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Know Your Client Rule takes on new importance

Peter R. Greene, Affleck Greene Orr LLP.

THE RULE

When asked to speak on the impact of technological changes taking place in the retail stock market on the "Know Your Client Rule", I was somewhat at a loss in that if you had asked me several months ago what "Surfing the Net" meant I would have thought it was a surf in the Hawaiian Islands! I am very familiar with the Know Your Client Rule having acted as defence counsel for one of Canada's largest brokerage firms for a number of years. I have endured the brunt of Judicial tongue lashing for failure of investment advisors to adhere to that Rule. If I have heard it once, I have heard it judicially stated a dozen times, that investment advisors and dealers are "**Not Just Order Takers**". In a recent article by one of my colleagues at the Bar, the relationship between the broker (I shall use throughout this article the lay person's terminology of broker rather than the legal terminology of investment advisor or registered representative) and client was described as follows:

*"Nevertheless, one of the fundamental relationships in the stock market - that between stockbroker and client has not changed significantly in the last 65 years. It is a relationship essentially verbal in nature, built fundamentally on trust, dependent in large measure on tradition, mystique, salesmanship, puffery and occasionally greed and it is relationship that sometimes ends up in the Courts, often in cases involving perverse facts and unusual litigants".*¹

Judicially, the relationship of a broker to one's client has been described as:

*"The relationship was one in which in return for a fee, the Defendants were to give the Plaintiffs advice and to execute the client's orders".*²

¹ Peter C. Wardle, *Playing the Market: An Exploration of Stockbrokers' Liability for Clients' Losses*, (1996) 27 *Canadian Business Law Journal* at page 324

² *Maghun v. Richardson Securities of Canada Ltd.* (1986), 58 O.R. (2d) 1 (Ont. C.A.) per Brooke, J.A. at page 14

For a broker to fulfill one's obligation to provide advice the broker must know the client's circumstances. It is for that reason that the "Know Your Client Rule" exists. The Rule can be found within the *Security Act* regulations, TSE By-laws and is stated within the Investment Dealer Association ("IDA") Regulations as follows:

"Regulation 1300.1 - Each Member shall use due diligence:

(a) to learn the essential facts relative to every customer and to every order or account accepted;

(b) to ensure that the acceptance of any order for any account is within the bounds of good business practice; and

(c) to ensure that recommendations made for any account are appropriate for the client and in keeping with his investment objectives." 3

Under IDA Regulation 1300.2 Member firms are required to designate a director, partner or officer responsible for the opening of new accounts and **the supervision of account activity**. It is the failure to fulfill these duties that causes defence counsel in stock brokerage cases the greatest difficulty in fending off Plaintiffs' claims for substantial damages. Rest assured that when the client is making money the advice given by the broker is always suitable and in accord with the client's stated investment objectives. It is only when losses are sustained and the client is referred to the counsel who usually handle stock brokerage cases for Plaintiffs (the names of whom I am sure you are well aware) that we hear allegations such as "given the Plaintiff's circumstances the transaction was not suitable or in accord with the Plaintiff's stated investment objectives" **or** "the Defendant investment dealer failed miserably to properly supervise the Plaintiff's account in breach of its duty of care."

One of the leading decisions in this area of the law is the decision of Justice Keenan of the Ontario Court (General Division) *Varcoe v. Sterling* which was upheld by the Ontario Court of Appeal with leave to the Supreme Court of Canada being denied. Although the decision on the issue of the "Know Your Client Rule" primarily dealt with the *Commodity Futures Act*, Justice Keenan stated that for a broker and investment dealer to satisfy their respective duties, they must fulfill certain obligations and in so doing stated:

"Brokers are required to comply with the regulations governing the conduct of their client's affairs. The cardinal rule of the brokerage business is the "Know Your Client Rule". A broker who opens an account for a client is required to obtain from the client an "account application form". It contains detailed information about the client,

³ Constitution, By-Laws and Regulations, *Investment Dealers Association of Canada, Regulation 1300, Supervision of Accounts*

*including age, employment, income, net worth, trading experience and trading objectives, as well as personal and family responsibilities. The broker has an obligation to the client, to himself and to the industry to **keep up to date on the client's circumstances and informed of any significant changes in those circumstances.**"*⁴

