduciary from breaching his or her undertaking to act solely in the beneficiary's best interests. In the event that fiduciary obligations are imposed absent this undertaking, or any other common law indicia of a fiduciary relationship, the remedies in many cases will be inappropriate and harsh to dealers, and potentially subject to abuse by clients.

Once a fiduciary duty exists, violations of the duty are viewed on a standard akin to strict liability. Where a fiduciary acts in a manner contrary to a beneficiary's best interests, the fiduciary's motives are irrelevant and it is the mere fact of the breach that gives rise to liability:

> The law requires the fiduciary to act in a manner consistent with the best interests of the beneficiary in all matters related to the undertaking of trust and confidence. As a corollary to the heightened degree of loyalty required, <u>the actions of the fiduciary will be viewed with a strictness unknown to most other areas of law</u>. It is the fact of a departure from adherence to the beneficiary's best interests, rather than an evaluation of the fiduciary's motive in the departure, that constitutes a breach of fiduciary duty (Emphasis Added).
>
> - M. V. Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Carswell, 1988) at p 1-3.

As a result of this strict liability approach to breaches of fiduciary duty, it <u>is irrelevant whether or not the client has in fact suffered harm, or even gained a profit through the transaction in issue</u>. Consequently, an advisor or dealer who recommends an ultimately successful investment product but who fails to advise as to a product which could be seen as better suited to the client's "best interests" may nevertheless be successfully brought to court for breach of his or her fiduciary duty:

> As a corollary to the irrelevance of good faith, the fact that the transaction that is impugned actually has a beneficial effect for the beneficiary will not assist the defaulting fiduciary…
>
> - M. V. Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Carswell, 1988) at p 1-4.

In the event that the hypothetical dealer above received a commission in relation to the impugned, yet ultimately successful, investment, equity could require the disgorgement of the dealer's "profits" (i.e., commissions) to the beneficiary. Because a true fiduciary relationship is based on an imbalance of power and an undertaking to act selflessly, equity does not consider the beneficiary's windfall to be an obstacle to such a remedy.

As the example above suggests, a misplaced fiduciary duty may be subject to considerable abuse. Under Canadian law as it currently pertains to fiduciary obligations, an exempt market dealer selling a single product to a sophisticated client, without discretion or the reposing of trust and confidence, would not be subject to a fiduciary duty. Certainly, no remedies would be available simply because another investment product available on the market outperformed the otherwise successful investment product sold by the dealer. Under the standard proposed by the CSA, however, a fiduciary duty would be applied and an opportunistic client would be able to take the broker to court and seek the disgorgement of the broker's commissions, or other forms of volume-based compensation, on the basis that the failure to recommend the alternate

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product constituted a breach of the broker's fiduciary duty to act in the client's best interests. Further, the client would have the ability to seek compensation for any lost gains in relation to the more successful investment. The resolution of such a claim would be contingent upon the precise facts in issue, of course, but also upon the scope and content of the fiduciary duties imposed by the proposed standard, which, as set out above, are unclear.

In addition to permitting potential windfalls for unharmed beneficiaries, certain defences permitted under the common law are disregarded by equity in the context of a fiduciary breach. In the event that a client were to suffer a loss that was only loosely associated with the breach of a fiduciary duty, the advisor or dealer would not be permitted to defend itself on the basis that the client's losses would have been suffered whether or not the breach had been committed:

> Under a doctrine not dissimilar to the irrelevance of good faith, the fiduciary is not entitled to allege that the loss resulting from the breach would have occurred notwithstanding the breach. The premise for such a rule flows from the strictness, again, with which the activities of the fiduciary will be viewed; any deviation from the high duty of loyalty will meet with such judicial distaste that a defence on the basis that damages would have flowed notwithstanding the breach will not be entertained by the Court…
>
> …
>
> Practically, this approach alleviates against a requirement that the complaining party tie the loss to the breach and, where the breach and the related loss occur, the defaulting party is stopped from arguing the inevitability of the loss.
>
> - M. V. Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Carswell, 1988) at P 1-4.1 and 20-5 to 20-6

This is a harsh rule, but is justified on the basis that equity will go to great lengths to enforce a fiduciary's undertaking to act solely in a beneficiary's best interests.

