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Cally Jordan

Melbourne Law School, c.jordan@unimelb.edu.au

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The author is also affiliated with the European Corporate Governance Institute (ECGI) and the Center for Transnational Legal Studies (London).

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A NATURAL EXPERIMENT: ASSET MANAGER LIABILITY

CALLY JORDAN

MELBOURNE LAW SCHOOL; EUROPEAN CORPORATE GOVERNANCE INSTITUTE

c.jordan@unimelb.edu.au

Abstract

It is a natural experiment: two highly integrated national economies, sharing a vast continent, a common language and hundreds of years of common experience. They are bound by a free trade agreement which has fostered strong trade flows in goods, services and capital. Yet, in important respects, the structural characteristics of their financial institutions, and the regulatory framework in which they operate, are different, so different in fact, that one country has been crippled for several years now by the global financial crisis and the other has emerged virtually unscathed. The countries, of course, are Canada and the United States. The financial sector in the United States, and its regulation, has been exhaustively documented. Much less consideration has been given to the Canadian side of finance. But in light of the performance of each country in response to the global financial crisis, perhaps it is time to take a closer look.. The discussion which follows focuses on one particular corner of the financial sector, asset managers and is based on a study undertaken for a collaborative work on asset manager liability published by Oxford University Press in 2012.

1. INTRODUCTION

It is a natural experiment: two highly integrated national economies, sharing a vast continent, a common language and hundreds of years of common experience. They are bound by a free trade agreement which has fostered strong trade flows in goods, services and capital. Yet, in important respects, the structural characteristics of their financial institutions, and the regulatory framework in which they operate, are different, so different in fact, that one country has been crippled for several years now by the global financial crisis and the other has emerged virtually unscathed. The countries, of course, are Canada and the United

States. The financial sector in the United States, and its regulation, has been exhaustively documented. Much less consideration has been given to the Canadian side of finance. But in light of the performance of each country in response to the global financial crisis, perhaps it is time to take a closer look.

The discussion which follows focuses on one particular corner of the financial sector, asset managers, and is based on a study undertaken for a collaborative work on asset manager liability published by Oxford University Press in 2012.¹ The organizational framework of that study was a European one, primarily inspired by the Markets in Financial Instruments Directive (MiFid) in the European Union. Viewing one regulatory and legal system through the lens of a very different one, in and of itself, produces interesting insights. For example, the complex interaction of self-regulation, industry practice and technical regulatory overlay has more or less obscured the operation of basic principles of private law, primarily contract, in the asset manager-client relationship in common law Canada. However, in Quebec, the systematizing influences of a civil code and the greater significance of analytical doctrinal writing, more consistent with a European approach, make the private law foundations of the asset manager-client relationship more readily discernible.

Although there is relatively little case law in this area in Canada, due to the structural impediments to litigation thrown up by English style rules of civil procedure (even in Quebec), the bases of liability in the argued cases appear somewhat different than in the United States. Negligence is the preferred cause of action, rather than contractual claims or ones based on a principal-agent relationship. In addition, in common law Canada, again in the English tradition, there is a more robust understanding of the extent and applicability of fiduciary duties than is found in the United States.

As in the United States, self-regulation and the self-regulatory industry organizations are important features of the overall regulatory framework. But although the industries and professions in the United States and Canada demonstrate a high degree of integration and reinforcing influences, self-regulation may be expressing itself in a different manner in Canada. First of all, the Canadian financial community is smaller, with a smaller number of participants. These are well educated participants, as a CFA designation, unlike in the United States, is mandatory and rarely waived. Despite the great geographical distances in Canada, these participants are concentrated in three or four centres, with one (Toronto) dominating. For a very long time, and for better and worse, the prevailing regulatory environment has been one more akin to the “tea

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¹ “The Liability of Asset Managers in Canada”, with P. Hughes, in *Liability of Asset Managers*, D. Busch, D. DeMott (eds) (Oxford: Oxford University Press, 2012).

with the Governor of the Bank of England” approach. Regulation by moral suasion survives in Canada, where reputational forces continue to operate in a strong form.

Self-regulation in Canada may also find a stronger expression because it plays a different role; its operation on a national basis compensates for the inefficiencies of a fragmented regulatory environment in the securities law area, given the absence of a federal securities regulator such as exists in the United States. This regulatory fragmentation in one corner of the financial markets has produced, not regulatory competition, but rather a high degree of regulatory cooperation. This cooperation is evidenced in the “informal” but very influential Canadian Securities Association, a grouping of provincial regulators acting in concert, a de facto national regulator.

But behind it all are the big retail banks in Canada which dominate the financial landscape and which weathered the storms of the global financial crisis with such aplomb. Securities dealers are the small fry in this financial ecosystem and the great majority of them work in bank-owned subsidiaries. At the banking level there is no regulatory fragmentation in Canada; a small number of large, well-capitalized banks are subject to the oversight of one federal regulator, the Office of the Superintendent of Financial Institutions.

1.1 Canadian Economy and Financial Markets

Canada is a wealthy, mid-sized federal state with a population of a little over 34 million people as of 2010. It is the world’s tenth largest economy, with a high per capita income.² Largely unaffected by the global financial crisis of 2007-2009, Canada’s GDP grew by 3.9% between June 2009 and June 2010 and its total government debt burden was the lowest of the G8 countries as of 2008.

The Toronto Stock Exchange (TSX)³, the product of recent domestic consolidation, is the senior equities exchange for Canada, the third largest, by market capitalization in North America and 8th largest in the world. A proposed merger between the TMX and the London Stock Exchange which would have resulted in a combined exchange with a market capitalization of \$6.9 billion dollars, making it the 7th largest in the world, was derailed in 2011.⁴ Shareholders chose instead a rival hostile bid launched May 25, 2011 by a consortium of some of Canada’s largest banks and pension funds, merging the TSX and Alpha Group, a rival automated trading system.

² Canada is the 14th largest economy in the world (cf <<http://imf.org>>).

³ Derivatives, and a limited number of Quebec-based equities, are traded on the Montreal Exchange, a wholly-owned subsidiary of the TMX Group which owns the TSX.

⁴ “LSE and Canada’s TMX agree merger” Financial Times, Feb 8, 2011.

Canada, the United States and Mexico are parties to the North American Free Trade Agreement (NAFTA) which entered into force in 1994, and is a successor agreement to the bilateral Free Trade Agreement between Canada and the United States which dates back to 1987. Both trade agreements increased the already high degree of economic integration in the provision of goods and services between Canada and the United States. Capital markets are also highly integrated; Canadian issuers form, by far, the largest single set of foreign issuers raising capital in the United States and benefit from a regulatory mutual recognition system for public offerings of securities put in place in 1991.⁵ With respect to capital markets regulation, not surprisingly, there has been a significant degree of harmonization of the Canadian regulatory framework with that of the United States over the last two decades. Industry practices in Canada are strongly influenced by those of the United States.

Nevertheless, Canadian regulation of its financial intermediaries has remained somewhat distinct from that in the United States and there is not the same degree of interpenetration of markets by US and Canadian financial intermediaries as might otherwise be expected. There are several possible explanations for this. One is the nature of banking institutions and their regulation in Canada, which is quite different from that of the United States. Unlike the fragmented banking industry with its multiple regulators in the United States, there are just a handful of large, well capitalized banks in Canada under one federal regulator. These banks own the investment dealers, the capital markets intermediaries, and which operate as separate subsidiaries subject, for the most part, to province by province regulatory licensing and oversight.

1.2 Nature of Asset Management Sector in Canada

Canada's assets under management (AUM) reached an impressive 1.9 trillion dollars in 2009. The managed money structure is divided between institutional segments and individual segments. Pension plans⁶, insurance and corporate⁷ and not-for-profit entities⁸ make up the institutional sub-segments while investment funds⁹, private investment counsel¹⁰ and discretionary brokerage¹¹ comprise the individual sub-segments.

Since 2006, and largely as a result of the economic downturn, the overall asset mix shifted away from equities toward fixed income. In the latter half of 2009, managed assets moved from short-term investments to fixed income as investors assumed more duration and interest rate risk. Fixed income accounts for 37

⁵ As of December 2010, 36% of foreign private issuers in the United States are incorporated in Canada. The multijurisdictional disclosure system, implemented by Canada and the U.S. in 1991, allows Canadian issuers to offer securities in the United States using a Canadian prospectus, with certain additional disclosure.

⁶ Including externally managed assets of defined benefit, defined contribution and hybrid plans.

⁷ Including investment assets of Canadian life insurance companies and corporate balance sheets.

⁸ Including associations, charities and private foundations.

⁹ Including mutual funds, segregated funds, fund wrap accounts and closed-end funds.

¹⁰ Including private client pooled funds and separately managed accounts.

¹¹ Including separately managed wrap accounts, in-house wrap accounts and advisor managed accounts.

percent of the overall managed asset mix in 2009, as compared to 35 percent for Canadian equity. Although domestic equities benefited from the economic recovery, any gains made in international equities were offset by the continuing strength of the Canadian dollar. Foreign equity accounts for only 14 percent of the overall asset mix. Real estate, cash and short-term assets and various unspecified alternatives round out the mix of assets that fall under the umbrella of managed assets. Overall, Canada's managed money is relatively strong, fuelled by institutional growth in the insurance and corporate segment. By the end of 2009, managed money saw positive year over year growth for the first time since 2007.

There are 551 money managers in Canada. Thirty focus only on institutional assets, 382 deal only with individual assets and 139 manage both institutional and individual assets. Competition in the managed money sector continues to intensify, with nine new managers entering the market in 2009. There are several major players in the managed money industry. The "Big Six" Canadian banks¹² control nearly one quarter of the managed money market with a mix of institutional and individual business. In addition to the banks, the 10 largest fund companies control 18 percent of the total managed money. These funds include Affiliated Manager Group, CI Financial, Fidelity Investments and Power Financial, among several others. Mid-size firms with AUM between \$1 billion and \$10 billion are experiencing the largest area of growth in both number of firms and assets managed.¹³

Foreign-owned entities have also made inroads in Canada since 2006, with an increased share of assets and number of managers. However, the pace slowed in recent periods due to the strength of the Canadian dollar and attractiveness of other domestic investments. Canadian money managers also have a presence abroad with AGF Investments, Mackenzie Investments and Great West Lifeco increasing the relative importance of business outside of Canada.¹⁴

1.3 Overview of the Regulatory Framework

For many decades in Canada, the regulation of capital markets activities (those of banks excepted), has operated at the provincial level due to constitutional disputes between the federal and certain provincial governments. This means that each of the ten provinces and three territories which comprise Canada has its own securities regulator, irrespective of the level or importance of capital markets activity. This anomalous

¹² Royal Bank of Canada, Toronto-Dominion Bank, The Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce and National Bank of Canada.

¹³ In the latter half of 2009, managed assets moved from short-term investments to fixed income as investors assumed more duration- and interest-rate risk. Fixed income accounts for 37 per cent of the overall managed asset mix in 2009, as compared to 35 per cent for Canadian equity. Although domestic equities benefited from the economic recovery, any gains made in international equities were offset by the continuing strength of the Canadian dollar. Foreign equity accounts for only 14 per cent of the overall asset mix. Real estate, cash, and short-term assets and various unspecified alternatives round out the mix of assets that fall under the umbrella of managed assets. Cf Investor Economics, *Managed Money Advisory Service Report*, 6th ed. (Toronto: Spring 2010). The author would like to thank Earl Bederman of Investor Economics for making the report, which has provided many of the statistics in this section, available to her.

¹⁴ Investor Economics, *Managed Money Advisory Service Report*, *ibid*.

situation has seen constitutional challenges work their way through the courts without satisfactory resolution. A proposal for a national Canadian securities regulator was well advanced, as was draft legislation based in large part on existing provincial legislation and other instruments. However, the constitutionality of a national securities regulator was challenged by two provinces, Alberta and Quebec. The highest appellate courts in both provinces ruled that a national securities regulator was unconstitutional, stating that the regulation of securities is properly within provincial jurisdiction. The federal government referred the issue to the Supreme Court of Canada in April 2011 and a decision the following December struck down the federal proposals.¹⁵

In addition, the rapid and very recent consolidation of exchanges in Canada, now under common ownership and organized along lines of product specialization, has produced significant structural changes in the securities industry lately. The failed merger of the London Stock Exchange and the TMX Group would have added a new, international, dimension to an already dynamic period of change and rapid adaptation. This, however, appears to be a time of national entrenchment on many fronts.

Capital markets activity and the financial intermediaries which service it are concentrated in two jurisdictions in particular, Ontario (the home of the TSX) and Quebec (the home of the Montreal Exchange, the ME).¹⁶ In the absence of a national regulator, several compensatory mechanisms have developed to produce harmonization and standardization of regulatory approaches in an effort to reduce the costs and inefficiencies associated with multiple, overlapping regulatory systems in Canada. One is the Canadian Securities Administrators (CSA) which describes itself as an “informal” association, the members of which are the Chairs of the provincial and territorial securities regulators who meet on a regular basis.¹⁷ “The CSA is primarily responsible for developing a harmonized approach to securities regulation across the country. The CSA brings provincial and territorial securities regulators together to share ideas and work at designing policies and regulations that are consistent across the country and ensure the smooth operation of Canada's securities industry.”¹⁸

¹⁵ See Cristie Ford and Hardeep S. Gill, “A National Systemic Risk Clearinghouse?” in Anita I. Anand, ed., *What Next for Canada? Securities Regulation after the Reference* (2012); available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094794.

¹⁶ The provinces of resource rich Alberta and British Columbia also attract venture capital activity associated with the mining and oil and gas industries, in particular. The TSX Venture Exchange (a successor exchange to the Canadian Venture Exchange (CDNX), itself a merger of the Vancouver Stock Exchange and the Alberta Stock Exchange) is jointly regulated by the Ontario, Alberta, British Columbia and Quebec securities regulators and has offices in Calgary, Vancouver, Toronto and Montreal.

¹⁷ See [www.securities-administrators.ca]. “By collaborating on rules, regulations and other programs, the CSA helps avoid duplication of work and streamlines the regulatory process for companies seeking to raise investment capital and others working in the investment industry. In recent years, the CSA has developed a the “passport system” through which a market participant has access to markets in all passport jurisdictions by dealing only with its principal regulator and complying with one set of harmonized laws. It is a major step forward in improving Canada’s securities regulatory system by providing market participants with streamlined access to Canada’s capital markets. The CSA’s impact on most Canadians comes through its efforts to help educate Canadians about the securities industry, the stock markets and how to protect investors from investment scams.”

¹⁸ *Ibid.*

The CSA is responsible for the development of “National Instruments”, in effect, model regulation developed cooperatively by the provincial and territorial securities regulators, and then implemented in all the jurisdictions by rule-making at the provincial level (for example, NI 31-103 on registration of intermediaries. “Multilateral Instrument” may be agreed to by a group of, but less than all, the provincial and territorial regulators. With respect to asset managers, the most significant National Instrument is National Instrument 31-103, Registration Requirements and Exemptions (NI 31-103), effective September 28, 2009, a national registration rule governing licensing and conduct of dealers, advisers and investment fund managers.¹⁹ The purpose of NI 31-103 is to streamline and harmonize the registration requirements and procedures in Canada on a nationwide basis.²⁰ Interpretative “policy statements”, at the national, multilateral and local level, complement the instruments.

As in other jurisdictions with active capital markets the various exchanges (equities, derivatives, venture), now grouped under the common ownership of the TMX Group, have their own rules and regulations which operate on a nationwide basis. As with other demutualized exchanges, disciplinary functions have been severed from the exchanges themselves, so as to avoid the appearance of conflicts of interest. In addition, there is a nationwide self regulatory industry association, the Investment Industry Regulatory Organization of Canada (IIROC), formed in 2008 by the merger of two separate associations, the Investment Dealers Association (IDA) and Market Regulation Services, Inc. (RS). IIROC regulates dealers which operate in Canada’s equity and debt markets, including dealers that act as portfolio managers, in terms of conduct and qualifications, and is overseen by members of the CSA. IIROC sets regulatory and investment industry standards and has quasi-judicial powers (it may hold compliance hearings) and has the power to suspend, fine and expel members and registered representatives, such as investment advisers.²¹

At the industry level, there are parallels to the industry associations and organization of exchange business in the United States. The obvious difference in Canada is the lack of a national regulator comparable to the Securities and Exchange Commission (SEC) in the United States. Rather, coordination on a jurisdiction by jurisdiction basis is required, with the CSA, the exchanges and the industry association providing the national level coordination function. One other difference should be noted: criminal law power for serious offences in Canada is a federal matter,²² unlike in the United States where it is under the separate jurisdiction of each state. The *Criminal Code of Canada*²³ does create various commercial crimes, mostly

¹⁹ On April 15, 2011 the CSA published amendments to NI 31-103 and Companion Policy 31-103CP Registration Requirements and Exemptions that come into effect on July 11, 2011. NI 31-103 and the Companion Policy will be renamed Registration Requirements, Exemptions and Ongoing Registrant Obligations.