He goes on to state in dealing with the question of suitability:

*"The suitability of every client who is not specifically excepted is required to be assessed and monitored. Obviously, the suitability of an experienced and sophisticated client will be easier to establish than that of a neophyte. Nonetheless, the requirement to assess applies to both types of client. **The broker is obligated to continue to monitor that suitability. The broker is required to be alert to changes in the client's personal circumstances that may adversely affect suitability to trade at a certain level of activity or to trade at all.** Changes in circumstances which would affect suitability include: loss of employment income; need to divert capital to replace lost income; diversion of capital to finance a business venture; assumption of personal obligations; over-extension of trading activities; and trading losses."*⁴

From my experience it is frankly a very rare case in which the broker and/or investment dealer has been provided by the client, although requested to do so on an ongoing basis, with changed circumstances information. Justice Keenan indicates that such information should be available to the broker to facilitate the broker being able to fulfill his/her duty to advise of the suitability of a transaction. It is highly unlikely that the numerous customers who I have had the opportunity to examine on discovery would provide the type of information on an ongoing basis which Justice Keenan indicates the broker should be cognizant of prior to the broker fulfilling his/her obligation to provide advice. Most customers would tell their broker that their overall financial circumstance is none of their broker's business. Further, most customers do not get on the telephone and immediately telephone their broker the day they get fired! To the contrary, they would usually want to keep such information from their broker to enable them to keep trading. When would a customer inform his or her broker that he or she was investing in a business venture? I would suggest rarely.

It is important to note that the **Due Diligence Regulation** (Regulation 1300.1) requires that each member learn the essential facts relevant to every customer **and to every order**. Further, the obligation of the house to supervise account activity

⁴ Varcoe v. Sterling (1992) 7 O.R. (3d) 204 (Gen. Div.) per Keenan, J. at page 213; appeal and cross-appeal dismissed 10 O.R. (3d) 574 (C.A.)

⁴ Ibid.

requires supervision of each transaction. As such it is arguable that for there to be compliance with the house's supervision duty, the individual designated to fulfill that obligation must learn the essential facts relevant to every order placed. With respect to the authors of the "Due Diligence" Regulation, such a requirement is Alice in Wonderland in that it is totally impractical. The obligation to supervise accounts and for the individual broker to use due diligence should not be tied to each individual transaction but to the overall investment objectives/strategy. In addition, the obligation to advise of changed circumstances should be an obligation placed upon the customer to advise the broker. If that is not the case, the broker, prior to accepting any order would be obligated to ask the customer whether his or her circumstances changed since the customer placed his or her last order.

As you no doubt appreciate I am not overly impressed with the "Know Your Client Rule" or how it has been Judicially interpreted. As presently drafted, the Rule is a Rule which cannot be fulfilled. It is physically impossible to satisfy. A more realistic rule would require brokerage houses to confirm that a customer's circumstances and information previously provided remains accurate to permit the house to continue to rely upon that information to fulfill its duties. The customer should be required to confirm that there have been no changes in circumstances preferably in writing. Further, the obligation of due diligence and supervision should not relate to each and every transaction, unless such a transaction is completely at odds with the customer's initial investment objectives. It should be an obligation to use due diligence and supervision of the strategy which has been employed over a period of time.

TECHNOLOGICAL CHANGE

It was recently stated in an article in *The Financial Post* that "the launch of Internet-based systems renews concerns about the impact new technology will have on investing everything from checking how suitable a specific trade is for a client to guarantees behind transactions".⁵ In an earlier article, entitled "Internet A Gold Mine of Investment Advice", it was reported:

"Some investors are using the Internet now for stock orders. Green Line Investment Services introduced this fall its WebBroker, the First Internet Securities Trading Service offered by a Canadian broker.

Using WebBroker, a Green Line client can register to trade equities or options by filling out an electronic trading agreement. The client is assigned a password to make and verify trade requests.

