THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

Fiduciary Duties and Financial Advisors

Frequently Asked Questions and Answers

This series of questions and answers is intended to provide general information about the legal relationship between a financial advisor and his or her clients and outlines why there is no need to legislate a fiduciary duty into the relationship.

1 What is "fiduciary duty"?

In general terms, a "fiduciary duty" is a concept used by Canadian courts to impose a duty of loyalty on a person who has been entrusted to look after the best interests of someone else. It usually arises in circumstances where one person is vulnerable to the other because of the personal nature of the relationship, or because of the broad scope of authority given to the other.

Some types of relationships always include a fiduciary duty. Lawyers have a fiduciary duty to their clients because of the personal nature of the relationship. Directors have a fiduciary duty to the companies they serve because of the scope of authority they have over the company.

With other relationships, a fiduciary duty does not automatically exist, but can arise in specific circumstances. For example, a fiduciary duty may arise when one person places so much trust, confidence and authority in another as to become vulnerable to that other person, and that other person proceeds with an awareness of such trust and confidence.

"Fiduciary duty may arise when one person places so much trust, confidence and authority in another as to become vulner-able to that other person, and that other person proceeds with an awareness of such trust and confidence."

2 Are financial advisors in Canada already subject to a fiduciary duty?

Generally, no, but in some situations, yes. Pursuant to Canadian common law, whether or not a financial advisor would be found to be a fiduciary to his or her client would depend on the particular facts.

The existence of a fiduciary duty in a given situation would depend upon the reasonable expectations of the parties based on such factors as vulnerability, trust, reliance, discretion, confidence, complexity of subject matter and com munity or industry standards.

The sort of advisor-advisee relationship that would likely be found not to be fiduciary in nature would be one where the client simply placed orders with a discount broker who then carried out the requested transaction. On the other hand, an advisor-advisee relationship that would likely be found to be fiduciary in nature would be one where an elderly, unsophisticated client placed his or her retirement savings in the hands of an investment advisor to invest as the advisor deemed necessary to achieve certain investment objec tives for the client (e.g., to provide income through retirement).

Financial advisors are already subject to extensive regulation by Canadian securities regulators. These regulations impose many of the same require ments that apply to situations where a fiduciary duty exists.

3 What is a person required to do under a fiduciary duty?

It varies, based on the circumstances. A person who has a fiduciary duty toward someone else as well as authority to make decisions on that other person's behalf must place that other person's interests ahead of their own when exercising that authority. This is the case with directors of corporations. In some contexts, this means that the person with the fiduciary duty cannot personally benefit from the relationship except to the extent that the other person has provided informed consent.

There are other variations of the duty based on the risks that the courts are trying to address. Canadian courts have held that the fiduciary duty is dierent in important respects from the ordinary duty of care, and that, while the fiduciary obligation carries with it a duty of skill and competence, the special elements of trust, loyalty and confdentiality that underlie a fiduciary relationship also give rise to a corresponding duty of loyalty.

4 What would a financial advisor be required to do under a fiduciary duty?

It's not clear. The obligations of a fiduciary duty vary depending on the circumstances and how the Canadian courts define it. One expectation is that a fiduciary duty would require that the financial advisor disclose to his or her client the amount of compensation that the financial advisor is going to receive as a result of the client's investments, and obtain the client's consent before proceeding.

The existing regulation of financial advisors already requires that this information be disclosed at the time that the client opens their account. There are other occasions during the relationship when the financial advisor discloses his or her compensation to the client before the client decides to proceed with an investment.

5 Why are some people proposing that a fiduciary duty should be imposed on financial advisors?

There are mainly two concerns expressed by the people who are proposing a fiduciary duty for financial advisors.

The first concern is that some financial advisors may be doing a sub-standard job for their clients due to insucient knowledge or skills.

The second concern is that there is a perception that financial advisors will recommend to their clients that they purchase the product that will best compensate the financial advisor, rather than the product that is most appropriate for the client.

6 Will the introduction of a statutory fiduciary duty address any concerns over knowledge or skills?

No. Financial advisors already are subject to regulatory and other legal requirements to use care, skill and diligence when providing advice to their clients. Introducing a statutory fiduciary duty would add a requirement with respect to loyalty, not skill and knowledge. The way to deal with any person who has inadequate knowledge or skills is to train and educate them better. Think about the issue of unskilled car drivers. We already have rules of the road that prohibit bad driving. Adding a new rule that "everyone must put the interests of other drivers ahead of their own" won't improve unskilled drivers.