²⁰ Note that Ontario implemented certain provisions of registration reform through amendments to the Ontario Securities Act (OSA) itself, rather than through exercise of rulemaking authority of the securities regulator. For purposes of the discussion in this paper, subsections of the OSA and corresponding sections of NI 31-103 are referenced.

²¹ <http://www.iiroc.ca/English/Enforcement/OurRole/Pages/default.aspx>

²² Minor infractions may be subject to provincial jurisdictions.

²³ R.S.C. 1985, c. C-46

fraud or market manipulation offences, which may implicate actors in the securities industry, and to the extent that it is federal legislation, operates on a nationwide basis.

1.3.1 Provincial Level Regulation

The greater part of securities industry regulation in Canada is at the provincial level, and principally, although not exclusively, in the two most populous central provinces, Ontario and Quebec, which together have a population of over 21 million people.²⁴ Each province has its own regulator, the Ontario Securities Commission in Ontario and the consolidated financial regulator, the Autorité des marchés financiers (AMF) in Quebec. Each has its own legislation, the Securities Act (Ontario) (OSA)²⁵ and the Quebec Securities Act (QSA)²⁶, together with associated rules, regulations, statements of policies, etc. Each commission has wide powers of discretionary and rule-making authority, enters into various memoranda of understanding with other administrators and regulators independently, and can make orders and rulings which may be appealed to the courts of ordinary jurisdiction. Penal sanctions under the securities acts are enforceable in provincial courts.

To this point, this overview has been firmly focused on the regulation of the securities industry and its regulatory authorities in Canada, with little differentiation being made between what in some systems would be a fundamental divide, that of private law and public law. It is fair to say that in both Canada and the United States, the securities industry is a highly regulated industry, with a long history of complex and detailed regulation, which to a great extent has eclipsed what might be termed the “general law”, or private law analysis. Nevertheless, “private law”, principles of contract and tort (or delictual responsibility in Quebec), continue to operate in the background, but are of much diminished importance in comparison to the regulatory framework, the “public law” applicable to the industry. Common law systems generally do not make the same pronounced distinction between public law and private law, and with respect to Quebec with its civil code heritage, many of the forces at work do not originate in Quebec.

As noted above, there exist strong pressures to produce an integrated and harmonized securities industry in Canada, and in practice, these efforts are reasonably successful, given the structural impediments of the regulatory regime. Nevertheless, the legal analyses and doctrinal sources applicable to the securities industry do vary as between Ontario and Quebec, in large measure due to the common law and civil law divide.

²⁴ Alberta and British Columbia are also economically significant in Canada, but Ontario and Quebec together with 62 percent of the Canadian population maintain an historic center of gravity.

²⁵ R.S.O 1990, c.S.5

²⁶ RSQ c. V-1.1

First of all, although a number of common law provinces use the OSA as a model act, and enact legislation very similar to the OSA, that is not the case for Quebec. Although the substance of the QSA reflects the general approach and principles of the legislation in the common law provinces, the organization of the statute, its drafting and some of its regulatory mechanisms differ. Looking behind the regulatory framework, to the “common law” (as it might be termed in Ontario) and the “private law” (as it might be termed in Quebec), the differences in the principles applicable to securities industry participants (and in particular, asset managers), between Ontario and Quebec, the common law and the civil law, become more apparent.

1.3.1.1 Ontario

Historically, Ontario law has been derived from and primarily influenced by English law. So to the extent that they have not been displaced by more modern judicial developments or statutory enactments, the basic principles of contract, tort and fiduciary responsibility may still harken back to old English law. More recently, and not unexpectedly, developments in the United States may overlay the old English law. In addition, self-regulation has a long history in this industry in both the UK and the United States, dating back centuries. Importantly, industry rules, standards of industry conduct, industry expectations, all persist tenaciously, even in the face of regulatory action.

More specifically, the relation of industry intermediary, the asset manager, to the client is primarily a contractual one, subject to the usual vagaries of contractual drafting (despite extensive use of industry-wide standard form contracts). The contract may create a principal (client) to agent (asset manager) relationship, subject to particular (and often, quite ancient) rules of English agency law. The agent-principal relationship underlying the asset manager/client relationship however may be so implicit as to not be readily apparent, and may also be overridden, in any event, by specific contractual provisions and industry standards of conduct.

Despite the underlying contractual and principal/agent basis for the legal relationship of asset manager to client, most of the judicial actions brought in this area in common law Canada appear to be based on negligence, a tort, or breach of a fiduciary duty. There may be a number of reasons for this. Judicial action will likely always be at the instance of the client for quantifiable loss of some kind. The contract, on the other hand, may often be a standard form produced by the intermediary, and thus give little room for judicial contestation by the client. Also, the common law develops slowly and incrementally, case by case. Cases are decided based on the strategic decisions of plaintiff’s counsel in terms of the framing of the issues in the context of the particular facts. The law applicable in areas of potential liability for industry intermediaries, asset managers, may thus remain undeveloped in certain respects.

In Ontario, case law may develop even more slowly than might otherwise be expected, which despite its population at 13 million people, is decidedly less litigious than comparable commercial jurisdictions in the United States. The rules of procedure in Ontario, in the English fashion, are deliberately designed to discourage litigation. The result is that there may be no tidy body of “general law”, in any of contract, tort or fiduciary responsibility, to guide clients’ counsel in judicial actions against market intermediaries such as asset managers.²⁷

1.3.1.2 Quebec

Quebec, on the other hand, is a true civil code jurisdiction in the area of private law. Despite its heritage, it operates in the realm of English administrative law (which includes the administration of justice, i.e. the courts) and the overlay of Canadian federal law as applicable in Quebec. Moreover, like the Civil Code of the Netherlands, the Civil Code of Quebec (CCQ)²⁸ is a modern civil code which came into force in 1994 after a long period of gestation (some thirty years or more).²⁹ This means that the CCQ has been drafted with modern commercial practices, of the North American variety, in mind, taking into account the desire to firmly imbue the code with traditional civil code concepts. In true civil code fashion, the law of contract and delictual responsibility is systematized and principles-based, addressing traditional civil code contracts such as mandate and services as well as negligence. In addition, given the North American common law context in which the CCQ operates, a fiduciary-like institution has been included in the code, as well as a section on the administration of the property of others. Being a civil code jurisdiction, doctrinal analysis is more systematized and straightforward, and doctrinal analysis itself more highly valued.

1.4 Summation

The following discussion of asset manager liability in Ontario and Quebec should be considered in light of the above. The “general law” or “private law” providing the underlying support for the asset manager/client relationship is common law based in Ontario and modern civil code based in Quebec,. Thus the legal characterization may be substantially different. Thanks to its civil code tradition, the analysis of the asset manager/client relationship is more explicitly and systematically developed in the doctrine in Quebec, and the CCQ itself. In Ontario, assumptions as to the nature of the relationship may be implicit, rather than explicitly stated and analyzed; judicial decisions may provide only a patchwork of analysis upon which to draw. Nevertheless, industry practices, the standards and oversight of IIROC (the self-regulatory body charged with determining many aspects of securities industry participant activity) and the strongly

²⁷ Cf, however, M. Condon, *Rethinking Enforcement and Litigation in Ontario Securities Regulation* 32 Queen’s LJ 1 at pp 8 et seq (2006) for an assessment of the enforcement activity of the OSC.

²⁸ R.S.Q., c. 64

²⁹ It should be noted here that Quebec has never had a European-style Commercial Code, due to the strong influence of the English merchant class in Quebec in the 19th century. Certain English-style commercial statutory law is applicable in Quebec either because it has been specifically enacted or, as is the case with banking, the subject matter falls under federal jurisdiction.

harmonized regulatory framework exert pressure in both Ontario and Quebec to produce similar expectations and practical effect.

2. Characterization of Asset Management

2.1 Regulatory Characterization of Asset Management

The asset management industry in Canada generally falls within one of three distinct categories, each subject to its own particular regulatory requirements. The largest segment of the market participates in the self-regulatory organization (SRO), the Investment Industry Regulatory Organization of Canada (IIROC) which has its own set of guidelines and industry practices to which its members must adhere. However, some asset managers do not fall into this category and thus, while subject to the general principles of private law and provincial securities legislation, may not be specifically governed by formal industry guidelines.

Although the Canadian chartered banks, including the ‘Big Six’, nominally have the power to provide asset management services from within their federally regulated bank entities, in practice, such services are provided through non-bank subsidiaries regulated by IIROC. The power to provide such services in-house was given to banks in 1991, but this initiative caused controversy with provincial governments, who consider securities regulation to be a provincial matter under the Canadian constitution, and who argued against any expansion of bank in-house securities powers beyond their historical boundaries. Faced with this opposition (and the possibility of the provinces seeking to regulate banks that accessed this new power), the federal government declined to put in place regulations that would have established a harmonized parallel regime to that in place provincially. In these circumstances, Canadian banks have not sought to exercise this in-house power in a meaningful way.

In Ontario, no distinct category of asset manager fits squarely within the European Market in Financial Instruments Directive (MiFID) definition.³⁰ Rather, a portfolio manager, the term used in subsection 26(6) of the OSA, is a category of ‘adviser’, ie ‘a person or company engaging in or holding himself, herself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of

³⁰ Although the focus of this piece is liabilities stemming from individual and not collective asset management (such as the management of mutual funds or collective investment schemes), encompassed within the purview of individual asset management are the activities of an asset manager who invests in investment funds or units of a collective investment scheme on behalf of his client. Frequently, a portfolio manager establishes investment funds for the purpose of investing money he manages on behalf of clients in units of the fund. This definition of individual asset management is consistent with the definition of asset management (portfolio management) in Art 4(1)(9) of MiFID, which reads as follows: ‘Managing portfolios in accordance with mandates by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments.’ The MiFID definition thus excludes asset managers that act as managers of funds. The MiFID definition of asset management explicitly excludes execution-only activities in which the intermediary exercises no discretion, as intermediaries that only provide financial advice without actually managing portfolios. An ancillary activity of asset managers may be the provision of custodial services liability for which is addressed in paras 15.123–15.130, for Ontario and Quebec.

securities' (OSA s 2(2)). The OSA defines 'portfolio manager' as someone who is 'authorized to provide advice to a client with respect to investing in, buying or selling any type of security, *with or without discretionary authority* granted by the client to manage the client's portfolio' (emphasis added). Thus, the OSA's definition of portfolio manager is broader than the comparable MiFID definition of asset manager because it is not restricted to actions of the adviser pursuant to discretionary authority granted by the client.

IIROC rules (which also apply in Quebec), include the concept of 'managed account' and 'portfolio manager', the latter of which, unlike the OSA, is limited to a registered representative (a defined term) exercising discretionary authority over a managed account. Section 1300.3 of the IIROC Rules defines managed account as an 'account solicited by a Dealer Member in which the investment decisions are made on a continuing basis by the Dealer Member or a third party hired by the Dealer Member'.³¹

In addition, the courts have developed a test for determining when someone acts as an adviser, subject to regulatory requirements. In *Re Donas*,³² an adviser was found to be someone who advises in securities in a manner that reflects a business purpose. To determine whether an individual or a firm must register under the regulations, the business purpose or 'business trigger' test is used to determine whether advisory activities are being carried out. Generally, an individual or firm will be considered an adviser (which would include an asset manager) if they mediate between buyers and sellers of securities; carry on the activity, directly or indirectly, with repetition, regularity, and continuity; receive or expect compensation for carrying on the activity; and directly or indirectly solicit investment transactions.³³

This judicial business trigger test, which results in the application of registration requirements, was incorporated in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) by the Canadian Securities Administrators in 2009. Companies and individuals in the 'business of advising' clients become subject to the registration requirements of NI 31-103. The OSC examines a non-exhaustive list of five factors in deciding whether registration is required: the same four factors included in the business trigger test, as well as considering whether the activities are similar to that of a registrant.³⁴

³¹ IIROC amended its rules in 2009 to harmonize them with NI 31-103 and to move towards a principles-based approach for registration-related requirements to allow IIROC members greater flexibility in developing compliance and supervision structures and processes that are applicable to their business. Cf *infra* paras 15.99 et seq.

³² 1995 LNBCSC 18.

³³ In *Re: First Federal Capital (Canada) Corp.*, (2004), 27 OSCB 1603, the OSC panel used this test to determine whether or not an individual was acting as an adviser.

³⁴ Section 1.3, *Fundamental Concepts of Companion Policy 31-103CP Registration Requirements, Exemptions and Ongoing Registrant Obligations* ('31-103CP'), discusses in detail the business trigger for trading and advising, and states in part: 'We refer to trading or advising in securities for a business purpose as the "business trigger" for registration. We look at the type of activity and whether it is carried out for a business purpose to determine if an individual or firm must register. We consider the factors set out [in *Fundamental Concepts* of 31-103CP], among others, to determine if the activity is for a business purpose. For the most part, these factors are from case law and regulatory decisions that have interpreted the business purpose test for securities matters.'

The operative concept in Quebec is also that of ‘adviser’, defined in section 5 of QSA as ‘a person engaging in or holding himself out as engaging in the business of advising another with respect to investment in or the purchase or sale of securities, or the business of managing a securities portfolio’. As in Ontario, Quebec’s definition of ‘adviser’ is broader than the MiFID definition of asset management. It encompasses providing advice to a client when the client has not granted discretionary authority, as well as portfolio management pursuant to full discretionary authority.

Individuals may become ‘advisers’ (and thus subject to registration and other regulatory requirements) when their actions constitute those normally undertaken by an adviser. For example, a dealer under section 5 of the QSA may be considered an adviser if his actions constitute more than simply trading or distributing securities (which constitutes the restrictive role of a dealer under the QSA). Much of the case law concerning asset managers, in fact, involves dealers who exceeded their authority by acting as asset managers in their dealings with clients.³⁵ Doctrinal writers also generally equate asset manager liability to investment dealer liability, and thus our discussion includes materials in which securities dealers were considered to have acted as asset managers.

2.2 Private Law Characterization of Asset Management

The relation of a financial intermediary, the asset manager, to the client is primarily contractual and subject to the usual vagaries of contractual drafting. However, the widespread use of standard form contracts, together with the relatively small number of large financial intermediaries, produces a somewhat consistent approach.

The ‘general law’ or ‘private law’ providing the underlying support for the asset manager–client relationship is based on common law in Ontario and modern civil code in Quebec. As a consequence, the legal characterization or activities may be substantially different. Thanks to its civil code tradition, the analysis of the asset manager–client relationship in Quebec and the CCQ itself is more explicitly and systematically developed. In contrast, in Ontario, assumptions about the nature of the relationship may be implicit, rather than explicitly stated and analysed; judicial decisions may provide only a patchwork of analysis upon which to draw to produce similar expectations and practical effect.

As a common law jurisdiction, Ontario does not have categories of contract comparable to those found in the ‘nominate contracts’ section of civil codes. There is no specialized contract known as mandate; a contract

³⁵ For example, the analysis of J. L. Baudouin: ‘Portfolio management is an activity which has known . . . a substantial evolution. . . This evolution is not without consequence with regards to the liability of actors, including the securities dealer, in the forefront’ (all translations are unofficial). J.-L. Baudouin and P. Deslauriers, *La Responsabilité civile, Vol II: Responsabilité professionnelle* para 2-194 (2007).

for services is simply that, a contract for services, with no specific characteristics or consequences. In the common law, the functional equivalent of the civil code contract of mandate would be the agent–principal relationship, which is not necessarily created by contract.

The asset management contract (referred to in the industry as an Investment Management Agreement, or IMA) may create a principal (client) to agent (asset manager) relationship, subject to particular (and often, quite ancient) rules of English agency law. The agent–principal relationship underlying the asset manager–client relationship may be so implicit as to not be readily apparent. In any case, specific contractual provisions and industry standards of conduct may override the operation of general agency law.

In an agent–principal relationship in Ontario, the principal consents to the agent representing or working on his or her behalf, and the agent similarly consents to do so. Although the principal–agent relationship primarily arises out of commercial relationships, the relationship imposes a heightened duty of loyalty from the agent to the principal, depending on the nature of the relationship. An increase in the discretionary authority that is afforded to the agent raises the level of the duty. Whether an agent is considered a true ‘fiduciary’, and thus subject to the full extent of fiduciary duties, will depend on the circumstances, and in particular, the degree of discretion which the agent exercises. In the narrow circumstances of provision of a specific service or matter, which is the sole basis for the relationship, a principal would usually not be putting trust in the agent, and thus the relationship would not be a fiduciary one. Note here that fiduciary-like responsibilities may, in fact, be imposed in such circumstances by regulation or industry standards.

On the other hand, an asset manager who exercises discretionary investment authority over the principal’s portfolio would usually be considered a fiduciary.³⁶ In the case of asset managers, the terms of the contract, in particular the discretionary investment powers of the manager and the investment parameters of the client, would indicate the existence of a fiduciary relationship creating a duty of loyalty to the client and also establish the intensity of such a duty.

