

Brokers and Investors: A New Age of Accountability Coming Soon to a Courtroom Near You?

by Michael G. COCHRANE LL.B.

It is difficult to open the without seeing headlines and stories and the resulting disappointment and Toronto Stock Exchange has estimated invested in equity markets through retail investments. In addition to the relationship, we now have discount creating even more opportunities for Canadians to get into the market. The Internet has also dramatically changed the way in which investors make their decisions. A wealth of information is now available at the touch of a few keys - and some of it is even accurate! While these developments have contributed to an unprecedented participation in the marketplace by Canadians, they have also created some spectacular disappointments and misunderstandings for investors.



business section of most newspapers about stock frauds, misrepresentations anger of frustrated investors. The that close to 40% of adult Canadians are pension funds, mutual funds or direct more traditional broker-investor brokerage houses and online trading,

With some important new legislative investor protections coming down the pipe in December of 2005, it is a good opportunity to reflect on the basis of the relationship between stock brokers and Canadian investors.

Certainly, your stock broker may be a reliable advisor and even a personal friend, but when the courts have been asked to consider the relationship between an investor and a broker, they have consistently held that a broker is an agent of his or her client. This agent owes the investor client a number of duties. While a broker is never obliged to carry out instructions that are illegal or unethical, he/she must carry out the client's instructions. If there is a written agreement between the broker and the investor, it must be honoured. In some cases, even verbal promises between broker and investor can become contractual terms. Last but not least, the broker must never permit personal interest to conflict with the investor's interests. "Churning" an account or failing to make full and fair disclosure concerning a transaction are two of the most frequent breaches of this duty between broker and investor.

Courts have also added a new component to the broker-investor relationship and sometimes treated the relationship as a fiduciary relationship. In those circumstances, an even higher standard is demanded of the broker, who may have additional obligations to advise carefully, honestly and in good faith. This is one of the highest standards known to law.

At the root of this broker-client relationship is what brokers refer to as the "Know Your Client Rule." It is considered to be the cornerstone of the regulatory framework of the industry and is in part satisfied when a broker completes a new account application form with the client each time the client opens an account. This application form allows the broker to do an assessment of this particular investor's tolerance for risk and to determine their investment objectives. It all seems great in theory, but brokers and investors know that the nature of their relationship, and the level of sophistication of the investor, changes over time. Investor-broker relations can sour when a broker no longer "knows the client."

Discount brokers and e-trading present a whole other world of challenges to, not only investors, but the marketplace generally. The broker's personalized advice is no longer a factor and investors, sometimes relying on downright scary sources of information, can make catastrophic decisions. Among lawyers the old adage is "A lawyer who represents himself has a fool for a client." The same may now be true for those investors who are new to "playing the market."

It is these and other problems that led the Ontario Government to making changes to the *Securities Act* to allow broader rights for secondary market investors to sue for misleading disclosure, the failure to make timely disclosure, as well as misrepresentations, fraud and market manipulation.

The changes to the *Securities Act*, which come into force December 31, 2005, give investors the right to sue public companies and other key parties, such as officers, directors and experts, when there is false or misleading information in materials that public companies disclose to investors.

Over 90% of all equity trading in Canada occurs in this secondary market, where investors buy shares from other investors. Their decisions are often based on information provided by the company or its directors or officers. Media spokespersons may quote experts to generate interest in their initial public offering. These sources will now be under a microscope. Until the recent amendments, an investor who relied on inaccurate information provided in such circumstances had little, if any, redress. After December 31, 2005, investors will not only have the right to sue, they will have the ability to gather themselves into a group and use Ontario's class action procedures to gain strength in numbers.

Since Toronto's Stock Exchange is the largest national marketplace, these amendments will be of interest to all Canadians. It is likely that other provinces will follow suit with similar legislative reform. The goal of these reforms is to ensure that public companies have stronger incentives to disclose accurate and complete information and to thereby increase the confidence in capital markets.

So, as millions of Canadians enter the marketplace as investors, the watch words for brokers will still be "Know Your Client" and for investors "Know Your Limits." For everyone else, "Know Your Rights." A vibrant marketplace that uses accurate information is healthy for all Canadians, as every person has a stake in the capital markets through Canada Pension Plan, their RSPs, other pension plans and, of course, personal investments.

Maybe it is a good time for brokers and investors to get to know each other again.

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