In practice, such a rule may permit a client to sue his or her dealer for losses on an investment on the basis of any fiduciary breach, even where the breach was not the cause of the loss. For instance, a commission paid on the sale of an ultimately poorly performing product, held to be a conflict of interest and a fiduciary breach by the courts, could result in damages to the full extent of any losses suffered in relation to the investment in issue. It would be irrelevant to the courts in such an instance that the investment's poor performance was due to a market crash, and that virtually any product available to the client would have resulted in a loss. Further, and as noted above, the dealer may also be required to disgorge the commission to the client, resulting in a windfall. In the context of a sophisticated client purchasing the only product offered by an exempt market dealer, and the only product the dealing representative is proficient to sell, the remedies described above are inappropriate and unwarranted.

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?

The law in Canada currently prohibits even potential conflicts of interest in the context of a fiduciary relationship. It appears clear that compensation structures such as embedded commissions or volume based payments would be barred under the proposed standard:

> In essence, the law requires the individual subject to the duty to scrupulously avoid placing himself in a possible or potential conflict of interest. Therefore, the

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> fact that a conflict could have arisen, but did not, does not exculpate the fiduciary from wrongdoing... Entering into a *potential* conflict of interest is a breach whether or not the conflict is operative; once such a conflict becomes operative to jeopardize the beneficiary or his property, the fiduciary breach would then give rise to the remedies available in law.
>
> - M. V. Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Carswell, 1988) at P 1-5

It should be noted that dealing representatives in the exempt market context will in most cases be paid by way of embedded commissions. As a result, many exempt market dealers would be required to completely overhaul their financial relationship with their dealer representatives in order to avoid conflicts of interest arising as a result of the payment of commissions.

In our assessment, there is no ascertainable benefit to effectively prohibiting commissions in relation to the sole investment product offered by an exempt market dealer, or in circumstances where such a dealer offers only a limited range of similar products. Where a proper fiduciary relationship arises and an advisor or dealer has been granted power or discretion over a client's business affairs, prohibiting the receipt of commissions becomes appropriate: as a fiduciary, the advisor is properly required to avoid even potential conflicts of interest, and a commission earned on a particular product amongst a range of products creates a conflict of interest. However, where a dealing representative only sells a single product, and has no discretion, power or ability to sell any other product to that client, imposing a fiduciary duty and prohibiting a commission on that product serves no purpose.

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

The adoption of the proposed standard will likely lead to considerable uncertainty about the nature and content of the duties owed by many exempt market dealers, and may lead to undue burdens and responsibilities being imposed upon dealers whose client relationships exhibit none of the indicia of a true fiduciary relationship.

For instance, many exempt market dealers and their dealing representatives sell a limited number of products, or potentially only a single product at a time. These dealing representatives are not licensed or qualified to advise clients on their financial affairs generally. Further, such representatives are certainly not required to familiarize themselves with alternative products otherwise available on the market, which may conceivably be required under the standard proposed. While these representatives are required to perform a suitability analysis and to conduct their dealings with clients honestly, fairly and in good faith, it could not possibly be said that prospective clients expect these representatives to act on a best-interests standard, or that such a standard would otherwise be applied by the courts. In our assessment, the imposition of a fiduciary standard in these circumstances would lead to inappropriate consequences and for no ascertainable benefit to clients or the industry.

In addition, under the proposed standard, the sale by a dealing representative or advisor of an investment product produced by a related party could be viewed by the courts as a conflict of interest, whether or not such products are tied to a commission or volume-based incentive plan. Fiduciaries are obligated to avoid actual as well as potential conflicts of interest, and such products could be viewed as a conflict of interest simply on the basis that the sale of a related-party product creates a benefit for the dealer's organization as a whole. Many exempt market dealers exclusively sell such related party products, and such products are commonly produced

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and sold by the larger banking institutions and mutual funds. A decision by the courts prohibiting related-party products on the basis of the proposed standard would have far-reaching implications across the Canadian securities industry.

Conclusion

In Walton's assessment, the adoption of a universal best interest standard is inappropriate. The indiscriminate application of such a standard will result in considerable uncertainty as to nature of the duties imposed and make available equitable remedies that will often be harsh to dealers and potentially subject to abuse by clients. Any potential benefits which might arise from the application of such a standard will be outweighed by the burdens that such an unprincipled approach will inevitably impose. Walton submits that the consistent enforcement of the existing standards is a more appropriate solution to the concerns raised in the Consultation Paper.

We would be happy to discuss our comments with you. Please do not hesitate to contact us if you have any questions.

Yours Truly,

WALTON CAPITAL MANAGEMENT INC.

Mark McKenna
President

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