As a civil code jurisdiction, Quebec recognizes contracts of mandate and contracts of services. Although there is some discussion as to how to characterize an asset manager agreement, ultimately this will depend on the factual context. In an older case,³⁷ examining the activities of an investment dealer who also acted as a portfolio (asset) manager, the Supreme Court of Canada (SCC) characterized the portfolio manager as a mandatory, and the client, a mandator under Articles 1701 et seq of the Civil Code of Lower Canada (CCLC), the predecessor code to the CCQ and applicable to the facts of that particular case. The court identified the object of the mandate as being not simply the carrying out of a transaction, but rather the

³⁶ See M.V. Ellis, *Fiduciary Duties in Canada*, Carswell 1988, at 3–6.

³⁷ See N. L’Heureux, *La Révocation d’un agent et le statut d’intermédiaire de commerce* 18 C. de D. 397 at 438 (1977).

management of the client's portfolio, using a greater or lesser degree of discretion'.³⁸ The CCLC has since been replaced by the CCQ and doctrinal writers now suggest a new characterization of the portfolio (asset) manager relationship with a client,³⁹ which has been adopted by the Quebec Court of Appeal.

As a general matter, the contract governing an investment dealer (whether or not acting as an asset manager) and his client is a contract of mandate under Articles 2130 et seq CCQ; the investment dealer is purchasing securities on behalf of the client, with or without the client's grant of discretionary authority.⁴⁰ The investment dealer may, additionally, act in other capacities and advise the client on investment options, in which case the doctrinal writers refer to this relationship as an 'extended mandate contract'.⁴¹

However, when the investment dealer performs acts that go beyond simply counselling the client (for example, executing transactions for the client on the dealer's own initiative), then some doctrinal writers maintain that the contract constitutes more than simply a mandate and should be characterized as a contract of services.⁴² For example, a dealer is paid by commission on the transactions executed, whereas an asset manager will more likely be paid, for the entire set of services he or she offers, as a percentage of assets under management or profits on the portfolio. In such circumstances, rather than acting as a mandatory, the investment dealer is acting as an asset manager engaged in offering a service and the contract falls under Articles 2098 et seq CCQ (contract of services).⁴³

The difficulty in distinguishing the contract as one of mandate or services arises from the fact that an investment dealer may be acting in a number of different capacities for the same client. And while the doctrinal writers argue for a characterization of the contract as one of services when the investment dealer is acting in the capacity of an asset manager (exercising discretionary authority), that view may not be completely shared by the courts in Quebec, which, in addition to considering contracts of mandate and services, have also applied the provisions of the CCQ applicable to the administration of the property of others (Arts 1299 et seq).

The rules on the administration of the property of others are found in Book Four, Title Seven CCQ and were introduced for the first time with the new CCQ in 1991. Book Four of the CCQ is the book on Property; Book Five deals with Obligations (ie contractual and extracontractual). Thus, the rules on the administration

³⁸ *Placements Armand Laflamme inc. v Prudential-Bache Commodities Canada Ltd*, [2000] 1 RCS, para 27.

³⁹ See Art 2130 CCQ; L. I. Beaudouin, *Le Contrat de gestion de portefeuille de valeurs mobilières* 45–52 (1994). Cf infra paras 15.32 et seq.

⁴⁰ J. V. O'Donnell and A. Olivier, 'Les Grandes Tendances de la jurisprudence récente' in *La Responsabilité civil des courtiers en valeurs mobilières et des gestionnaires de fortune: Aspects nouveaux* 8 et seq (J.-L. Baudouin and P. Deslaurier eds 1999).

⁴¹ *Ibid* 9.

⁴² *Ibid* 10.

⁴³ O'Donnell and Olivier, *supra* note [], 10 et seq.

of the property of others do not derive from traditional civil code rules on contract or extracontractual obligations. In fact, the CCQ rules on the administration of the property of others are designed to mimic, using civil code principles, the operation of a common law trust by imposing strict, fiduciary-like obligations on the administrator.⁴⁴

Looking to the new CCQ, the Quebec Court of Appeal identified three categories of financial intermediary, based on the capacity in which the intermediary is acting.⁴⁵

Simple Mandate. The intermediary, generally an investment dealer, simply executes transactions at the instruction of the customer, ie the traditional brokerage function.

Assisted Management Contract. Here, the powers of the manager and the activities he or she is entitled to perform are delineated in the contract, and depending on their terms may be characterized as either a contract of mandate or contract of services. The contractual provisions determine the extent of the manager's authority and supplement and extend the codal provisions.

Management Contract. Where the manager is given full discretion over a client's portfolio, and is acting in the capacity of an asset manager (as defined in MiFID), the contract itself is considered to be a contract of services. However, an asset manager, due to the extensive discretionary authority exercised over the client's portfolio, may also be considered an administrator of the property of others and subject to the fiduciary-like obligations of Title Seven CCQ.⁴⁶

The third category, the management contract, is the most closely comparable to asset managers under MiFID, although category two, assisted management contract, may also confer certain discretionary investment powers on the manager.

The qualification of a relationship thus depends on the capacity in which the financial intermediary is acting. However, the lines of demarcation are not clear-cut in the case law. Generally, when an investment dealer is involved, the courts tend to follow rules regarding the contract of mandate, even when the activities of the investment dealer go beyond simple execution of clients' instructions and may involve aspects of portfolio management. However, a more appropriate characterization of the activities of an investment dealer in the latter circumstances would be that of an asset manager performing a contract for services, which would also be subject to the application of the relevant rules regarding the administration of the property of others (CCQ Arts 1299 et seq).

⁴⁴ For example, Art 1309 CCQ requires the administrator to act with prudence and diligence and honestly and faithfully in the best interests of the beneficiary of the administration; Arts 1310 CCQ et seq impose rules dealing with conflicts of interest.

⁴⁵ *Groupe Albatros International Inc. v. Financière Mclario Inc.*, 2003 CanLII 14547 (Qc CA).

⁴⁶ CCQ Arts 1299 et seq.

3. The Regulatory Framework: Institutions, Processes, Rules

For many decades, the regulation of non-bank asset managers and their activities, to the extent characterized for constitutional purposes as securities regulation, has operated at the provincial level in Canada.⁴⁷ The capital markets and the financial intermediaries that service them are concentrated in two jurisdictions: Ontario (the home of the Toronto Stock Exchange (TSX)) and Quebec (the home of the Montreal Exchange (ME));⁴⁸ thus these jurisdictions are the most significant for regulatory purposes. The exchanges themselves, once influential as SROs albeit subject to formal government regulatory oversight, have succumbed to very recent consolidation and are now under common ownership. Now organized along lines of product specialization, consolidation of the exchanges has produced significant, ongoing, structural changes in the securities industry. The proposed acquisition of the TMX Group, the owner of the TSX, by a syndicate of Canadian banks, pension funds, and insurance companies that would involve merger of the TSX with Alpha Group and acquisition of CDS Clearing and Depository Services Inc., would add a new dimension.

Although these dramatic changes have not affected the asset manager industry directly as of yet, they may do so in the future through a shift in general regulatory approaches to the markets and its participants. In the absence of a national regulator, several compensatory mechanisms have developed to produce harmonization and standardization of regulatory approaches in an effort to reduce the costs and inefficiencies associated with multiple, overlapping regulatory systems. One such mechanism, the CSA described above, is among the most important. The CSA has as its primary goals the development of a harmonized approach to securities regulation across Canada and the promotion of the smooth operation of Canada's securities industry.⁴⁹

The CSA is responsible for the development of 'National Instruments', in effect the model regulation developed cooperatively by the provincial and territorial regulators and then implemented in all the jurisdictions by rule-making at the provincial level. A similar 'Multilateral Instrument', such as Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions, may be agreed to by a group of, but less than all, the provincial and territorial regulators.

With respect to asset managers, the most significant national instrument is NI 31-103, effective 28 September 2009, which is a national registration rule governing licensing and conduct of dealers, advisers,

⁴⁷ The activities of banks, on the other hand, have always been under federal jurisdiction.

⁴⁸ The provinces of resource-rich Alberta and British Columbia also attract venture capital activity associated with the mining and oil and gas industries, respectively. The TSX Venture Exchange (a successor exchange to the Canadian Venture Exchange (CDNX), itself a merger of the Vancouver Stock Exchange and the Alberta Stock Exchange) is jointly regulated by the Ontario, Alberta, British Columbia, and Quebec securities regulators and has offices in Calgary, Vancouver, Toronto, and Montreal.

⁴⁹ Ibid.

and investment fund managers.⁵⁰ The purpose of NI 31-103 is to streamline and harmonize the registration requirements and procedures across Canada.⁵¹ Interpretative ‘policy statements’, at the national, multilateral, and local levels, complement this instrument.

3.1 Regulatory Institutions

The OSC and the AMF act as primary regulators for non-bank asset managers in Ontario and Quebec, respectively. Securities legislation is in place to ensure that advisers (which would include both individual asset managers and asset managers operating in corporate or other organizational form) meet certain qualifications in terms of registration, competence, and relevant industry experience. However, it is important to remember the role of the CSA in the development of national instruments implemented by the securities regulatory authority in each province and territory. NI 31-103 governs who registers as an adviser and sets out the registration requirements for advisers.⁵² Lastly, IIROC, as a traditional self-regulatory association, plays an important role with respect to its members.⁵³

In Ontario, advisers, advising representatives, and associate advising representatives, all must be registered with the OSC under OSA section 25(3). Portfolio management services, which would include the activities of asset managers, fall under the adviser category (OSA s 26(6)). The OSA does not apply to all financial instruments however, only securities as defined.⁵⁴ As in the United States, commodities and futures are subject to a different regulatory regime; anyone wishing to act as an adviser concerning commodities or futures must separately register under section 22.1(b) of the Ontario Commodity Futures Act.⁵⁵

Equally in Quebec, portfolio managers, a defined term that would include asset managers, must be registered under QSA section 148; the AMF is the body responsible for granting registration to portfolio managers. Quebec does not have separate commodity futures legislation but does separately regulate trading and advising regarding derivatives under the Quebec Derivatives Act, which came into force on 1 February 2009.

⁵⁰ On 15 April 2011 the CSA published amendments to NI 31-103 and 31-103CP that came into effect on 11 July 2011. NI 31-103 and the Companion Policy were renamed Registration Requirements, Exemptions and Ongoing Registrant Obligations.

⁵¹ Note that Ontario implemented certain provisions of registration reform through amendments to the OSA itself, rather than through exercises of rulemaking authority by the securities regulator. This discussion references subsections of the OSA and corresponding sections of NI 31-103.

⁵² However, none of the OSA, QSA, or NI 31-103 regulate the contents of IMAs where the relationship between clients and portfolio managers is primarily set out.

⁵³ The predecessor to IIROC, the Investment Dealers Association of Canada or IDA served both as self-regulatory association with regulatory authority and an investment dealer industry lobby group. In 2008, the IDA and Market Regulation Services Inc., a market regulator, merged to become IIROC and the lobbying functions of the IDA were transferred to the Investment Industry Association of Canada.

⁵⁴ Subsection 1(1) of the OSA includes a long list of financial instruments that constitute a ‘security’, including ‘any commodity futures contract or any commodity futures option that is not traded on commodity futures exchange registered with or recognized by the Commission under the *Commodity Futures Act* or the form of which is not accepted by the Director under that Act’.

⁵⁵ RSO 1990, c. C.20.

3.2 Regulatory Processes: Registration/Licensing/Examination requirements

3.2.1 Ontario

3.2.1.1 Registration

Any individual or company that engages in the business of advising anyone with respect to investing in, buying, or selling securities must be registered as an adviser under OSA section 25(3). As noted above, portfolio managers (a category that encompasses, but is wider than asset managers within the meaning of MiFID) must register as advisers under OSA section 26(6).⁵⁶ Registration requirements applicable to individuals as portfolio managers are contained in Part 3 of NI 31-103; these managers must satisfy general educational and proficiency requirements and possess relevant securities experience (NI 31-103 ss 3.11–3.13). Importantly, they must earn a Chartered Financial Analyst (CFA) designation and possess a certain amount of experience in the relevant industry. Acting for more than one registered firm is restricted (NI 31-103 s 4.1).

3.2.2 Licensing

Licensing under NI 31-103 entails meeting requirements for proficiency, internal controls and systems, financial condition, dealing with clients, and handling client accounts. The requirements for proficiency of individuals who fall within the definition of portfolio manager, which would include asset managers, cover education, training, and experience. Education requirements are exam-based, rather than course-based; individuals only need to pass the relevant course exams (eg the CFA exam) in order to qualify. Proficiency requirements also include relevant experience requirements, such as a minimum amount of time working in the industry. The regulator may grant an exemption from any of the education and experience requirements if it is satisfied that an individual has qualifications or relevant experience that is equivalent to, or more appropriate in the circumstances than, the prescribed requirements.⁵⁷

3.2.3 Character and fitness

Registered individuals must demonstrate honesty and integrity. The regulator will assess the integrity of individuals through the information they are required to provide on registration application forms and as registrants, and through compliance reviews, which includes information about conflicts of interest, such as other employment or partnerships, service as a member of a board of directors or relationships with affiliates, and any regulatory or legal actions against the applicant. The regulator will assess the overall financial condition (including contingent liabilities under some circumstances) of an individual applicant or registrant. An individual that is insolvent or has a history of bankruptcy may not be fit for registration or to continue as a registrant.

⁵⁶ Portfolio managers employed by IIROC member firms register with the OSC and IIROC dealing as representatives of an investment dealer but are exempt from registration as an adviser under the OSA.

⁵⁷ See ss 3.11–3.13 of NI 31-103 and Part 3 Registration requirements—individuals of 31-103CP.

3.2.4 Exemptions from registration and limitation of liability

There are numerous exemptions from registration, including for financial institutions that are regulated elsewhere.⁵⁸ For example, a regulated financial institution is exempt from the adviser registration requirement (which would include asset managers) as long as it limits its activities only to those not prohibited by its governing legislation. Therefore, financial institutions that act as asset managers are regulated by financial institution regulation, not Ontario securities legislation. However, as noted above, although Canadian chartered banks have the power to provide advisory services within federally regulated bank entities, in practice they provide these services through non-bank dealer subsidiaries regulated by IIROC. Although perhaps not falling within the definition of asset manager, trust companies may exercise in-house asset management powers, eg when they act as a trustee over a group of investment assets. In addition, under provincial trust law, the concept of a 'common trust fund' is used to set up pooled funds for clients to invest in. Credit unions, on the other hand, are not regulated federally, as they do not have a retail function, but act through provincial centrals serving as capital accumulation bodies and acting as a means through which credit unions can exercise clearing activities. Under provincial legislation, credit unions have been granted significant in-house investment management powers.

An IIROC registered dealer or its registered representative that acts as an asset manager is also granted an exemption from adviser registration requirements (which would be otherwise applicable to asset managers) under Ontario securities legislation, provided the pertinent activities are conducted in accordance with IIROC rules.⁵⁹ Thus, asset managers employed by IIROC member firms are subject to IIROC rules, not provincial securities legislation, with respect to licensing, proficiency requirements, and many aspects of their conduct as advisers, although they remain subject to dealer registration requirements of provincial securities legislation.

3.2.5 Sub-advisers

Although no specific legislation in Ontario restricts the use of sub-advisers, general principles of agency and fiduciary law apply as discussed in paragraphs 15.26 et seq and IMAs between the manager and the client often refer to the use of sub-advisers. On the other hand, international sub-advisers are specifically exempted from registration by OSC Rule 35-502 Non-Resident Advisers, section 7.3. An Ontario registered adviser is liable for the actions of an exempt international sub-adviser and the Ontario registrant cannot be

⁵⁸ Section 35.1(1) of the OSA grants an exemption from adviser registration to the following financial institutions:

1. A bank listed in Schedule I, II, or III to the Bank Act (Canada).
2. An association to which the Cooperative Credit Associations Act (Canada) applies or a central cooperative credit society for which an order has been made under subsection 473(1) of that Act.
3. A loan corporation, trust company, trust corporation, insurance company, treasury branch, credit union, caisse populaire, financial services cooperative, or credit union league or federation that is authorized by a statute of Canada or Ontario to carry on business in Canada or Ontario, as the case may be.
4. Business Development Bank of Canada.

⁵⁹ s 8.24 of NI 31-103.

relieved by its clients from its responsibility for losses incurred due to actions of the international sub-adviser (cf. *infra* paras 15.156 et seq, 15.192 et seq).⁶⁰

3.2.6 Non-Canadian asset managers

NI 31-103 provides important exemptions to international dealers and advisers (which would include asset managers) permitting them to undertake limited activities in Canada, primarily with very high net worth Canadian individuals and institutions that qualify as ‘permitted clients’.⁶¹ Generally speaking, permitted clients include most customary institutional clients, corporations with net assets of at least CAD\$25 million, and high net worth individuals (CAD\$5 million in net financial assets).