⁵ "Versus Launches Retail Trading Service on the Net" *The Financial Post*, Thursday, January 23, 1997, page 5

*The client logs on and sends his request to Green Line via the Internet.
Green Line asks the client to confirm the order using the password.
The order is then passed to Green Line's trading desk.*

*Orders can be placed 24 hours a day."*⁶

I was recently told by a colleague who is associate counsel of one of Canada's leading brokerage firms that he had recently reviewed an article about another Canadian investment house, which had gone on-line, indicating that the house within 15 to 20 seconds of a customer placing an order through the Internet could determine whether the order was suitable for the customer. I was somewhat intrigued by the comments in those articles and, in particular, the statement that orders could be placed 24 hours a day. Admittedly having no abilities to "Surf the Net" and given that my 11 year old daughter was not available at the office to assist me on the computer to go surfing, I called upon the assistance of my associate and our Articling Student to "Surf" in search of on-line trading systems offered by companies in Canada. If one does not have the correct name or E-mail address, "Surfing the Net" is not as easy as the promoters of the Internet will have you believe. Even one as knowledgeable as our Articling Student can get lost in cyberspace searching for investment services. That fact alone will deter all but the most sophisticated Internet users from using the Internet to transact investments. However, when we did land back on earth, we were able to find advertising material on the Net of some of the on-line trading institutions with web sites. Their advertisements contained statements such as:

- ". . . one of the most secure Internet trading services now offered in North America."

- ". . . allows the self-directed investor to place, buy and sell orders for North American equities and **options** through the Internet **24 hours a day**." [emphasis this author]

- ". . . you can get real - time equity and option quotes, review your account balance and portfolio, transaction history and any outstanding or filled orders."

- ". . . you will receive a 20% discount on commission rates".

⁶ "Internet a gold mine of investment advice" *The Financial Post*, Thursday, January 16, 1997, page 26

- "... open an account now - **you could be trading in seconds!**"
[emphasis this author]

"Apply On Line

Complete an Individual Account Application, Joint Account Application or Custodial Account on-line; your application is reviewed **within seconds** and you may be eligible to trade immediately. We must receive payments for trades by settlement date, which is usually three business days after the trade." [emphasis this author]

I have not been asked to address the possible dangers in a system which permits someone to open an account in the absence of at least one face to face meeting with a broker. However, I cannot resist a comment. Such a system is open to fraudulent conduct, such as opening an account in somebody else's name or if someone secures an on-line customer's password, liquidating all the assets within the account. I would also be concerned about confidentiality issues of accounts being transacted on the Internet. I am not as convinced as others that the system is as secure as one is lead to believe!

However, more germane to my topic is the issue of suitability. If a customer places an order on the Internet in the absence of receiving any advice from or prior review of the proposed transaction by a responsible broker and/or investment dealer, that order is accepted without assessment of suitability. Surely that would be a breach of the "Due Diligence Regulation" as presently drafted and, in particular, the obligation under Regulation 1300.1(b) "to ensure that the acceptance of **any order** for any account is within the bounds of good business practice". I know of no existing computerized system which can fulfill the duty to assess suitability; obviously a very subjective test. Justice Keenan in the *Varcoe* decision detailed the circumstances which are very subjective in determining suitability. It appears that the operators of Internet based trading systems do not intend to fulfill an investment dealer's obligation to supervise trades to ensure that the trade is suitable and in accordance with the client's objectives on a trade by trade basis. Trading in this manner will open investment dealers to criticism that they are acting as mere order takers rather than being paid a fee not only for taking the order but for providing advice with respect to orders. The real question is whether the regulators will turn a blind eye to such conduct. Yes it will cost less but you pay for what you get!

It has been indicated to me by certain individuals within the investment business that there is no difference in receiving an order from a customer through the Internet (E-mail) verses a telephone call directly to the broker. With respect to those views, I disagree. If a customer places an order directly with the broker, especially if the order is unsolicited, the broker's mind is immediately directed to whether the order is in accord with the customer's usual trading practices and hopefully their stated investment objectives. Usually a discussion between the broker and the customer will take place about the investment which leads to the broker providing advice, something which he is being paid to provide. I can envisage Internet orders not being reviewed

by a broker at all. Undoubtedly customer E-mail orders on the Internet will merely go directly to the trading desk. Such conduct will open investment dealers and brokers to further legal claims for failure to fulfill their respective duties under IDA Regulation 1300. E-mail orders will, for the most part, be unsolicited orders which presumably will have to be filled immediately upon being received (ie. any unreasonable delay could result in a claim by the customer). Receiving orders by E-mail will give rise to a conflict between the broker's duty to fill orders promptly and the duty to advise.

