



November 2008

## Hedging Risk

*Avoiding Legal and Regulatory Risk for Investment Advisors*

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A successful investment advisor (IA) is skilled at managing risk for clients who participate in the public markets. However, even successful IAs have ignored, to their peril, the risks that regulators and courts present to their business.

The past few years have been challenging ones for the public markets. The past few weeks have been beyond challenging. Clients are not as trusting as they once were and there are a growing number of lawyers who specialize in cases against IAs and who are willing to bring claims on a contingency basis. There are also stronger, better-funded regulatory bodies monitoring IAs' conduct.

Just as IAs regularly take stock of their clients' rates of return, they should take stock of their own compliance with current regulatory and legal obligations. Failure to do so can lead to painful and expensive litigation and regulatory proceedings. In addition to costing money, these proceedings distract from money-making endeavors and put the IA's reputation at risk.

Courts often hold that IAs have a fiduciary duty to their clients. This means that when an IA seeks and accepts a client's trust and confidence and undertakes to advise the client, the IA must do so fully, honestly, and in good faith. In the face of litigation, IAs must prove they fulfilled this obligation.

In light of this duty and the current litigious trend in the financial services industry, I have outlined a list of common mistakes made by IAs, along with tips to help IAs take stock of how well they are living up to their legal and regulatory obligations.

### The Common Mistakes

#### Failure to Know Your Client

Often IAs do not fully know their clients. A common and detrimental mistake IAs make is to disregard their clients' individual circumstances and changing needs.

IAs frequently do not have clients' current information, and often their account opening documentation – Know Your Client (KYC) forms – is out of date. Failure to keep up with clients' personal and financial status leads to unsuitable trades and lawsuits and regulatory complaints inevitably follow.

To protect yourself as an IA, the golden rule is to know and understand each individual client's personal circumstances and to handle their financial affairs accordingly. This concept is trite but it still represents the most common failure on the part of IAs.

You should ensure that your KYC forms are accurate, current, and consistent with the trading activity in the portfolio. KYC forms should fit the client's goals, have a correct and personalized allocation, and be in line with industry standards.



Currency is important because what was once suitable for your client may not be suitable anymore. The overall portfolio and each transaction should be tailored to the client's current needs. Knowing your client is important at all ages. Even during retirement your client's needs may change.

Be aware that lawyers will look for inaccuracies in your KYC forms during litigation. These inaccuracies can be the biggest hurdle to defending yourself. Even an excellent broker can get into trouble because of inaccuracies in KYC forms. You should not leave it to your assistant to update these KYCs because you will be the one held responsible for them.

KYC forms should be updated at least once a year, face-to-face with your client. This is a good business practice and will provide good protection.

#### **Failure to Obtain Informed Consent**

Another source of trouble for IAs and their clients is incomplete discussion of risk, poor communication, and lack of informed consent with respect to investment decisions.

In order for your clients to provide informed consent, they should understand the risks and potential consequences of the investment as well as other options that are available.

If you encounter clients who do not take an active interest in their investments and who are not engaged in discussing the status and activity of their financial portfolios, you should be concerned. Although at the outset they may be passive and encourage you to do whatever you think is best, they likely will have a great deal to say if the market takes a turn for the worse and they suffer significant losses. It is up to you to ensure they are involved in the process and that they are providing you with properly informed consent.

#### **Failure to Document**

After discussing the importance of obtaining informed consent, it follows that the discussions you have with your clients in obtaining this consent should be well documented.

IAs get themselves into trouble when they make changes to a client's investment strategy without documenting their discussions with the client. If the KYC form on file is not updated and there is no record that the

client consented to a change in the investment strategy, subsequent trades will appear to be out of line with the client's instructions.

Accordingly, it is important to take notes of all communications with your clients and any action you take on their portfolios.

It is especially important to take detailed notes if a trade is made that does not appear to be in line with the client's historical investment strategy. In certain cases you should be writing to the clients confirming the risks they are taking through a so-called "risk letter".

#### **Failure to Recognize Trouble**

Trouble comes in at least two forms.