The international adviser exemption in OSA section 35.2(1) and NI 31-103 section 8.26 is available to an adviser whose head office or principal place of business is in a foreign jurisdiction provided the adviser is acting in conformity with that foreign jurisdiction’s securities legislation. The international adviser exemption is not available when its asset management activities in Canada exceed a certain threshold.⁶² Further, an international adviser must advise only with respect to ‘foreign securities’, ie the securities of a non-Canadian government or an issuer organized outside Canada. International advisers may not advise in Canada on securities (whether equity or debt) of Canadian issuers unless that advice is incidental to advice provided with respect to a foreign security. Additionally, international advisers must submit a completed Form 31-103F2 Submission to Jurisdiction and Appointment of Agent for Service to the OSC. Before advising a client in Canada, an international adviser must provide the client with a notice that includes certain information: (1) the fact that it is a non-registered adviser in Canada; (2) its home jurisdiction; (3) the name and address of its local agent for service; and (4) the potential difficulties associated with enforcing legal rights against the adviser because it is resident outside Canada and all or substantially all of its assets may be situated outside of Canada.⁶³ Finally, written notice of the adviser’s activities must be given to the OSC within 10 days of the first use of the exemption.

3.2.2 Quebec

⁶⁰ See s 7.3(c) OSC Rule 35-502.

⁶¹ See ss 8.18 and 8.26 of NI 31-103. The 2011 amendments to NI 31-103 clarify that the requirements in NI 31-103 in referring to permitted clients mean *Canadian* permitted clients, ie an individual resident of Canada, a trust governed by the laws of a jurisdiction of Canada, or an entity otherwise incorporated, organized, or continued under the laws of a jurisdiction of Canada.

⁶² More than 10 per cent of the aggregate consolidated gross revenue of the adviser, its affiliates, and affiliated partnerships is derived from portfolio management activities in Canada. The 2011 amendments to NI 31-103 clarify that the 10 per cent limit should be calculated only as of the end of the adviser’s most recently completed financial year and not on an ongoing basis.

⁶³ An international adviser who might be characterized as an asset manager would also be exempt from the requirement to register as a dealer in respect of a trade of an investment fund if: (1) the adviser were acting as the fund’s adviser and investment fund manager; and (2) the trade would be to a managed account of a client of the adviser. As an anti-avoidance measure, this exemption is not available if the managed account or investment fund is used primarily for the purpose of qualifying for the exemption. In the 2011 amendments to NI 31-103, the CSA augmented this exemption from the dealer registration requirement to include all investment funds, not just non-prospectus qualified funds, as was formerly the case.

In Quebec, as in Ontario, a portfolio manager (which would include an asset manager) must be a registered person under QSA section 148. A natural person cannot act as a dealer or adviser but must be registered as a representative of a registered person under section 148.⁶⁴ The AMF will grant registration if the conditions set by QSA⁶⁵ are met. As in Ontario, the AMF must verify fitness (competence and integrity), as well as financial solvency, in the interests of investor protection. The AMF has broad discretion to impose conditions under which an asset manager may operate, including a limitation on the duration of registration. Registrants must advise the AMF of any changes to the information furnished at the time of registration.⁶⁶ Furthermore, a registrant must pay both an initial registration fee, as well as annual fees. The requirements of NI 31-103, including the 2011 amendments, would also apply in Quebec (cf. paras 46, 50 et seq). The international adviser exemption in NI 31-103 section 8.26 described in paragraphs 15.56–15.58 supra is also available in Quebec, but there is no Quebec equivalent to the sub-adviser exemption in OSC Rule 35-502 section 7.3.

3.3 Rules

3.3.1. General Standards

The general standards applicable to asset manager activity in Canada are not neatly systematized; rather there is overlap and duplication of duties imposed by general principles of private law (in particular, under common law principles), specific regulatory (and self-regulatory) provisions, all supplemented by professional standards. Similar or identical obligations may be imposed from multiple sources. Although this results in complexity, there is a potentially beneficial reinforcing effect.

3.3.1.1 Ontario

An adviser, which would include an asset manager, has certain basic obligations to know its client and take reasonable steps to ensure that trades are suitable for the client. Further, advisers are required to avoid conflicts of interest, or situations in which conflicts of interest might arise. Furthermore, NI 31-103, which also applies in Quebec, imposes restrictions on various selling and marketing practices such as tied selling and referrals, as well as stipulating financial reporting, bonding, and insurance requirements. The provisions of NI 31-103 are supplemented by industry codes and a number of federal statutes.

3.3.1.1.1 Duties to Clients - Fiduciary duty and duty of care

Advisers have two main duties to clients in Ontario, a fiduciary duty and a duty of care. A fiduciary obligation is a product of the courts of equity and independent from the duty of care. These duties may arise

⁶⁴ See s 149 QSA.

⁶⁵ See s 151 QSA.

⁶⁶ s 159 of the QSA.

from different sources: legislation, regulations, and contracts such as IMAs.⁶⁷ The know-your-client duty is now embodied in legislation⁶⁸ and often considered to fall within the duty of care.

The know-your-client rule began as an industry standard used by the courts to determine whether an adviser violated regulatory or private laws. It subsequently became embedded in NI 31-103 as a duty imposed on an adviser to ascertain the client's identity, investment profile and goals, financial means, and risk tolerance when establishing a client account, as well as a duty to update the information frequently. Registrants are required to make inquiries if they have cause for concern about a client's reputation. Further, a registrant must take reasonable steps to determine if a client is an insider of an issuer whose securities are publicly traded.⁶⁹ These latter two requirements highlight the dual purpose of the know-your-client rule. Registrants not only have a duty of care to their clients but also function as gatekeepers, assuring the integrity of the capital markets by seeking to prevent insider trading and market manipulation.

In *875121 Ontario Ltd v. Nesbitt Burns Inc.*, it was noted that the duty of a registered representative (applicable to both advisers and dealers, and thus also to asset managers) under the know-your-client rule was:⁷⁰ (1) to be aware of the risk associated with the investment proposed; (2) to be fully aware of the client's risk tolerance with respect to the investment being proposed; and (3) to communicate to the client the risk of the investment so as to be satisfied that the client accepts the risk. These three responsibilities are now included in NI 31-103, sections 13.2–13.3. Since the know-your-client rule is usually regarded as falling within the duty of care, breach of the rule often results in a finding of negligence. NI 31-103 requires registrants to take reasonable steps to ensure each trade is suitable for a client. Registrants must have an in-depth knowledge of each product including risks, key features, and initial and ongoing fees.

In addition to the know-your-client rules, since portfolio managers (including asset managers) fall within the 'adviser' category,⁷¹ they are subject to potential liability for failure to meet the requirements applicable to them under the OSA and NI 31-103. Persons acting as advisers (individuals and companies) must be registered,⁷² failing which they become subject to such sanctions such as fines or prohibitions from advising or trading for an extended period of time.⁷³

⁶⁷ Paras 85 and 86 of *875121 Ontario Ltd v Nesbitt Burns Inc.* (1999), 50 BLR (2d) 137, summarize the cases dealing with the different types of adviser duties.

⁶⁸ ss 13(2) of NI-31-103.

⁶⁹ ss 13(2) of NI-31-103.

⁷⁰ *875121 Ontario Ltd v Nesbitt Burns Inc.*, (1999), 50 BLR (2d) 137 at para 89.

⁷¹ Under s 26(6) OSA.

⁷² Under s 25(3) OSA.

⁷³ *Re: Dodsley*, (2003), 26 OSCB 1799. The individual was holding himself out to be an adviser, without being registered under s 25(1)(c) of the OSA, which stipulated that an adviser had to be registered under the OSA. The individual was also found to be trading without being a registrant. He was prohibited from trading directly or indirectly for 10 years. He was still allowed to trade in securities owned by him and for his own personal account.

The OSA imposes a statutory duty of compliance with Ontario securities law upon registrants⁷⁴ and itemizes various other requirements. Section 32(2) stipulates that every registrant must establish and maintain systems of control and supervision to uphold the regulations to which the adviser, firm, and employees are subject. OSC Rule 31-505 Conditions of Registration specifically imposes a duty on registered advisers and their representatives to deal fairly, honestly, and in good faith with their clients.⁷⁵ Although NI 31-103 does not explicitly formulate a standard of care, it is implicit in the sections relating to dealing with clients (s 13.2) and suitability (s 13.3).

Advisers must identify and respond to a broad range of conflicts of interest as part of their obligation to act in the best interests of their clients. In order to comply with NI 31-103 section 13.4(1), a registered firm⁷⁶ must take reasonable steps to identify existing material conflicts of interest, as well as material conflicts of interest that the registered firm in its reasonable opinion would expect to arise between the firm (including each individual acting on the firm's behalf) and a client. After identifying conflicts of interest, a registered firm must respond to them. When responding to any conflict of interest, registrants need to consider their standard of care for dealing with clients and apply consistent criteria to similar types of conflicts of interest.

In general, three methods are used to respond to conflicts of interest: avoidance, control, and disclosure. If the risk of harming a client or the integrity of the markets is too high, the conflict should be avoided. If a registered firm does not avoid a conflict of interest, it should take steps to control or disclose the conflict, or both. The firm should also consider the internal structures or policies and procedures that would enable it reasonably to respond to the conflict of interest.

Registered firms must design their organizational structures, lines of reporting, and even physical locations to control conflicts of interest effectively. For example, certain situations are considered to present a conflict of interest,⁷⁷ and depending on its nature, appropriate controls would be required to be put in place.

3.3.1.1.2 Tied Selling

NI 31-103 prohibits tied selling. A registered adviser must not require a person to engage in a transaction, as a condition of supplying or continuing to supply another product or service.⁷⁸ For example, if a financial

⁷⁴ s 32(1) OSA.

⁷⁵ s 2.1 and 2.2.

⁷⁶ For these purposes, a registered firm includes a registered dealer, registered adviser, or a registered investment fund manager (NI 31-103). Asset managers would fall within the category of registered adviser.

⁷⁷ eg if the organization is structured so that advisory staff report to marketing staff; compliance or internal audit staff report to a business unit; or dealing representatives and investment banking staff work in close proximity so that client information cannot remain confidential.

⁷⁸ s 11.8 of NI-31-103.

institution makes the acquisition by a client of a mutual fund product sponsored by the financial institution a condition precedent to the client receiving a loan, the institution has engaged in tied selling.⁷⁹ Relationship pricing (ie the practice of industry participants offering financial incentives or advantages to certain clients) or other beneficial selling arrangements are not prohibited.

3.3.1.1.3 Referral arrangements

Referral of a client to another financial service provider, divulging a client's personal information, or engaging in commission splitting, can all potentially give rise to conflicts of interest or trigger fiduciary-like responsibilities on the part of the asset manager. Under fiduciary principles, these responsibilities may arise irrespective of whether the arrangements are prejudicial to the client. NI 31-103, sections 13.7–13.11 set out detailed requirements for permitted referral arrangements. For example, the referring person must take reasonable steps to satisfy itself that the person to which the referral is made is appropriately qualified and registered.⁸⁰ Written disclosure of the referral arrangement must be made to the client and registered firms must be parties to any referral agreements entered into by their representatives. This ensures that the registered firm is aware of these arrangements and can adequately supervise its representatives and monitor compliance.⁸¹

3.3.1.1.4 Bonding, insurance, and financial statements

A registered adviser must maintain bonding or insurance⁸² and prepare and file annual financial statements with its regulator.⁸³ The insurance requirements for advisers depend in part on whether the adviser holds or has access to client assets.⁸⁴

3.3.1.1.5 IIROC rules

As the national self-regulatory organization for the Canadian investment industry, IIROC is responsible for setting and enforcing rules and regulations regarding proficiency, business and financial conduct, and trading activities of individuals and firms under its jurisdiction. IIROC-regulated firms must properly and effectively supervise the actions of their asset manager advisers. Firms that fail to fulfil this obligation may face disciplinary actions and penalties. The 'best execution' duty requires a firm to seek to execute clients' orders on the most advantageous terms reasonably expected in the market at the time. Historically this has meant getting the client the best price available at the time the order is received; however, firms may also

⁷⁹ See *ibid.*

⁸⁰ NI-31-103, s 13.9.

⁸¹ s 13.8 of 31-103CP.

⁸² See s 12.4 of NI 31-103.

⁸³ See s 12.10 of NI 31-103.

⁸⁴ s 12.4 of 31-103CP.

take into consideration such things as speed and certainty of execution and the overall cost of executing the trade.⁸⁵

IIROC precludes advisers (which includes asset managers) from engaging in any personal financial dealing with their clients. Such dealings include lending to or borrowing money from clients, paying clients their losses out of advisers' personal funds, or sharing a financial interest in an account with a client. Advisers are precluded from front-running client orders.⁸⁶

3.3.1.1.6 Industry standards

Apart from the securities law or IIROC framework, industry standards also prescribe rules for advisers (which would include asset managers). For example, the CFA Institute, the licensing body for the Chartered Financial Analyst (CFA) designation, is not a self-regulatory organization recognized by securities legislation and does not have the power to impose statutory or regulatory requirements. However, since most asset managers hold the CFA designation and need it to obtain their positions, most managers must comply with the rules and regulations of the CFA Institute. Its Code of Ethics and Standards of Professional Conduct⁸⁷ stipulate fiduciary-like duties and procedures to be followed with respect to several parties, one of which is the client:

1. Loyalty, Prudence, and Care: acting for the benefit of the client and placing the client's interests before an employer's or their own.
2. Fair Dealing: dealing fairly and objectively when providing investment analysis or advice.
3. Suitability: making reasonable inquiry into a client's investment experience, objectives, and risk tolerance and making recommendations accordingly; carrying out investment actions that are consistent with the objectives of the portfolio, where specified in the mandate.
4. Performance Presentation: making reasonable efforts to ensure that the communication of investment performance is fair, accurate, and complete.
5. Preservation of Confidentiality: keeping information about current and former clients confidential, unless otherwise required by law.

This overlap and duplication is characteristic of the overall 'regulatory' approach to the activities of asset managers; similar or identical obligations 'accrete' over time, imposed by different forms of instrument.

⁸⁵ See <<http://www.iroc.ca>>

⁸⁶ Front-running occurs when a market participant receives a client order that could reasonably be expected to affect the market price of a security, and then enters his or her own order ahead of the client order.

⁸⁷ Effective as of 1 July 2010.

3.3.1.1.7 Federal legislation governing the conduct of investment advisers

Additionally, federal statutes govern the conduct of investment advisers (which would include asset managers). Federal statutes, of course, apply equally in Ontario and Quebec, as well as in the rest of Canada. Criminal code violations may be triggered by fraudulent activity, and, in certain cases, conflicts of interest giving rise to ‘secret commissions’ under subsection 426(1) of the Criminal Code.⁸⁸

More recently, in the wake of the terrorist events of September 11, 2001, a heavy burden of new federal regulations has been imposed on the financial industry in general, which also catches the activities of asset managers.⁸⁹ Among other things, the reporting requirements of the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA), stipulate that securities dealers (which includes asset managers) must report suspicious transactions, terrorist property, and large cash transactions (more than \$10,000). Additionally, when a record of a large cash transaction is required, advisers must take reasonable measures to determine whether the individual is acting on behalf of a third party. If a third party is involved, the adviser must obtain specific information about the third party and its relationship with the individual providing the cash or the account holder.⁹⁰ Advisers must also take reasonable steps to determine whether or not they are dealing with a ‘politically exposed’ person.⁹¹

Advisers must also comply with a suite of federal legislative provisions, referred to as the Canadian Sanctions Legislation, which applies to all persons and entities doing business in Canada.⁹² Essentially, Canadian Sanctions Legislation implements various international obligations taken on by the Canadian government and may require advisers to determine whether they are dealing with certain kinds of ‘designated persons’, disclose client information to government authorities, and freeze client assets.

⁸⁸ RSC 1985, c. C-46. See also the case of *R. v Kelly*, 2 SCR 170, in which an adviser approached a real estate developer to sell the developer’s Multiple Use Residential Buildings (MURBs) for a commission. The adviser sold all the units, mostly to its clients, thereby profiting \$925,586 in commission. The relationship between the adviser and developer was never disclosed to the adviser’s clients. The trial judge found that the adviser was an agent of its clients and had placed itself in a criminal conflict of interest with its clients. The adviser was found guilty on four counts corruptly accepting a reward or benefit contrary to s 426(1). The British Columbia Court of Appeal and SCC upheld the conviction.

⁸⁹ The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* SC 2000, c. 17, imposes legislative requirements on portfolio managers within the definition of ‘securities dealer’ under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations*, SOR/2002-184. A ‘securities dealer’ means a person or entity that is authorized under provincial legislation to engage in business of dealing in securities or any other financial instruments or to provide portfolio management or investment advising services. This definition catches asset managers. Securities dealers are required to establish a compliance regime in addition to complying with the reporting, record keeping, and identity verification requirements of the PCMLTFA.

⁹⁰ ss 6 and 6.1 PCMLTFA.

⁹¹ s 9.3(3) PCMLTFA.

⁹² Canadian Sanctions Legislation is made up of five principal statutes: *Criminal Code*, RSC 1985, c. U-2, *Special Economic Measures Act* SC 1992, c. 17, *Foreign Extra Territorial Measures Act* RSC, 1985, c. F-29, and *Export and Import Permits Act* RSC 1985, c. C-51.