7 Will the introduction of a statutory fiduciary duty address any concerns regarding possible conflicts of interest?

Not really. If a conflict of interest exists as a result of compensation, it will continue to exist even if there is a statutory fiduciary duty. A financial advisor still could make the same recommendations to clients as long as the financial advisor's compensation is fully disclosed to the client and the client agrees to proceed. In many ways, existing securities regulation is more strict since it includes numerous outright prohibitions regarding compensation in order to eliminate various opportunities for conflict of interest. Existing securities regulation also includes requirements relating to the disclosure of, and proper handling of, conflicts of interest.

Investors who would prefer not to pay commissions on each transaction out of concern it might create a conflict of interest in the advisor can instead choose an advisor who provides a fee-based account.

A “fee-based account” is one where the client is charged an annual fee by their dealer, rather than commissions for each transaction they request. The fee is calculated as a percentage of the value of the account.

8 Should Canada restrict or prohibit embedded fees, similar to what is apparently being done in the U.K. and Australia, and what the U.S. is considering?

To be clear, “embedded fees” usually refers to up-front commissions and ongoing trailer commissions that the mutual fund’s manager pays to the financial advisor and later recoups over time out of the management fees paid by the mutual fund. In Canada, embedded fees are not hidden: they are disclosed in the mutual fund’s prospectus and by the financial advisor to his or her client.

Embedded fees are handy tools for investors. When the manager, rather than the investor, pays the up-front commission to the financial advisor, it enables 100% of the investor’s money to be invested in the mutual fund, rather than first deducting a commission from the investor’s money. When the manager pays the annual trailer commission to the financial advisor, it ensures that the investor’s advisor is compensated annually for ongoing service in circumstances where the investor may not be able to do so through a fee-based account where the investor pays their financial advisor directly.

9 What is the current state in Canada with respect to fiduciary duties for financial advisors?

Canadian common law already addresses in what situations a fiduciary duty will appropriately be found to exist between a financial advisor and his or her client. In addition, financial advisors already are subject to extensive regulation by our securities commissions and by the SROs, a fundamental goal of which is to protect investors. Also, every financial advisor must work through a dealer company that also is subject to further extensive regulation. On top of that are further regulations that govern the way products are sold and operated. Every financial advisor and his or her dealer also is under the supervision of at least two regulators – the securities commission in their jurisdiction and an industry-specific regulator: either the Mutual Fund Dealers Association of Canada or the Investment Industry Regulatory Organization of Canada. In most cases, members of the public and media are not aware of the scope and extent of these regulations. The impact of these regulations begins long before an investor ever becomes a client of the financial advisor, and continues at several levels throughout the relationship between the client and his or her financial advisor. These regulations include the following:

- A requirement to deal fairly, honestly and in good faith with clients
- A requirement to observe high standards of ethics and conduct in the transaction of business with clients
- Proper disclosure and handling of conflicts of interest
- Prohibited sales practices
- Supervision of activity in client accounts
- Background checks (such as police, credit, employment, education and proficiency course completion)
- Industry-specific education requirements
- Compensation disclosure
- Insurance and bonding

Every dealer is responsible for maintaining systems to monitor compliance with all of these regulatory requirements.

10 If introduction of a statutory fiduciary duty would not add much protection for clients, then why not institute it?

The main reason is that it would perpetuate a myth that it would dramatically improve the regulation of financial advisors. Financial advisors already are subject to specific rules and regulations that clearly address the main issues that arise in the relationship between a financial adviser and his or her client. These include existing requirements to deal fairly, honestly and in good faith with clients and to observe high standards of ethics and conduct in the transaction of business with clients (2.11 of the MFDA Rules; 29.1 of the IIROC Rules). The introduction of a statutory fiduciary duty would not help to clarify the scope of an advisor's duties from situation to situation.

Another reason is that a fiduciary duty is not as comprehensive a solution as many think. Even with a statutory fiduciary duty, financial advisors would remain entitled to be paid for what they sell, as long as it is disclosed to the client and the client agrees to proceed. A statutory fiduciary duty does not mean that clients always will buy the product for which the advisor is paid the least amount.

Last, investors need to remain focused on what is the best investment for them, rather than rejecting good investment recommendations simply because of how much their advisors would be paid.

The securities regulators and mutual fund industry have started providing Fund Facts, a document that is intended to provide investors with more simplified disclosure of the types of information that investors find most helpful, including past performance and dealer compensation. More than ever before, investors will have immediate access to information which will help them ensure they are buying the right investment for their circumstances, and can balance it against the amount they know their dealer is being paid to complete the sale for them.

We also encourage both investors and members of the media to become more familiar with the scope and extent of existing regulation in Canada that protects investors throughout their investment cycle.