First, troublesome clients can be the culprit. All IAs undoubtedly have difficult clients. Ask yourself why clients who put your business and reputation at risk are still your clients. It is advisable to fire clients who are troublesome. However, make sure you end the relationship in a professional way.

Second, troublesome investments can be the culprit. Ask yourself whether the trouble posed by a high-risk investment is worth the potential upside. Remember that in many circumstances you will be considered a fiduciary which means the court or regulator will expect you to behave with the utmost good faith toward your client (similar to how you would expect your physician or lawyer to behave). Any high-risk investment you recommend should be consistent with your obligations to your client and should be in your client's interest (not your own interest). If the high-risk investment is unsolicited, make sure you advise the client of the risk and document your discussions. You should not blindly take unsolicited orders without advising clients of risks. Do not view yourself as a mere order-taker. In fact, there may be situations where you should refuse to execute the requested order.

You have a duty to inform your client about any potential conflicts of interest you have with the investments you recommend. For example, a conflict of interest can manifest itself in the form of an unusual commission or incentive to sell a particular investment, a controlling position or an employment relationship with a recommended investment, or an additional commission for a leveraged investment.



### **Failure to Investigate Investment Recommendations and to Properly Inform Your Client**

Before you recommend an investment to a client, ensure that you have carried out the appropriate due diligence. Do not make recommendations that are not rooted in good research. This means you should have a proper system and a valid reason for recommending a buy or sell transaction. This information should be relayed accurately to your client. It is also important to continually monitor investments and notify your clients of any material changes.

Understand that higher-risk portfolios call for higher due diligence on the part of IAs.

Finally, to avoid allegations of discretionary trading, for all transactions, you should have an agreement with your client on the type of shares, the share price, and the number of shares (unless, of course, you have a discretionary account which has been approved by your firm).

### **Failure to Know the Rules**

The credit crisis, Enron, WorldCom, and other scandals have eroded confidence in the public market place and have led to regulators with larger budgets, more enforcement staff, and more power. IAs are monitored by provincial securities regulators (*e.g.* the Ontario Securities Commission) and the Investment Industry Regulatory Organization of Canada (IIROC), which is the result of the merger of the Investment Dealers Association and Market Regulation Services Inc. These regulators regularly issue notices to the industry. If you are not regularly reading these notices and reading your firm's compliance bulletins, you may inadvertently be putting yourself at risk. For example, are you familiar with your gatekeeper responsibilities as expressed by IIROC?

It is your responsibility to keep current. Take the time to review notices from your regulators. All regulators have helpful web sites with detailed information on the obligations of IAs. Also, your compliance department and branch manager can assist you.

### **Hedge Your Risk**

To effectively manage your risk as an IA, you should survey yourself from time to time with the following questions:

1. Do you truly know your client?
2. If a client takes issue with your investment advice, will your KYC be accurate and support you?
3. Do the portfolio allocations in your KYC reflect the reality of your client's portfolio?
4. Are you confident that your client's portfolio is suitable and that they can take on the risk in their portfolio?
5. When your client makes investment decisions, are they informed decisions based on accurate information?
6. Is there sufficient documentation of discussions and meetings with your client?
7. Are you pursuing your clients' best interests and acting in the utmost good faith to your client?
8. Do you disclose any potential conflicts of interest to your clients?
9. Do you perform sufficient due diligence prior to advising your clients to make investment decisions?
10. Are you ensuring that for all transactions you have an agreement with your client on the type of shares, the share price, and the number of shares?
11. Are you regularly reading regulatory notices and compliance bulletins and taking the necessary steps to conform to their standards?
12. Have you taken action to rid yourself of troublesome clients?



If you avoid the common mistakes identified in this article and follow the foregoing advice you will have gone a long way toward avoiding the pain, expense, and embarrassment of legal or regulatory proceedings.

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*Thanks to Alison Mackay, a Summer Legal Clerk with Bennett Jones LLP, for her contributions to this article.*

This article was originally published in the October 2008 edition of IMCA Canada's *Investments & Wealth Monitor*.

## Contact

This article is not intended to provide legal advice, but to highlight matters of interest in this area of law. If you have questions or comments, please call the following contact:

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