Lastly, advisers are subject to the requirements of privacy legislation, in particular the federal Personal Information Protection and Electronic Documents Act (PIPEDA),⁹³ which applies to all organizations, such as asset managers, that collect, use, or disclose personal information for commercial activities. PIPEDA provides that organizations must be transparent about their privacy practices and may not collect, use, or disclose personal information without the consent of the individual, except when an enumerated exemption applies.

3.3.1.1.8 Compliance

A registered firm, which would include asset managers, must maintain and apply policies and procedures that establish a system of controls and supervision to ensure compliance with securities legislation and SRO rules. It must manage its business in accordance with prudent business practices.⁹⁴ A compliance system would include internal controls and mechanisms that are reasonably likely to identify non-compliance at an early stage and allow the firm to correct non-compliant conduct in a timely manner. A large registered firm with diverse operations may require a larger team of compliance professionals with several divisional heads of compliance who report to a Chief Compliance Officer dedicated entirely to a compliance role. As well, the OSA stipulates a long list of regulations that a registered adviser must comply with in addition to Ontario general securities law.⁹⁵ Registered firms must also keep accurate books and records⁹⁶ and are subject to capital requirements.⁹⁷ The OSC may, at any time, require a registered adviser to direct its auditor to conduct an audit or financial review of the firm for delivery to the OSC.⁹⁸ Additionally, the OSA contains detailed provisions on false representations, prohibitions on the voting of clients' securities, and document delivery obligations, among other things.

Importantly, registered portfolio managers in Canada do not provide custodial services. A registered firm must hold client assets (a) separate and apart from its own property; (b) in trust for the client; and (c) in the case of cash, in a designated trust account at a Canadian financial institution, a Schedule III bank, or a member of IIROC.⁹⁹ In the case of a written safekeeping agreement with respect to a client's unencumbered

⁹³ SC 2000, c. 5.

⁹⁴ s 32(2) OSA; NI 31-103 s 11.1.

⁹⁵ These include regulations regarding proficiency standards, business conduct; submission of information respecting ownership; management, directors, officers and any other persons or companies exercising control of the registrant; opening accounts and reporting trades; record-keeping; custody of clients' assets; conflicts of interest; tied selling and referral arrangements; client complaints; appointment of auditors and preparation and filing of financial information; procedures to be followed when a relationship is terminated between a representative and a registered dealer or registered adviser or when the representative commences a new association with a different registered dealer or registered adviser; and reinstatement of registration (s 32(1) OSA).

⁹⁶ NI 31-103 s 11.5.

⁹⁷ NI 31-103 s 12.1.

⁹⁸ s 27(4) OSA.

⁹⁹ NI 31-103, s 14.6. A registered portfolio manager cannot hold a client's assets because it would not be a member of CDS Clearing and Depository Services Inc. (CDS). Financial institutions and IIROC member firms that are clearing brokers (as

securities, section 14.8 of NI 31-103 specifies a registered firm's obligations. Institutional investors almost always have their own custodian for their assets; on the other hand, retail clients may have an account with a broker to which the asset manager may have access.

3.3.1.1.9 Marketing practices

Three issues have been of particular recent concern to the OSC: (1) marketing materials used by portfolio managers; (2) assessment of asset managers' compliance with Ontario securities laws; and (3) identification of regulatory gaps.¹⁰⁰ In particular, the OSC has recommended a best practice with respect to the calculation of investment returns used in marketing materials.¹⁰¹ Overall, the OSC allows marketing by all categories of adviser as long as it does not violate the rules of acting honestly and in good faith with respect to clients.¹⁰²

3.3.1.2 Quebec

Many of the rules relating to areas of potential liability for asset managers, including disclosure obligations and know-your-client rules, apply in both Ontario and Quebec. In 2009, QSA section 161 was repealed and replaced by NI 31-103 as part of a process of harmonizing and consolidating provincial securities legislation governing licensing and conduct of dealers and advisers. In addition to NI 31-103, the QSA provides a public law 'code of conduct' for asset managers. Article 160, which addresses ethics, stipulates that all persons registered as dealers, advisers, or representatives are required to deal fairly, honestly, loyally, and in good faith with their clients. Furthermore, QSA section 166 imposes an obligation on registrants to make statements regarding the actual existence of conflicts of interest and conflicts of interest that might reasonably arise between the registrant and the registrant's clients.

Similarly, the QSA requires advisers to maintain books, records, and other documents related to their activities, which can be accessed and inspected by inspectors. In addition, specific civil code rules apply to the administration of the property of others.¹⁰³ Registrants are considered to assume the office of

opposed to introducing brokers) are members of CDS. An IIROC member must participate in CDS in order to clear and settle trades of securities deposited in CDS. CDS is Canada's national securities depository, clearing, and settlement system, analogous to Depository Trust Corporation in the United States.

¹⁰⁰ Ontario Securities Commission Staff Notice 33-729 (Notice 33-729), *Marketing Practices of Investment Counsel/Portfolio Managers*, dated 9 November 2007.

¹⁰¹ Notice 33-729 recommended that actual returns be advertised as opposed to hypothetical returns based on firm strategy.

¹⁰² An example of inappropriate and illegal advertising is in *Re Dodsley*, 26 OSCB 1799, in which an unregistered person advertised investment advice that was deemed to be in furtherance of trading in securities. The OSC called the advertising, which was titled 'unlimited profit, no risk,' dangerous and contrary to the public interest.

¹⁰³ Arts 1299 et seq CCQ.

administrator of the property of others and thereby assume the obligation to act with prudence and diligence, honestly, and faithfully in the client's best interests.¹⁰⁴

4. Enforcement of regulatory rules and remedies

Although criminal law is primarily a matter of federal jurisdiction in Canada, provinces and provincial agencies can impose a wide range of civil and administrative sanctions, as well as criminal sanctions for 'provincial offences' created under provincial legislation. Although an asset manager's conduct might constitute an offence under the federal Criminal Code thereby triggering federal criminal sanctions, the overwhelming burden of enforcement resides with provincial regulators under provincial criminal and administrative powers.

In addition, due to the interaction of standardized contractual provisions of the IMA and regulatory licensing and regulatory requirements, the enforcement of regulatory rules may in fact be complemented by private law mechanisms. For example, a portfolio manager cannot contractually derogate from the licensing, proficiency, and registration requirements of the OSA and NI 31-103 because they are mandatory to carry on business as an adviser. IMAs contain covenants with respect to compliance with regulatory requirements, and in the event of breach of these covenants, jeopardize the contractual validity of the IMA (which may be found to be void or voidable). As a result, public law duties become private law duties owed to the client through incorporation of statutory and SRO requirements into the IMA. However, portfolio managers may receive compliance audits from the OSC or IIROC that order or recommend certain improvements or changes. In nearly all cases, imposing these required changes or recommendations will not void the IMA.

One particularly effective enforcement procedure is suspension of a registrant's status. In addition to the reputational stigma, suspension puts the offender out of business during the suspension period thus imposing significant economic hardship. The registration of each dealer and advising representative of a suspended registrant is also suspended until reinstated or revoked (NI 31-103).¹⁰⁵

4.1. Ontario

Failure to comply with Ontario securities law triggers various sanctions under the OSA. The most serious penalty is the provincial offence (criminal in nature) created under section 122(1)(c) OSA; conviction for contravention of Ontario securities law carries with it a fine up to CAD\$5 million or imprisonment for up to

¹⁰⁴ For a full list of the legal obligations of administrators, see Arts 1299 to 1318 CCQ.

¹⁰⁵ s 6.4 NI 31-103. Section 6.5 deals with the suspension of dealing and advising activities and s 6.6 states that an individual's registration is revoked on the second anniversary of the suspension, if there is no intervening reinstatement.

five years less a day, or both.¹⁰⁶ Due to the possibility of imprisonment, guilt would have to be proven beyond a reasonable doubt, a heavy burden to meet.

The most powerful enforcement tool possessed by the OSC, and one to which there is frequent recourse by regulators, is the ‘public interest’ or ‘section 127 order’,¹⁰⁷ which permits the imposition of a wide range of civil and administrative sanctions¹⁰⁸ against all market participants and registrants (which includes asset managers).

Importantly, given the fragmented nature of provincial securities regulation in Canada, the OSA provides for inter-jurisdictional enforcement allowing Ontario to make orders if a person or company has been convicted of an offence relating to securities laws in other provinces or territories of Canada.¹⁰⁹ In *Re: Noram Capital Management Inc.*,¹¹⁰ for example, a portfolio manager’s non-compliance with former OSA sections regarding regular financial reporting and maintenance of a prescribed amount of minimum free capital (requirements now found in NI 31-103) resulted in a section 127 order. The portfolio manager’s registration was suspended for six months, and it was required to provide the OSC with quarterly financial statements and working capital calculations with reports from auditors.

4.2 Quebec

As in Ontario, the QSA contains a wide range of general penalties for acts that contravene the statute, including illegal trading or asset management by unregistered individuals.¹¹¹ The QSA also sets out numerous specific prohibitions and penalties regarding regulated activities of advisers and which would apply to asset managers. For example, sections 187 to 194 QSA deal with the use of privileged information (including insider trading), prohibited representations, multiple transactions, and short sales. The QSA also creates ‘offences’ that are subject to penal (ie provincial) criminal sanctions.¹¹² The list includes contravening decisions of the AMF; failing to furnish documents; use of a non-registered representative; influencing market prices by improper or fraudulent practises; various misrepresentations involving prospectuses, repurchase of shares, or the future value of a share; and third-party information disclosure.

¹⁰⁶ This severe penalty is often imposed in cases of insider trading.

¹⁰⁷ A reference to s 127 OSA, where the provision authorizing the order is found.

¹⁰⁸ A ‘public interest’ or ‘s 127 order’ order can be used to: (1) force a market participant to submit to a review of its practices and thereafter to implement any changes ordered by the OSC; (2) reprimand or fine a firm or an individual; (3) prohibit a person from becoming or acting as director or officer of any issuer; (4) order a person to resign or be prohibited from being a director or officer of a registrant; (5) order that a person or company who has not complied with Ontario securities law pay an administrative penalty of not more than \$1 million for each failure to comply; and (6) order a person or company to disgorge to the OSC any profits gained as a result of non-compliance.

¹⁰⁹ s 127(10) OSA.

¹¹⁰ (1999) 22 OSCB 6635.

¹¹¹ s 202 QSA.

¹¹² ss 202–13 QSA. Under s 205 QSA, any officer, director, or employee of a principal offender who authorizes an offence is liable to the same penalties as the principal offender. Further, penalties are applicable to persons who conspire to (s 207) or aid, by act or omission, in the commission of the offence (s 208).

5. The Private Law Duties of an Asset Manager

In this discussion, the ‘private law’ duties of an asset manager refer to contractual, fiduciary, or other private law duties that might arise whether from market practices or otherwise. Of course, violation of such private law duties usually results in liability under private law principles. In the cases and doctrinal writing, the ‘duties’ of asset managers are often not clearly distinguished from the ‘liability’ that results from their breach and the terms are often used interchangeably.

It should also be noted that the common law in Ontario does not make any significant distinctions with respect to the various pre-contractual, contractual, and post-contractual stages of an asset manager’s relationship with a client. Contractual obligations, and the resulting liability for their breach, are based on the final, executed IMA, and unless specifically so stated in the IMA, would usually not survive its termination. It is possible that tortious (ie extra-contractual) conduct on the part of the asset manager (or, exceptionally, the client) may occur at various stages of the relationship, triggering possible liability, for example, for negligent or fraudulent misrepresentation.

5.1. Interaction between private and public law duties

Additionally, private and public law interact in a complex manner, with the common law in Ontario not making a crisp distinction between the two. For example, the know-your-client rule appears in NI 31-103, and ultimately finds expression in provincial regulatory instruments. However, the know-your-client rule also serves to establish the standard of care under private law principles in cases of an adviser’s negligence. The breach of the rule would need to be shown to be a proximate cause of the client’s loss.¹¹³ The IMA can impose responsibilities on the asset manager in addition to those imposed by statutory and SRO requirements, including, for example, stricter conflicts of interest prohibitions and disclosure, additional reporting, use of specified sub-advisers, and geographic diversification of investments. A court may impose higher standards than those set out in regulation requirements or agreed to by the client and asset manager in the IMA. However, in finding an asset manager liable to his client under private law for failure to meet these higher standards, a court would likely find that the asset manager had breached the duty of care or fiduciary duty owed to the client .

In Quebec, the statutes, the courts, and the doctrinal writers more explicitly consider the interaction between public and private law rules. QSA section 213.1 includes a specific direction on the interaction of the CCQ civil liability provisions and the provisions of the QSA. Statutory actions for damages created under the

¹¹³ See *Abrams v Sprout Securities Ltd* (2001), 13 BLR (3d) 7, *Newman v T. D. Securities*, 26 BLR (4th) 270, *Rhoads v Prudential-Bache Securities Canada Ltd*, [1991] BCJ No 138.

QSA ‘do not prevent an action for damages from being brought under ordinary civil liability rules’ of the CCQ. Furthermore, it is widely recognized that the statutory rules set out in the QSA and its regulations serve as a ‘Code of Ethics’, frequently referred to by civil courts when assessing an asset manager’s conduct towards his client.

Also, a doctrinal theory developed in Quebec civil law, following the Supreme Court of Canada decision *Morin c. Blais*,¹¹⁴ proposes that if the violation of a statutory requirement constitutes the violation of an elementary norm of prudence, the violation can constitute a fault engaging liability. Thus, if a Quebec court were to consider the ethical requirements imposed upon asset managers to be elementary norms of prudence, one could theoretically propose that violating such norms could constitute fault that would require civil reparation (ie damages).¹¹⁵

5.2 Duties of the asset manager prior to entering into the asset management contract (IMA)

Tortious (ie extra-contractual) conduct on the part of an asset manager may occur at the pre-contractual stage of a potential client relationship, triggering liability, for example, for negligent or fraudulent misrepresentation. An asset manager might induce a client to enter into an IMA by making fraudulent or negligent misrepresentations about the dollar value of its assets under management, composition of its client base, or past performance of portfolios under management.

In Quebec, an asset manager’s extra-contractual liability may also arise during the pre-contractual stage of the relationship with a client. Article 1457 CCQ creates the duty upon any person to abide by the rules of conduct which lie upon him, according to the circumstances, usage or law, so as not to cause injury to another.¹¹⁶ For example, an asset manager may trigger the provisions of Article 1457 CCQ by causing injury to a *potential* client by sending misleading or fraudulent information before entering into a contract. An asset manager may also incur liability under Article 1457 CCQ to third parties, other than potential clients, for example, with respect to information the manager publishes in journals, columns, public announcements, etc.

¹¹⁴ *Morin v Blais*, [1977] SCR 570.

¹¹⁵ This theory has not been argued or mentioned in any ruling but has been proposed by several authors, including O’Donnel and Olivier, supra note [], 14 and Baudouin, supra note [].

¹¹⁶ Art 1457 CCQ states in full: ‘Every person has a duty to abide by the rules of conduct which lie upon him, according to the circumstances, usage or law, so as not to cause injury to another. Where he is endowed with reason and fails in this duty, he is responsible for any injury he causes to another person by such fault and is liable to reparation for the injury, whether it be bodily, moral or material in nature. He is also liable, in certain cases, to reparation for injury caused to another by the act or fault of another person or by the act of things in his custody.’

If the information is misleading or influences the market price of shares, the asset manager may be liable towards third parties for any losses related to the use of the information.¹¹⁷ This is a very broad basis for liability, in contrast with the common law standard. Although it may include circumstances constituting fraudulent or negligent misrepresentation in the common law, the duty created by Article 1457 CCQ is much broader. Generally, doctrinal writers agree that if a plaintiff demonstrates a causal link between the investment report issued and the losses incurred, the transmission of the information in the misleading report may constitute a fault under Article 1457 CCQ and thus be actionable.¹¹⁸

5.3. Duties of the asset manager during the asset management contract (IMA)

In Ontario, IMAs are the most important source of the rules, duties, and standards applicable to the asset manager–client relationship. In keeping with the common law tradition, great deference is given to the parties’ freedom to structure the contract as they will. Nevertheless, the IMA will always include a standard of care clause that contractually delineates the manager’s duties and responsibilities to that client. The typical contractual standard of care may vary from one manager to another, as well as from one client to another. As the IMA is typically drafted by the asset manager, unless the client is an institutional investor with considerable bargaining power, the contractual standard of care and duties imposed on the asset manager will not be unduly onerous. In keeping with the penchant for overlap and duplication found in the common law, as well as the rather blurred distinction made between private and public law, IMAs contractually incorporate much of the regulatory language taken from NI 31-103.

Although the IMA may in fact create a principal–agent relationship in common law, agency principles tend to operate more implicitly than explicitly, having been submerged by the overlay of regulation, self-regulatory, and industry standards, plus more or less standardized contractual provisions.