Technological change will in certain instances enhance the efficiency of the investment business. Customers will be able to place orders without having to track down one's broker (or as is normally the case the broker's assistant). Confirmations of a transacted order will be immediate rather than the two to three days it now requires for the confirmation contracts to be received by the customer. Thus it will not be open to the customer to complain three or four days after the fact that a transaction was not made in accordance with his/her instructions (a complaint only made if the transaction loses money). Upon the filling of an order, confirmation would take place immediately. However, a word of caution. In addition to confirmation contracts being sent through the Internet, a hard copy of the confirmation contract should be sent to the customer. The brokerage house should record and store customers' orders received through the Internet in order that there is no argument the order was in fact received from the customer (ie. avoids discretionary trading or not following instructions arguments). Customers regularly complain that if they had known the state of their account on a particular day they would have done something different. As required under the IDA regulations, monthly statements of account must be sent to customers. For an active trader, that information is usually slightly out of date by the time it is received. However, the customer having Internet access on an hour by hour basis of the state of his or her account would not be able to argue that he was not kept fully informed about the positions in his account. In addition, if the customer was so inclined, he could on an ongoing basis keep his broker immediately advised of any changed circumstances (what a hope).

At present, margin calls are usually made over the telephone. Some investment dealers send telexes and faxes but that is the exception rather than the rule. Normally, there is no evidence when one reaches the doorsteps of the Court House to support that a margin call was made on a certain day, at a certain time and for a particular amount but for the oral evidence of the broker. That evidence is normally disputed by the customer. If a customer is operating his account through the Internet, a margin call could immediately be made on the Internet with the hard copy record of such being downloaded as proof that it was made upon the customer. Investment dealers will have to review their customer account agreements to ensure that the customer when opening the account and signing the account agreement consents to margin calls and the receipt of confirmation contracts being made and sent through the Internet.

Generally, communication between the broker and the client will be greatly enhanced if communication takes place through the Internet. Market conditions can change drastically very quickly and telephone communication is not normally successful in responding to such a situation. A broker rarely would go to the trouble of typing and faxing a letter to the customer if in deed the customer has fax access. A broker, if

computer literate (which most are these days), would be more inclined to immediately E-mail the customer an urgent message. An E-mail record would provide the broker with evidence that in fact he attempted to contact the customer and provide advice respecting the changing market circumstances. In addition, market conditions on an hour by hour basis can usually be found on the Internet by the customer.

CONCLUSION

Technological change by way of using the Internet as a primary communication tool will enhance the broker's and investment dealer's ability to better serve the customer in that communication will be faster and more reliable. In addition, rather than having to mail advice about a particular investment, if the financial research regarding that investment is available on the Net the customer could be immediately referred to that information. Technological change, as we have seen in the last twenty years, makes life move a lot faster. However, we must be careful not to discard all that is good in favour of expediency.

Brokers and Investment Dealers are and will continue to be obligated for not only taking orders but with providing advice about those orders. That is what they are paid for. Our Courts have consistently ruled that that is their duty and obligation. Their failure to fulfill the obligation to provide advice based upon a customer's circumstances and in accordance with their stated investment objectives will lead to liability for damages suffered by a customer caused by the failure to provide the required advice. Based upon news media statements and advertisements, suitability is something which appears not to be of concern to the on-line trading systems. That may not be the case. However I query how a system which can offer 24 hour a day orders, in the absence of a mechanical system to determine suitability, (which in my view is impossible) can satisfy the obligation of advising on suitability with respect to each transaction. It is an area of concern which the self-regulatory body of investment dealers (the IDA) and our regulators (the O.S.C.) will have to address as on-line trading systems in Canada expand.

About the author

Peter Greene is a founding partner of Affleck Greene Orr LLP. He practises commercial litigation, with an emphasis on surety, fidelity and dishonesty bond claims, banking and securities litigation.