The TAMRIS Report

Suitability, Minimum Standards & Fiduciary Duty

In the Canadian Financial Services Industry

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1 INTRODUCTION

One of the supposed cornerstones of the financial services industry is the rule that stipulates the sanctity of the suitability of the transaction, the product and the portfolio recommendation.

You would have thought that something as important as a recommendation suiting the client's financial needs and risk preferences, as well as the current risks in the market place, would be well defined.

You would have thought that suitability would be etched in statute, in the courts, in common law, in financial services rules and regulations, in compliance departments rule books, in corporate quality control procedures, in the minds of everyone in the industry.

It is not explicitly or specifically etched anywhere. There are no rules that say what is and what is not suitable, there are no principles that must be followed, no effective standards of disclosure, nothing. All that really exists is the word itself amidst vaguely worded paragraphs on the subject. Indeed, because current thinking limits justification of suitability to the transaction there is in reality no substance to what is and is not "suitable".

In fact, the closest the Canadian financial services industry has got to putting principles of suitability into stone is the common garden "Know Your Client" form. As this document will show, the "Know Your Client" form cannot safeguard the suitability of a transaction because it cannot effectively relate the transaction to financial needs, existing investments, risk preferences or current risk/return relationships.

Fiduciary duty is another cornerstone of the financial services industry, especially if an individual is seeking to claim restitution against their advisor. Historically a fiduciary was someone who took complete responsibility for the transaction and management decisions surrounding a portfolio. A fiduciary duty was and still is owed by the fiduciary when the individuals they are responsible for are totally dependent on their expertise and knowledge. The trouble is that while the nature of the financial services industry has developed beyond recognition the definition of fiduciary duty has not. Many wrongly expect that their advisor owes them a fiduciary duty. If an advisor does not owe a fiduciary duty then the individual investor becomes responsible for identifying suitability, good and bad advice and for taking action in good time if the feel they have been wrongly advised.

As such, not only is there is a limited understanding of suitability but responsibility for decisions is still determined by a very narrow and archaic definition[1] of fiduciary duty. Until the financial services industry develops better standards defining suitability and fiduciary duty it is up to the individual to make sure the market for financial advice operates in their favour.

This is important since taking action against unsuitable advice is extremely difficult and very costly after the fact. If there are no clear rules as to what is and what is not suitable then the courts are unlikely to be able create precedent in this important area. As it is, the legal system is left with archaic definitions of fiduciary duty on the one hand and minimum standards on the other

Having your advisor put everything in writing is an important first step. But, if you are to get good advice you need to make sure that the advice is appropriate and has considered all important factors affecting the suitability of your advice. Much of the TAMRIS website is dedicated towards detailing the standards it considers to be worthy of suitability and fiduciary duty.

The TAMRIS website discusses what your advisor should be doing if your assets are to be properly managed to meet your financial needs over time. These guidelines relate not only to higher standards of suitability but an implicit responsibility/fiduciary duty to ensure that all transactions are suitable to client

[1] There is no real bona fide definition of fiduciary responsibility in the context of the duty owed by financial entities towards their private clients, either in the context of the substance and structure behind their services or in the quality and intent of the services they deliver.

financial needs and risk preferences given the disposition of all assets and the current risk/return relationship in the market place.

This document discusses many aspects of suitability and responsibility. The overriding message is that suitability is a very complex area and mere knowledge of investments and basic investment concepts is insufficient for an individual to be responsible for all the components of the transaction decision. Current minimum standards used to define suitability of the transaction, the product and the portfolio are also assessed and their deficiencies explained.

What this document discusses is the importance of defining the universe of suitability before we can fully understand the universe of fiduciary duty. The industry, the regulators and the legal system do not fully understand what suitability is. A better understanding and a more structured definition of suitability within the investment context is an important first step in protecting investor rights.

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2 SUITABILITY

We all live in the same investment universe; we just occupy different positions within it. This investment universe holds all asset classes with varying, risk, return and liquidity characteristics. Each asset class could within reason be included in any individual portfolio.

However, what defines the proportion to be invested in each is determined by the nature of risk and return at a point in time and the nature of risk and return over time relative to the needs of the investor (in technical terms, liabilities) over time. Effectively any investment is suitable but suitability can only truly be addressed by assessing the whole; that is the relationship between an investor's total financial assets and total financial needs over time.

Industry suitability rules do not address the total relationship and do not address the total relationship over time because they are not trained to assess the whole.

This section of this report defines the true components of suitability and the prerequisites of suitability. Indeed, if you do not understand the components and the requirements of suitability you cannot define fiduciary duty.