In Quebec, contracts pertaining to asset managers are characterized as either contracts of mandate or contracts of service under the CCQ, depending on the nature of the client–asset manager relationship. Both types of contract impose similar duties but also have requirements specific to each contract type. Under Article 2138 CCQ, governing the contract of mandate (which corresponds roughly to a common law principal–agent relationship), a mandatory must act with prudence and diligence, honestly, faithfully, and in the best interests of the mandator.¹¹⁹ A services contract, on the other hand, imposes a similar but slightly

¹¹⁷ O’Donnel and Olivier, *supra* note [], 26. For an example of accountants who found themselves in this type of situation with regard to an erroneous report, see *Caisse Populaire de Charlesbourg v Michaud*, [1990] RRA 531, 535 (CA). However, in this case, no damages were awarded because causality was absent between the loss of profit and the report.

¹¹⁸ O’Donnel and Olivier, *supra* note []; Baudouin, *supra* note [], para 2-199.

¹¹⁹ There is also a duty to keep the mandatory informed and to follow-up at the end of the mandate (Arts 2139 and 2182 CCQ).

different standard: to act in the best interest of the client, with prudence and diligence, in accordance with the practice and rules of Article 2100 CCQ.

Generally, in civil law terms, the obligation imposed upon an asset manager is one of means (again, corresponding roughly to the common law ‘best efforts’ standard) and not of results. For example, an asset manager is usually not responsible for a simple investment loss incurred by the client, not having guaranteed a specific investment return as a ‘result’.¹²⁰ However, an obligation of results may be imposed in certain circumstances. For example, in a services contract, Article 2100 CCQ provides that if the service provider (here the asset manager) is bound to produce results (eg the manager guarantees a specific return on investments),¹²¹ then the manager is bound by an obligation to produce these results. Courts generally recognize the same principle in the context of a contract of mandate.

Quebec case law and doctrine recognize several other duties based on CCQ and statutory provisions that resemble, in some cases, those found in Ontario. Quebec recognizes a know-your-client rule, previously defined under section 161 of the QSA, and now embedded in NI 31-103. The asset manager must consider the client’s personalized needs, which entails enquiring about the client’s identity, investment objectives, solvency, and financial means.¹²²

A court may sanction an asset manager who invests the client’s funds in high-risk investments contrary to the client’s investment objectives established by contract or otherwise under know-your-client obligations.¹²³ Similarly, under Articles 2138 and 2100 CCQ (as well as under the QSA, see para 15.87), an asset manager must generally exercise diligence in the choice, diversification, and risk categories of a client’s portfolio, sometimes termed the personalized diligence duty.¹²⁴ Although ultimately derived from the CCQ and the provisions of NI 31-103, these principles provide the content for the contractual standards to which the asset manager is bound.

Under principles of mandate (Art 2139 CCQ), the asset manager has an ongoing and continuous duty to counsel and provide recommendations and advice to the client during the course of the relationship.¹²⁵ This duty may be more onerous when the customer is inexperienced¹²⁶ and also requires the asset manager to follow up on the advice periodically. A client may also pursue an asset manager who has not fully explained

¹²⁰ Baudouin, supra note [], para 2-201.

¹²¹ See O’Donnel and Olivier, supra note [], 21.

¹²² Baudouin, supra note [], para 2-206.

¹²³ *Placements Laflamme v Prudential Services*, supra note []; *Therrien v David*, 2002 CanLII 41869 (Qc CCQ).

¹²⁴ O’Donnel and Olivier, supra note [] 18.

¹²⁵ *Ibid.*

¹²⁶ *Placements Laflamme v Prudential Services*, supra note [].

the risks associated with certain transactions.¹²⁷ However, doctrinal writers note that an experienced investor, unlike an inexperienced one, may be held to have known information that was not specifically disclosed.¹²⁸ Conflicts of interest may be sanctioned both under the QSA as well as under private law; an asset manager must divulge any existing conflict of interest to the customer before undertaking a transaction.¹²⁹

5.4 Validity of contractual derogations from regulatory and private law duties

In Ontario, the IMA cannot relieve an asset manager from its obligations to comply with statutory and SRO regulatory requirements, although the OSC or IIROC, respectively, can do so. An asset manager may by contract limit its liability for breaches of contractual obligations to comply with regulatory and private law rules through limitation of liability clauses. In Ontario, IMAs generally include a carve-out from the limitation of liability for fraud, wilful misconduct, and gross negligence.

In Quebec, due to the statutory source of duties imposed by the QSA, liability cannot be completely avoided by contract. Only the AMF can exempt asset managers from the statutory and other requirements. As in Ontario, however, under Article 1474 CCQ permits contractual limitations of potential liability.¹³⁰ Such limitation of liability clauses are common practice and Quebec courts give them effect as written,¹³¹ barring gross negligence or acts of an intentional nature.

5.5. Contractual clauses, market practice, and model agreements

As a matter of industry practice, an asset management contract is usually referred to as an investment management agreement or IMA. Although an IMA could be described as a services contract, no particular legal consequences flow from that description in the common law. The content of IMAs is not regulated by

¹²⁷ Ibid para 2-208.

¹²⁸ Ibid para 2-209.

¹²⁹ See, e.g. *Paquette v Conseil de la santé et des services sociaux de la Montérégie*, 1996 CanLII 6130 (QC CA). A frequent practice amongst asset managers is to transact on a customer's line of credit in the course of managing the portfolio. The line of credit agreement generally contains a clause forcing the asset manager to sell all assets in the portfolio to pay down the line of credit if certain default provisions are triggered. Due to the presence of these clauses, rarely will the customer be able to obtain damages as reparation for the loss of profits due to the immediate sale of assets. Baudouin, supra note 29, para 2-211.

¹³⁰ Liability cannot be limited for acts of an intentional nature or for gross negligence. In addition, a management contract may be considered a contract of adhesion (see Art 1379 CCQ). Financial institutions make use of model contracts containing standardized limitation of liability clauses; these clauses risk being declared void if the contract is one of adhesion and the clause is considered abusive (Art 1437 CCQ).

¹³¹ See for instance *Lemire v Courtage direct Banque Nationale inc.*, 2009 QCCQ 14985 (CanLII); *Côté v Montrusco Bolton inc.*, 2005 CanLII 26180 (QC CQ); *Adams v Valeurs mobilières Tradefreedom inc.*, 2008 QCCQ 1681 (CanLII).

securities legislation, with the result that the portfolio manager and client can come to an agreement on virtually all major points. These contractual provisions, usually drafted by the asset manager, may differ from one manager to another and from one client to another, but usually incorporate much of the regulatory language of NI 31-103.

The IMA governs the relationship between an asset manager and its client. Usual matters dealt with in the IMA are: (1) compensation of the asset manager; (2) the manager's standard of care; (3) the grant of discretionary authority to the manager; (4) the circumstances that would give rise to liability of the firm and manager; (5) the client's investment parameters; (6) the manager's regulatory status; (7) confidentiality; (8) custodial duties, if any; (9) governing law; (10) non-assignability; (11) termination; and (12) financial reporting obligations.

An asset manager usually has full discretion to invest the client's funds according to an investment mandate attached to the IMA. The investment mandate specifies the types of securities (based on the client's risk profile) in which the asset manager may invest. In addition to representing and warranting compliance with applicable registration and licensing regulations, the asset manager agrees to comply at all times with applicable laws and regulations.¹³² Information with respect to fees is often attached as a separate schedule to the IMA, and usually calculated as a percentage of the amount invested (although no market practices require such an approach). The greater the amount invested, the lower the percentage fee.

The standard of care requires honesty, good faith, and acting with a view to the client's best interests. Depending on the client's bargaining power, this standard may be set as a professional one, imposing a higher standard of care than would otherwise prevail in circumstances of ordinary negligence.¹³³ Liability of the firm and its officers, directors, and employees for losses from any error of judgement (excluding losses resulting from wilful misconduct, bad faith, or gross negligence) are limited. The manager agrees to provide financial reporting on a periodic basis to the client and notify the custodian of every executed trade. In choosing a broker, the asset manager often agrees to use its best efforts to seek the best execution available. Termination of the contract by the client usually requires 30 to 60 days' written notice. Since advisers (which include asset managers) cannot perform custodial services, the agreement will stipulate how those services will be handled.

¹³² In some instances, the IMA includes a provision requiring notice to the client of any event that would disqualify the manager from providing the advising services. If this occurred, the manager would be in violation of the terms of the IMA, and the contract would be frustrated and no longer valid.

¹³³ Where there is a professional standard of care stipulated in the IMA that usually indicates that the IMA has been negotiated by an institutional investor with superior bargaining power.

Although the contents of an IMA are not specified in provincial securities regulation, IIROC Rule 1300 does regulate, to some extent, the content of IMAs entered into by IIROC member firms. In addition, the Business Conduct Division of IIROC has published a Managed Account Agreement checklist, including both required and recommended provisions.

Advisers that are not employed by an IIROC member firm are not subject to requirements of this self-regulatory organization, but industry organizations like the Investment Counsel Association of Canada set market-practice standards. Thus, despite the potential disparity of individual contractual arrangements, industry practices promote a certain degree of uniformity.

6. Liability of an Asset Manager

6.1. Liability for asset manager's own acts towards customers and third parties

The primary legal bases for the liability of asset managers are broadly the same in both Ontario and Quebec: asset managers may incur liability for conduct that constitutes tortious action, usually negligence, under common law principles in Ontario and extra-contractual (or delictual) responsibility under the CCQ in Quebec. Given the extra-contractual nature of this liability, asset managers may find themselves responsible to third parties, as well as to their own customers to whom they are bound by a contractual or principal-agent relationship. Despite the underlying contractual and, in Ontario, principal-agent, basis for the legal relationship between an asset manager and a client, most of the litigation involving asset managers appears to be based on negligence (a tort) or a breach of a fiduciary duty in Ontario. Equally, in Quebec the equivalent recourses under the CCQ¹³⁴ are pursued. There may be a number of reasons for this.

Judicial action usually takes place at the instance of the client for quantifiable loss of some kind. In Ontario, negligence provides the broadest basis for a client's claim; other, more specific claims such as fraudulent misrepresentation or deceit may be harder to prove. In Quebec, a client has recourse to the even broader provisions of Article 1457 CCQ.¹³⁵ Importantly, although the same conduct may give rise to claims in both contract and negligence, the contract itself is usually a standard form produced by the asset manager and thus give little room for judicial contestation by the client.

Also, in a common law jurisdiction like Ontario, private law develops slowly and incrementally, case by case. Cases are decided based on the strategic decisions of plaintiff's counsel in framing the issues in the context of particular facts. The law applicable to areas of potential liability for asset managers may thus remain undeveloped in certain respects.

¹³⁴ Arts 1457 and 1299 CCQ (the provisions on delictual responsibility and management of the property of others).

¹³⁵ Supra note [].

Nevertheless, many aspects of the relationship between an asset manager and its customers are determined solely by contract; the terms of a particular contract will govern when determining the existence and extent of an asset manager's contractual liability. Hence, retail investors may find themselves disadvantaged because the contract will likely be a standard form or contract of adhesion prepared by the asset manager, the terms of which would be driven by the asset manager's self-interest. Quebec investors, however, would have the benefit of CCQ provisions designed to provide redress for abusive clauses in contracts of adhesion. Ontario investors might have a more difficult argument to make, based on somewhat vague notions of unconscionability. In either case, contractual limitations of liability operating in favour of the asset manager are permissible, and in fact, very common. Institutional investors, on the other hand, may and often do fare better due to their superior bargaining power. While limitation of asset manager liability is still usual, the IMAs that institutional investors negotiate often impose a higher professional standard of care against which actions of the asset manager will be measured.

Despite the potential for widely varying contractual provisions from one asset manager's IMAs to another, there is a fair degree of standardization imposed on the contractual terms by industry standards and regulatory instruments such as NI 31-103. IMAs routinely incorporate industry standards and regulatory provisions into their contractual terms. In part, this practice is compensatory, standardizing practices and expectations on a pan-Canadian basis in the face of the fragmented regulatory landscape. Although the conceptual bases for liability of asset managers may vary as between Ontario and Quebec, the practice of transforming industry practices and national regulatory instruments into contractual provisions promotes harmonization across Canada. The liability of an asset manager in one part of the country is likely to be assessed against the same standards as that of one in another part, a desirable result from both a regulatory and commercial perspective.

Importantly, the incorporation of industry standards and national (and provincial) regulatory instruments into IMAs does not detract from the effectiveness of the former. Industry standards and regulatory instruments continue to operate in their own right, and may also serve as a basis for liability of an asset manager. Transgression of regulatory instruments, for example, can produce consequences, which for the customer, may be the equivalent to a finding of liability under private law principles, for example, section 127 orders under the OSA.

The know-your-client rules, irrespective of origin,¹³⁶ are another example. While breaching the know-your-client rules may have regulatory consequences, it may also be a contractual breach, depending on the terms of the contract. Although contractual obligations often incorporate by reference the regulatory framework,

¹³⁶ The know-your-client rule is embedded in NI 31-103, a regulatory instrument, is found in industry standards and may be included in internal guidelines of an asset management firm.

liability in this case arises from breach of contract, not regulatory or other contraventions. The know-your-client rule is also used to establish an asset manager's negligence or extra-contractual responsibility under private law principles. In Ontario, asset managers not in compliance with the know-your-client rule specified in NI 31-103 risk being found negligent, provided the breach can be proven to be a proximate cause of the loss.¹³⁷

In Quebec, several statutory remedies are available to a customer for breach of the QSA and related regulations.¹³⁸ The statute specifically states that the availability of these statutory remedies does not preclude concurrent actions being undertaken under rules of general civil liability.¹³⁹ However, there is generally no cause of action available under the QSA beyond a three-year prescription (limitation) period, which begins at the time of the event complained of.¹⁴⁰

Asset managers will also be subject to fiduciary-like responsibilities, the breach of which can result in liability to their customers. Indicia used to establish the existence of a fiduciary relationship are, among others, the exercise of discretion, influence over the client, and an inherent vulnerability on the client's part.¹⁴¹ In Ontario, these fiduciary-like duties arise primarily from the creation of a principal-agent relationship while in Quebec they are found in the CCQ provisions on the administration of the property of others.¹⁴² Again, the extent and content of these fiduciary-like duties is often determined by reference to industry standards and regulatory instruments (which themselves, in turn, have drawn on general fiduciary principles). Despite the somewhat circular logic operating here, in the result, the effect is to reinforce asset manager duties through the interaction of multiple, interrelated sources of duty, the breach of which will result in liability.

In addition, registered advisers, which would include asset managers, have their own internal rules concerning such matters as client accounts, margins, and trading limits. *Varcoe v Sterling*¹⁴³ established that if a firm fails to adhere to its internal rules and regulations, it can be found to have fallen below the industry's standard of care. Extra-contractual liability would follow provided the breach was a proximate cause of the client's loss.

¹³⁷ See *Abrams v Sprott Securities Ltd* (2001), 13 BLR (3d) 7, *Newman v T. D. Securities*, 26 BLR (4th) 270, *Rhoads v Prudential-Bache Securities Canada Ltd*, [1991] BCJ No 138.

¹³⁸ ss 213.1 to 233.2 QSA.

¹³⁹ ss 214 to 216 QSA, transactions effected without a prospectus or circular (may claim damages, have the transaction rescinded or the price of the securities revised); ss 217–225.1 QSA (primary market), misrepresentations—in prospectus, offering memorandum, other documents authorized in lieu of prospectus (claims may include damages, unless a defence under ss. 220, 224 is provided by the defendant); ss 226 to 233 QSA, use of privileged information; damages claimed may include liability for benefits accrued by the asset manager from the prohibited transaction, in addition to the harm caused to the client (s. 228 and s. 190 QSA).

¹⁴⁰ ss 234 et seq QSA.

¹⁴¹ *Hodgkinson v Simms*, [1994] 3 SCR 377.

¹⁴² Arts 1308 to 1318 CCQ.

¹⁴³ (1992), 7 OR (3d) 204.

6.1.2. Elements of Liability

A breach of statute (or regulation) will not automatically provide the basis for a finding of civil liability. Rather, unless the statute expressly provides for civil liability, a breach of the statute must be dealt with in the framework of negligence, which requires showing causation.¹⁴⁴ Merely proving a violation of the know-your-client rule, for example, does not establish negligence. Rather, the client must prove the usual elements: the existence of a duty of care owed to the client; breach of the duty by the manager; and damage resulting from the breach.¹⁴⁵ Equally, an asset manager that fails to adhere to its own internal rules may be found to have fallen below the industry's standard of care. Liability will follow, provided the breach can be shown to be a proximate cause of the client's loss.¹⁴⁶ In such circumstances, the court in *Varcoe v Sterling* stated that investor sophistication might be irrelevant. This decision was followed in *Zraik v Levesque Securities Inc.*,¹⁴⁷ in which the Ontario Court of Appeal upheld the trial decision stating that the adviser committed negligence by failing to properly supervise a sophisticated investor's account and by failing to observe its own internal guidelines.¹⁴⁸

As noted above, most of the cases concerning advisers, a class that includes asset managers, are framed in negligence. The modern law of negligence in Ontario can be traced back to the landmark decision of the House of Lords in *Donoghue v Stevenson*.¹⁴⁹ Lord Atkin's classic statement in *Donoghue* of the general duty of care in negligence, based on reasonable care and foreseeability, continues to apply.

To establish a cause of action for negligence, several elements must be present: (1) one party owes another a duty of care; (2) the defendant breaches that duty of care by acts or omissions; (3) the aggrieved party suffers harm; (4) the breach is the proximate cause of the harm suffered by the aggrieved party; (5) the defending party has no defences available that would release it in whole or in part from liability; and (6) an award of damages can compensate the aggrieved party for the harm suffered.¹⁵⁰ The essence of the cause of action in negligence is the defendant's duty to take reasonable care in order to avoid a risk of foreseeable injury to the plaintiff. A finding of negligent conduct can be relevant in establishing liability arising from a number of different sources: (1) common law tort; (2) a contract in which an indemnity or limitation of liability clause adopts a negligence standard; or (3) a statute or regulation stipulating a negligence standard.

¹⁴⁴ *Robinson v Fundex Investments Inc.*, 149 ACWS (3d) 935, para 148.

¹⁴⁵ A. M. Linden, *Canadian Tort Law* 98 (6th edn 1997).

¹⁴⁶ *Varcoe v Sterling* (1992), 7 OR (3d) 204.

¹⁴⁷ (2001) 153 OAC 186.

¹⁴⁸ Portfolio managers, however, are not guarantors of portfolio performance. If an adviser meets both the applicable fiduciary duty and duty of care, any losses in value of the portfolio will not be considered negligence. See *Braams v RBC Dominion Securities*, [1999] OJ No 2586, 1999 Carswell Ont 2197.

¹⁴⁹ [1932] AC 562 (UK HL).

¹⁵⁰ Klar, *Tort Law* 361–3 (4th ed 2008); Linden, *Canadian Tort Law* 108–10 (8th ed 2006); Fleming, *The Law of Torts* 121–2 (10th ed 2011).

It is a question of law whether the facts of a case can reasonably support a finding that the parties were in a relationship of sufficient proximity to support a duty relationship, ie one in which a duty of care is owed, and whether reasons of policy or precedent should limit or negate the duty. However, once all legal obstacles to the imposition of a duty are removed, the existence of a specific duty relationship will be a question of fact for the judge or jury. Similarly, it is well accepted that the question of whether gross negligence occurred is also a question of fact, depending entirely on the circumstances of the case.¹⁵¹

Albeit rarely so, clients may launch a class action suit in Ontario against their adviser provided that the issue in question satisfies the procedural requirements found in the Class Proceedings Act.¹⁵² In order to advance an action as a class proceeding, the plaintiff must convince the court that the suit satisfies the certification requirements laid out in section 5(1) of the Class Proceedings Act. This is a procedural matter, distinct from the merits of the case. The first securities class action certified in Ontario¹⁵³ involved shareholders of IMAX Corp. suing the company with respect to a decline in the price of their shares that they alleged was caused by misrepresentations in the companies' forms and annual reports. The plaintiffs asserted common law causes of action for, among others, negligence and statutory causes of action for misrepresentation under the OSA. The remedies available to clients and third parties are damages with the objective of restoring them to their position if the wrong had not occurred including loss of profits. Damages are further discussed below.

6.2. Liability for acts of delegates towards customers and third parties

Asset managers often use sub-advisers or delegates, so establishing the circumstances in which liability attaches to either or both is important. Regulatory rules overlay general principles of private law in the most usual of cases in Ontario and recourse is had to the specific rules on delegation of contractual obligations and general principles of delictual responsibility in Quebec. The sub-adviser exemption in section 7.3 of OSC 35-502 applies solely in Ontario. Although theoretically possible, it is unusual for a third party who is not a customer to claim against an asset manager's delegate.

6.2.1. Elements of Liability

¹⁵¹ *Crinson v Toronto (City)*, [2010] OJ No 216 (Ont CA) at paras 47–48; *McCulloch v Murray*, [1942] SCR 141 (SCC); *Cowper v Studer*, [1950] SCR 450 (SCC); Klar, *Tort Law* 363 (4th ed 2008).

¹⁵² 1992, SO 1992, c. 6. Note that class actions are a matter of procedure, not the basis for a substantive claim, such as negligence, breach of contract or breach of fiduciary duty, which must otherwise be made out.

¹⁵³ *Silver v IMAX Corp.*, [2009] OJ No 5585 (SCJ).

For regulatory purposes, asset managers' sub-advisers or delegates in Ontario fall into two broad categories, international advisers and specialized domestic advisers. The distinction is important, as the regulations require the incorporation of certain provisions into the IMA with respect to the allocation of legal responsibility for the actions of international sub-advisers, whereas an asset manager's liability for actions of a domestic specialty sub-adviser is left entirely to contract. The reason for this is that the domestic specialty adviser is subject to regulation under Ontario securities legislation, as well as IIROC rules, in most cases.

International advisers may be hired by a principal adviser to manage certain international investments in a portfolio. Under OSC Rule 35-502, section 7.3, such international sub-advisers are exempt from registration in Ontario as long as they are acting for an Ontario registered adviser or investment dealer. The international adviser does not rely upon the international adviser exemption in section 8.26 of NI 31-103 when acting as a sub-adviser. The registered adviser or investment dealer must include a provision in its contract (IMA) with its client, to the effect that the Ontario registered adviser will be responsible to its own clients for losses incurred due to actions of the unregistered international sub-adviser.¹⁵⁴

The other category of sub-adviser usually specializes in a segment of the domestic market in which the principal adviser wishes to invest. These matters are dealt with contractually through clauses in the IMA stipulating that the principal adviser may delegate management of certain portfolio assets to the sub-adviser. The principal adviser's liability depends on the IMA and the principal adviser will often use the opportunity to limit its liability for any actions of the sub-adviser. If such is the case, a client may negotiate a separate agreement directly with the sub-adviser in order to address issues of the sub-adviser's liability. Institutional investors, due to the size of their portfolios and the bargaining power they possess, are the clients most likely to engage in these types of negotiations.

Provisions relating to contracts of services¹⁵⁵ in Quebec explicitly permit the service provider to engage a third person to perform the contract (Art 2101 CCQ). However, the contract may stipulate otherwise, and the nature of certain services may be incompatible with delegation to a third party. The service provider remains responsible for the delegate's acts and performance. Thus, an asset manager who delegates performance of a contract for services remains responsible for the delegate's acts. There is no exemption under Quebec securities legislation analogous to section 7.3 of OSC Rule 35-502.

In contrast, when the relationship between an asset manager and a customer is factually described as a contract of mandate,¹⁵⁶ Article 2141 CCQ provides that the mandatory (ie the asset manager) may not

¹⁵⁴ OSC Rule 35-502, s 7.3(b).

¹⁵⁵ For the distinction between a contract of services and a contract of mandate under the CCQ, see paras 15.28 et seq above.

¹⁵⁶ As is often the case where a securities dealer also acts as an asset manager.

delegate the mandate if not authorized to do so by the mandator (ie the customer). In the event of such an authorization by the customer, the asset manager is responsible only for the care with which the delegate is selected and instructed (Art 2141 CCQ). Where a delegation occurs, the customer has a direct (extra-contractual) action against the delegate (Art 2141 para 2 CCQ). However, if only some acts are delegated and not the entire mandate, the mandator remains liable towards the mandator for the acts of the delegate, in a manner similar to the liability of a delegator in a services contract (Art 2142 CCQ).

Therefore, regardless of whether a court characterizes the contract between a customer and his asset manager as a mandate or a services contract, in both cases the asset manager generally remains liable for his delegate's acts but variations may occur depending on the circumstances. In addition, a client may also claim under general principles of extra-contractual responsibility against any person whose fault has resulted in damages to the client.¹⁵⁷ Thus, either an asset manager or a delegate, or both, may be liable to the client, again depending on the circumstances.

Although causation must be established in actions for breach of contract or fiduciary duty in Ontario, establishing causation in claims based on negligence, where it is a necessary element, often proves to be particularly problematic. Causation with respect to asset managers does not differ from the usual standard of causation needed to establish negligence. Although there is no relevant case law specifically on causation in relation to the liability of asset managers in Ontario, causation is likely to be established if the client can show a violation of the know-your-client rule. In accordance with the ordinary rules of negligence, the client would have to show that the adviser's negligence was a proximate cause of the loss.

Although not involving a portfolio manager exercising discretionary authority, ie an asset manager, the Ontario Court of Appeal decision in *Zraik v Levesque Securities Inc.*¹⁵⁸ considered the issue of proximate cause. The client Zraik, a sophisticated investor, actively invested in the notoriously risky futures markets. He initially indicated that his risk capital was CAD\$10,000, but he frequently exceeded this limit when making trades. After a brief period of success, his portfolio suffered massive losses. Zraik's action against his brokerage firm, Levesque Securities Inc., was based on negligence and a breach of fiduciary duty. The breach of fiduciary duty claim failed because the client, Zraik, was not considered to be vulnerable according to the test in *Hodgkinson v Simms*.¹⁵⁹ The negligence claim, on the other hand, succeeded. Levesque Securities failed to monitor the risk capital limit and allowed Zraik to exceed it on numerous occasions; the court considered this failure a proximate cause of the losses claimed.

¹⁵⁷ Art 1457 CCQ.

¹⁵⁸ (2001) 153 OAC 186.

¹⁵⁹ [1994] 3 SCR 377.

In Quebec, issues of causation arise in both contractual and extracontractual claims. In contract, damages must be an immediate and direct result of the contractual fault (ie breach); only foreseen or foreseeable damages may be claimed.¹⁶⁰ Extra-contractually, damages must also be an immediate and direct result of the fault.¹⁶¹

In *Placements Armand Laflamme v Prudential-Bache Commodities Canada Ltd*,¹⁶² the Supreme Court of Canada examined the issue of causality between a fault committed by an asset manager in the execution of a contract of mandate and the resultant damages. In *Laflamme*, the asset manager undertook the task of managing an inexperienced individual's portfolio, including drawing funds from a line of credit. As the value of his assets plunged, the client became worried and contacted the manager. The parties exchanged a few letters, including a letter from the client informing the asset manager that the client would like to approve each transaction before execution (which, in theory, would change the nature of the mandate into a non-discretionary one). Nonetheless, the asset manager ignored this letter and continued dealing in the client's portfolio.

The asset manager argued that there had been a rupture of the chain of causality in that the clients, the Laflamme family, were negligent in failing to liquidate or withdraw their portfolio earlier with a view to minimizing losses.¹⁶³ The court rejected this argument.¹⁶⁴ The court also examined the moment at which liability of the asset manager ceased due to a rupture in the link of causality, an issue associated with the client's obligation to mitigate damages.¹⁶⁵

6.3 Assessment of damages

As the purpose and intention of awarding damages in this context is to restore customers (and third parties) to their original position, damages typically are based on the capital losses stemming from a breach of duty. Importantly, trades that may give rise to damages are characterized as either unsuitable or unauthorized. Advisers without discretionary authority, who may not trade without the client's permission, but do, make an unauthorized trade. A portfolio manager with discretionary authority (ie an asset manager) may also make an unauthorized trade by executing a trade outside the scope of the IMA, for example, by purchasing foreign debt securities when it has been retained to manage a portfolio of Canadian equities. On the other hand, asset managers who carry out trades that are within the permitted scope of the IMA but are

¹⁶⁰ Art 1613 CCQ.

¹⁶¹ Arts 1457, 1607 CCQ.

¹⁶² Supra note [].

¹⁶³ *Ibid* para 56.

¹⁶⁴ *Ibid* para 58.

¹⁶⁵ Cf. section VI.5 (Contributory negligence, duty to mitigate damages and other corrective mechanisms).

nevertheless unsuitable trades given the client's age and financial position may breach the know-your-client rule.

Although not involving an asset manager (ie a portfolio manager exercising discretionary authority), the Ontario Court of Appeal decision in *Zraik v Levesque Securities Inc.*¹⁶⁶ discussed above provides a good example of issues involved in the assessment of damages.¹⁶⁷ A breach of fiduciary duty claim failed, but the negligence claim succeeded. At trial, in calculating the damages, profits from successful trades in the portfolio were used to offset capital losses being claimed.¹⁶⁸ On appeal, the court decided differently. The profits in Zraik's account at the time of the assessment of damages, representing gains realized independently of the cause of action, should not have been taken into consideration when damages were calculated.¹⁶⁹ The court also stated that since the previous unauthorized trades resulted in profits, Zraik was free to ratify them and sue only with respect to the losing trades.¹⁷⁰ Controversially, this decision may permit clients to 'cherry pick' winning trades and sue for losses associated with losing trades so long as these trades were unauthorized.

In addition to recovering capital losses, clients may also recover the lost opportunity of trades that could have been made instead of the unsuitable trades actually made. In *Secord v Global Securities*,¹⁷¹ the trial judge allowed the client to recover damages for the lost opportunity to have realized gains or a positive return had there been a suitable portfolio. In *Secord*, the court approved the use of the TSE 300 and Scotia McLeod indices to calculate lost opportunity damages. While the lost opportunity damages so calculated were substantial (in the hundreds of thousands of dollars), the court limited the lost opportunity award to a relatively modest sum based on two considerations: the inherent risks in equity investing and the fact that the client had already been compensated for nominal loss of capital.¹⁷² The trial judge also awarded damages to compensate for commissions paid on the unsuitable trades.¹⁷³ On appeal, the court reversed the damages for commissions paid (which it considered a form of double compensation)¹⁷⁴ but did not reverse the award for lost opportunity.

In Quebec, a party to a contract who causes losses to be incurred by the other contracting party due to a breach of contract is liable in damages for such losses; neither party can contractually avoid such liability

¹⁶⁶ (2001) 153 OAC 186.

¹⁶⁷ See also Hugh G. Lissaman, 'Important Recent Decisions in the Area of Broker Law', *Everything You Always Wanted to Know About Securities Law*, an Ontario Bar Association Publication, 2005.

¹⁶⁸ *Zraik v Levesque Securities Inc.*, 153 OAC 186, para 5.

¹⁶⁹ *Ibid* para 30.

¹⁷⁰ For this line of reasoning on the possibility of ratifying winners and suing for losing trades, see also *Techhi Holdings Ltd v Merrill Lynch Canada Inc.*, 2006 CarswellOnt 1966.

¹⁷¹ 2000 BCSC 1544.

¹⁷² *Secord v Global Securities*, 2000 BCSC 1544, para 210.

¹⁷³ *Ibid* para 211.

¹⁷⁴ *Secord v Global Securities*, 2003 BCCA 85, para 43.

(Art 1458 CCQ). In a contractual relationship, the client may claim damages that were foreseen or foreseeable at the time the obligation was contracted; in all cases, the damages claimed can only include immediate and direct consequences of non-performance (Art 1613 CCQ). Subsequent CCQ sections pertain to causality, assessment of damages, mitigation of damages, and limitations to the principle in Article 1613. A client (or a third party) may also claim damages for actions occurring during the contract, or in the pre-contractual phase of the relationship, under the general principles of extra-contractual responsibility (Art 1457 CCQ).¹⁷⁵

Under Article 1607 CCQ, barring contributory negligence, a claimant is entitled to physical, moral, or material damages that are an immediate and direct consequence of the fault in question. Damages must result directly from the fault at issue and be certain.¹⁷⁶ Furthermore, the principle of *restitutio in integrum* (making whole) will be applied in the award of damages; the damages aim to place the customer in the position in which he would have been had the transaction not taken place (for example, in the case of fraudulent misrepresentations) or if the manager had acted according to the required standards (for example, in buying or selling securities).¹⁷⁷

However, Quebec courts have rejected the approach of limiting damages to those designed to place the customer in the position in which he would have been if the transaction had not taken place, emanating from common law fiduciary-duty case law. The Quebec civil law principles must be applied, and so long as damages are foreseeable and direct, then the loss suffered by the customer, as well as the loss of potential gains, may be awarded.¹⁷⁸

The manner in which damages will be calculated will largely depend on the specific situation. In *Laflamme v Prudential Bache*,¹⁷⁹ an expert's report submitted to the court¹⁸⁰ was used and accepted to calculate loss sustained and the profits of which the plaintiff had been deprived.¹⁸⁰ This reliance on expert reports has been followed by Quebec judgments; in the absence of expert reports, only actual losses will be awarded, not the profits of which the claimant has been deprived.¹⁸¹ For example, if no expertise is presented, the court will award damages related to loss of enjoyment and actual damages, but not the amount relating to loss of profits.¹⁸²

¹⁷⁵ Supra note [].

¹⁷⁶ O'Donnel and Olivier, *supra* note 30, 30.

¹⁷⁷ Ibid.

¹⁷⁸ *Prudential-Bache Commodities Canada Ltd v Placements Armand Laflamme Inc.*, 1998 CanLII 12694 (Qc. C.A.) determined that losses relating to a market 'crash' do not qualify as 'certain' damages.

¹⁷⁹ *Placements Armand Laflamme Inc v Prudential-Bache Commodities Canada Ltd*, *supra* note [], para 62.

¹⁸⁰ The expert's report submitted by the appellant client was accepted in the absence of a counter-analysis or objection by the respondent.

¹⁸¹ *Trépanier v TD Waterhouse Canada Inc.*, 2010 QCCQ 866.

¹⁸² Ibid.

Contributory negligence is a factor in the award of damages. In Ontario, contributory negligence is defined as 'a plaintiff's failure to meet the standard of care to which he is required to conform for his own protection and which is a legally contributing cause, together with the defendant's default, in bringing about his injury',¹⁸³ and governed by the Negligence Act.¹⁸⁴ If it is not practicable to determine the respective degree of fault, all parties involved should be deemed to be equally negligent.¹⁸⁵ The Negligence Act is applied using a practical, 'common sense' approach. The degree of fault is based on the facts of the case. If contributory negligence is found in the context of investment dealings, the degree of fault between adviser and client is often split equally.

Two illustrative cases do not involve asset managers but apply principles which could be applicable to them, *Abrams v Sprott Securities Ltd*¹⁸⁶ and *Newman v T. D. Securities*.¹⁸⁷ In *Sprott*, Mr Abrams was an experienced investor who dealt with Ms Spork, a dealer, at Sprott Securities Ltd. Initially Mr Abrams enjoyed success with investing in initial public offerings. Ms Spork introduced him to special warrants of private companies, a riskier type of investment than any made previously. Ms Spork required Abrams to sign subscription agreements before investing, but he did not read them and in one form he indicated his occupation as a janitor (not true). In a peculiar twist, during trial, Abrams admitted that he did these things because he did not intend to be bound by the subscription agreements.¹⁸⁸ Abrams lost his investment and sued for breach of contract and negligence. The court found that Ms Spork was negligent in not properly warning Abrams about the increased level of risk the warrants carried. Sprott Securities, Ms Spork's employer, was deemed vicariously negligent. However, the court also found that Abrams's approach to the subscription documents was contrary to customary practices upon which reasonable people rely. As such, he was found to be 50 per cent contributorily negligent for the loss.

The second case, *Newman v T. D. Securities*,¹⁸⁹ involved a highly educated couple who blamed their adviser (Mr Martin) for the decreased value of their portfolio due to his failures to warn them about Nortel shares and abide by their investment instructions on their new account application forms (know-your-client forms). The court found that the adviser did sufficiently warn Mr Newman about selling some of the Nortel stock he owned due to an extremely high concentration of the stock in the portfolio,¹⁹⁰ but also found him negligent in recommending the purchase of more technology companies in light of the investment profile in the

¹⁸³ Fleming, *The Law of Torts* 302 (9th ed) LBC Information Services, Sydney (1998)). See *875121 Ontario Ltd v Nesbitt Burns Inc*, 50 BLR (2d) 137, para 64.

¹⁸⁴ RSO 1990, c. N.1.

¹⁸⁵ *Ibid* s 4.

¹⁸⁶ 177 OAC 148.

¹⁸⁷ 26 BLR (4th) 270.

¹⁸⁸ *Ibid* paras 52–53.

¹⁸⁹ 26 BLR (4th) 270.

¹⁹⁰ *Ibid* para 27.

account application.¹⁹¹ However, the client, Mr Newman, was found to have contributed to the loss because he ignored some of Mr Martin's suggestions and was an educated, well-informed, and highly involved investor who knew the industry and its risks when investing. As such, Mr Newman was found to be 50 per cent responsible and as such, both his and his wife's awards were reduced by 50 per cent because Mr Newman had handled their investments.

In Quebec, a customer may be contributorily negligent after he discovers a fault committed by the asset manager leading to the purchase of securities in the portfolio. If the customer continues to hold the securities in the hope that their value will increase, he may aggravate the loss.¹⁹² However, as seen in *Laflamme*,¹⁹³ the obligation on the client to sell such securities may depend on the circumstances, especially when the client is inexperienced. The client must also promptly liquidate any asset about which he received misleading information from the asset manager. Unless advised by the asset manager to keep such securities, the client may be deemed to have assumed the risk of holding them unless they are liquidated promptly.¹⁹⁴

A finding of contributory negligence is thus linked to efforts at mitigation. In Ontario, a client has a duty to mitigate damages, the consequences of which differ depending on whether there has been contractual breach, tortious conduct or breach of fiduciary duty. Although not involving an asset manager, *Hunt v TD Securities Inc.*¹⁹⁵ highlights the distinction between a breach of contract or a tort, in contrast to a breach of fiduciary duty. The court in *Hunt* referred to two earlier Supreme Court of Canada cases, *Hodgkinson v Simms*¹⁹⁶ and *Canson Enterprises Ltd v Boughton & Co.*¹⁹⁷

According to the court in *Canson*, in circumstances of negligence (tort) and breach of contract, each party is expected to continue to look after their own interests; so a duty of mitigation is imposed. In contrast, a fiduciary is expected to pursue the best interest of the client, and thus has little to complain of when the client fails to promptly shoulder the fiduciary's burden. This approach to mitigation is consistent with the basic principles of equitable compensation, in that the injured party should be reimbursed for all losses flowing directly from the breach. At some point, however, the client's failure to mitigate may become so egregious that it is no longer sensible to say that the losses which followed were caused by the fiduciary's breach. But until that point mitigation will not be required.¹⁹⁸ Essentially, if a client does not mitigate the

¹⁹¹ Ibid para 53.

¹⁹² W. Hesler, 'La Responsabilité du courtier en valeurs mobilières au service du particulier' in *La Responsabilité civil des courtiers en valeurs mobilières et des gestionnaires de fortune: Aspects nouveaux* 85 (J.-L. Baudouin and P. Deslauriers eds 1999).

¹⁹³ Supra note [].

¹⁹⁴ *Bazinet v Wood Gundy*, [1997] RRA 273 (CA).

¹⁹⁵ 2003, 175 OAC 19.

¹⁹⁶ [1994] 3 SCR 377.

¹⁹⁷ [1991] 3 SCR 534.

¹⁹⁸ See *ibid.*, per MacLachlan J, at 554.

damages due to a breach of fiduciary duty in a reasonable period of time, there is a chance that the loss will be considered a result of the lack of mitigation and not the breach.¹⁹⁹

Cases involving mitigation often concern the appropriate start dates and length of the mitigation period. *Asamera Oil Corporation Ltd v Sea Oil & General Corporation et al*²⁰⁰ established the general principle for determining the mitigation period, which should be the date of the breach or a period thereafter that is reasonable. The court also stated factors for postponing the date of mitigation from the date of the breach: the large number of shares involved; the volatility of the market; a request by the party in breach to postpone acting on the claim; and the time required to arrange the financing and careful reacquisition of shares.

15.188 More recently, the court in *Laflamme v Prudential-Bache Commodities Canada Ltd*,²⁰¹ involving a dealer who made speculative investments without the Quebec-based client's knowledge, addressed the client's duty to mitigate damages. The Supreme Court of Canada stated that a flexible approach must be taken in determining a reasonable period of time for the client to act and mitigate the damages, paying attention to the client's level of experience, knowledge of investments, and the complexity of the situation between the client and adviser.²⁰² While *Laflamme* involved a dealer, the principles it established also apply to asset managers.

Helpfully, the court in *Hunt v TD Securities*²⁰³ identified five factors that should be used when determining the mitigation period: (1) ease of purchase of replacement shares (availability in the market, the time and risk involved in their purchase); (2) the investor's degree of sophistication and experience; (3) the degree of trust reposed in the broker; (4) whether the broker was obliged to follow the investor's instructions in making transactions; and (5) the client's loss of confidence in the broker.²⁰⁴

6.4. Limitation and exclusion of liability

Most cases concerning asset managers are based on negligence, or in Quebec, its equivalent under the CCQ. The crux of negligence cases often revolves around the know-your-client rule, which is not only a well accepted industry standard but also a statutory duty appearing in NI 31-103. However, both sections 13.2 and 13.3 of NI 31-103, the applicable provisions with respect to the know-your-client rule and the suitability of investment advice, contain provisions stating that the sections do not apply if the client has waived, in writing, the requirements of the section. NI 31-103 is equally applicable in Ontario and Quebec.

¹⁹⁹ Cases such as *Secord v Global Securities*, 2003 BCCA 85, and *Vanderburgh v ScotiaMcLeod Inc.*, [1992] 4 Alberta Law Reports (3d) 138 address the issue of the length of time that clients should be afforded to find new advisers.

²⁰⁰ [1979] 1 SCR 633.

²⁰¹ *Supra* note [].

²⁰² *Ibid* paras 53–54.

²⁰³ 2003, 175 OAC 19.

²⁰⁴ *Ibid* para 97.

Limitation of liability clauses typically appear in the IMA, stipulating that the firm, officers, directors, and employees are not liable for any errors in judgment that may lead to loss of investment or poor results. However, wilful misconduct, bad faith, and, under common law principles, gross negligence cannot be excluded from liability. The courts have recognized that when used in a statute or contract, the term ‘gross negligence’ denotes a higher degree of carelessness than ordinary negligence.²⁰⁵ Although such cases fail to articulate any bright line test to distinguish gross negligence from ordinary negligence, the case law recognizes a distinction and the possibility that conduct may be negligent but not grossly negligent. In applying a gross negligence standard, courts consider whether there has been ‘very great negligence’ or a ‘very marked departure’ from the standard of care.²⁰⁶

As contractual documents, the provisions of IMAs may vary considerably from client to client and from asset manager to asset manager, at least in theory. In fact, there is a high degree of standardization.

Illustrative of a typical limitation of liability provision found in an IMA is the following:

The Adviser shall not be liable for any error of judgement or mistake of law or for any loss arising out of any investment or for any act or omission in the management of the Account, except for the wilful misfeasance, bad faith or negligence in the performance of its duties and obligations hereunder or other breach of the standard of care set forth in section X. As used in this section, the term ‘Adviser’ shall include the directors, officers and employees of the Adviser as well as that corporation itself.

In this example, it is useful to note that contractually the limitation of liability is more circumscribed than usual common law principles would permit because the provision excludes ordinary negligence (and not just gross negligence) from the limitation of liability, likely at the behest of an institutional investor. A retail investor might not get the benefit of a similarly circumscribed contractual provision.

In both Ontario and Quebec the use of sub-advisers is common and raise the issue of the applicability of exclusion or limitation clauses. The principal adviser will often seek to limit or exclude its liability under the terms of the IMA, as is usual when there are several registered sub-advisers. If the sub-adviser is a non-registrant not ordinarily resident in Ontario, the principal adviser must contractually agree to be responsible for loss resulting from failures on the part of the non-registrant.²⁰⁷ A registered adviser in Ontario cannot be relieved by its clients from its responsibility for losses incurred by violation of this section.²⁰⁸

In Quebec, on the other hand, the CCQ contains detailed provisions on the delegation under contracts of mandate and contracts of services, which may make it difficult for an asset manager to avoid or limit

²⁰⁵ Dobbs, *The Law of Torts* 351 (2001).

²⁰⁶ See eg *Markling (Next friend of) v Ewaniuk*, [1968] SCR 776.

²⁰⁷ OSC Rule 35-502, s 7.3(b).

²⁰⁸ *Ibid* s 7.3(c).

liability. Under Article 1474 CCQ, an asset manager may contractually limit his liability for the acts of his delegates, except for acts of an intentional nature or of gross negligence. As discussed above, if the IMA is considered a contract of adhesion,²⁰⁹ a limitation of liability clause may be declared void if considered abusive.²¹⁰ However, as a general rule, limitation of liability clauses with regards to the act of delegates are a common practice. Thus, a court in determining the liability of an asset manager to his customer with respect to a delegate's acts may take various factors into account.

Moreover, Article 2101 CCQ relating to services contracts is not considered to be a rule of public order; therefore the parties to an agreement may decide contractually to limit the asset manager's liability with regards to delegated tasks, notwithstanding the provisions to the contrary under 2101 CCQ. The same reasoning applies to a contract of mandate under Article 2142 CCQ whereby a mandatary remains responsible for the acts delegated to a third party.

6.5. Insurance

The availability of insurance always lurks in the background of claim for redress by a client. In both Ontario and Quebec, NI 31-103 requires a registered adviser (which would include an asset manager) to maintain bonding or insurance.²¹¹ In addition, accounts held at IIROC member firms in both Ontario and Quebec have considerable additional protection through the Canadian Investor Protection Fund (CIPF), which was created to protect client assets, within defined limits. If a client's assets disappear from an account during the firm's insolvency, CIPF covers the shortfall to a maximum of CAD\$1 million per account. Many investors have a general account, as well as a tax-deferred retirement account. In such cases, each account is eligible for CAD\$1 million in coverage. However, if an investor has several general accounts, such as cash, margin, and US dollar accounts, they are combined into one general account for coverage purposes. Similarly, different types of tax-deferred retirement accounts are combined into one retirement account for coverage purposes.

In Quebec, the obligation for an adviser and a dealer to have insurance or bonding is reinforced under the regulations to the QSA,²¹² which set out certain minimums for different categories of activities. The regulator has discretion to vary the minimums on a case by case basis. By regulation, the insurance or bonding must meet the requirements of self-regulatory organizations, if applicable.

²⁰⁹ Art 1379 CCQ.

²¹⁰ Art 1437 CCQ.

²¹¹ s 12.4(1).

²¹² Securities Regulation, RQ c. V-1.1, r.1, s 213.

6.6 Restitutionary Claims

Restitutionary claims against an asset manager, based on a void or voidable contract, may also be pursued by a client. For example, in an IMA, the manager usually represents, warrants, and covenants that it and its employees are and shall remain properly registered and licensed. A breach of this covenant makes the contract void and the client becomes entitled to return of the assets under management and to reimbursement of the fees paid to the asset manager. In both Ontario and Quebec, this would also very likely be the outcome even if the IMA did not contain such representations on the basis of an implied fundamental term of the IMA, breach of which renders the contract void.

7. Conclusions

The liability of asset managers in Canada, particularly in Ontario and Quebec, is determined by a complex set of factors that make direct comparisons to the European Union and its member states difficult. Given Canada's federal nature and the presence of both common law and civil code jurisdictions, the legal analysis of asset manager liability presents unique challenges. The basic principles of contract and of extra-contractual responsibility, as matters of provincial law, differ in detail if not ultimate outcome, from one place to another in Canada. More significantly, the operation of these basic private law principles has been for the most part supplanted by the overlay of a detailed and technical regulatory framework. In Ontario, the operation of private law principles may be only implicit, so submerged have they been by the regulatory and self-regulatory framework. In Quebec, a civil code jurisdiction, the CCQ's systematizing influence itself and the work of the doctrinal writers serve to articulate more explicitly the legal analysis of asset managers' liability. Given the ongoing constitutional difficulties associated with the creation of one federal regime of securities regulation in Canada, little will change in the foreseeable future to simplify this complex set of interrelated and overlapping regulations and other norms.

However, two factors serve to provide consistency and predictability to asset managers' activities and liabilities, as well as nurturing minimum investor expectations. The ethos of self-regulation in the form of industry practices and guidelines remains strong in Canada. Even when market participants may not formally be subject to IIROC membership requirements and sanctions, their activities will be measured by the courts against such industry guidelines and practices. Secondly, the CSA through the development of national instruments such as NI 31-103, which are incorporated into provincial regulation, exerts considerable harmonizing pressures across Canada. The CSA, despite its 'informal' nature, is active and significant in shaping the regulatory landscape for Canadian asset managers. Although a grouping of provincial regulators, it is attuned and responsive to industry. For example, the 2011 amendments to NI 31-

103, although of a housekeeping nature, run to five hundred pages. The CSA pays close attention to the securities industry and acts to overcome what would otherwise be serious regulatory inefficiencies.

The stabilizing influence of the big Canadian banks is also significant because they actively provide asset management services (typically through non-bank subsidiaries). These banks are large, well-run (as graphically demonstrated in the recent global financial crisis), and federally regulated by a single national regulator, the Office of the Superintendent of Financial Institutions.

In Canada, there is relatively little recourse to the courts in securities law matters, a reflection perhaps of a solid and healthy industry that functions well despite the complexity of its regulation. More to the point though, English-style rules of civil procedure that discourage litigation persist, resulting in a generally less litigious culture than in the United States.

Another possible feature of the Canadian industry that may promote industry-wide good practices is the high level of qualifications required of asset managers. Most asset managers must have a CFA designation, which is not the case in the United States. In fact, Toronto now has more CFAs than any other place in the world except New York City (approximately 7,000 in Toronto compared to 12,000 in New York City). Although the CFA-designation requirement may not assure an absence of fraud or abuse, it promotes consistent industry-wide standards and competencies. A more negative aspect of the CFA designation may be that it acts as a barrier to entry to the asset management business, possibly contributing to higher fees than elsewhere. The wealth management business is very profitable and few concessions are made with respect to the CFA-designation requirement (although regulatory waiver is possible).

On the general regulatory approach to asset managers' activities, the efforts of IIROC in 2009 to harmonize and coordinate existing rules may also indicate the future direction of rule-making for the industry. In keeping with prevailing regulatory trends, in 2009 IIROC endorsed principles-based rule-making, along UK lines. A second trend may be increased entry by foreign asset managers into the Canadian markets. Foreign entry may be prompted by the generous supply of CFA-designated professionals to staff such operations as well as potential increased demand from an aging and affluent population.