2.1 The five rules

There are five dimensions or component rules that comprise suitability. These are as follows.

1. An investment that is recommended must relate to a) the actual size and timing of financial needs over time and b) the relationship between financial needs and total assets over time (both current and future disposition of capital)[2].

    - This is complex, yet extremely simple to solve providing an organisation has the necessary decision rules that relate portfolio construction to financial needs over time.

2. After relating the allocation to a given investment or set of investments based on financial demands on the portfolio over time[3], the investment must then be able to relate to attitudes to risk and investment preferences. It is these risk and performance preferences that either increase the income and capital security of the portfolio[4] or increase/reduce the risk/return relationship of the portfolio.

    - We all live in the same investment universe but our risk preferences (in addition to our financial needs) determine our final position within it. These relationships are again complex, but simple to solve providing you understand the decision rules that relate risk preferences and financial needs to all points of the universe.

3. Thirdly, the recommendation must relate to all existing investments and the relationship that exists between these investments and financial needs at a point in time and over time. A recommendation may be a suitable investment if we just look at a simple profile, but if you already have enough of it, it may not be suitable. Being able to identify the asset allocation gaps in the portfolio and being able to relate the security to an asset allocation (and hence a valuation framework) is not an easy job.

[2] Why over time? Because the nature and risks of different asset classes change over time and because of this so will the structure of the portfolio depending on needs over time. Indeed, while many risk questionnaires look at time frames, they often only relate time frame to specific investments and singular objectives, which is inefficient.

3 There is a direct relationship between the fundamental nature of risk and return of assets over time and the risks to the ability of these assets to meet financial needs over time. This relationship is key to portfolio structure.

4 This directly relates financial needs and risk aversion to portfolio structure.

- Again an horrendously complex procedure if done manually, but extremely simple if you are able to model the relationship between all components of 1 and 2 above.

4. Fourthly, the recommendation made must make sense given the price of the investment at the time and the risks the investment is exposed to over time. Initial investment risk is a key risk aversion for many investors and many investors rely on their advisor's assessment of initial investment risks.

    - Buying an overpriced security (or portfolio of securities) poses significant risks to future financial security[5]. Indeed, while it may be virtually impossible to predict market timing it is possible to ascertain valuation risks to future return. If you are managing suitability you should not just be managing volatility but liability risks (risks to the ability of assets to meet planned financial needs over time).

5. Suitability can only be fully assessed with client interaction in the decision making process. This also means that education and communication regarding the basics of investment, the risks of investment, the manager's investment style and how portfolios are constructed, planned and managed to meet financial needs over time are key to agreeing suitability of transactions, products and recommendations.

    - Education and communication are also key to managing fiduciary risk which is a risk organisations take if they do not address the importance of education and communication. But as with all the above components, the ability to manage these components effectively requires a centralised wealth and asset management process.

Without communication of where the advisor stands on the first four rules of suitability, it is unlikely that a client is able to make an informed ex ante decision about transactions within an advisory relationship and an informed ex post assessment within a discretionary relationship or about the suitability of portfolio management structures within both advisory and discretionary relationships.

2.2 Rule 1 – relationship with financial needs over time

If your advisor does not know the disposition of all your assets and the disposition of all known or likely needs, or the specific assets and specific needs related to the mandate at hand, he or she cannot fulfil rule 1.

Irrespective of the process or discipline used by an advisor, transactions need to pass a suitability test defining the process in which the structure, planning and management of assets meet financial needs as and when they arise while managing the risks and the costs of such a process.

Since every investor has the right to know the limitations of the service they are receiving in this respect, a fiduciary duty should involve communication of the portfolio construction, planning and management process and its limitations with regard to suitability.

An organisation where the logically inherent limitations of a service are not communicated to a client, is taking a fiduciary risk, especially when promises of personalisation, customisation or risk management are made.

Since the structure of the portfolio and how it manages the risks to the ability to meet financial needs over time is key to risk aversion, the client also needs communication of this discipline and to be able to assess their aversion to this risk.

[5] The TAMRIS website, moneymanagedproperly provides further information on initial risk aversion.

2.3 Rule 2 – Relationship with attitudes to risk and performance preferences

If the amount that is allocated to each primary asset class and security is based on financial needs then each recommended portfolio should be unique.

However, what may be the most efficient asset allocation of transactions for the advising company's assessment of the investment universe, based on their disciplines, may not be one which the investor feels comfortable with.

Advisors that do not relate the structure, planning and management of assets to meet financial needs to all key risk factors (liability, performance/style and volatility/aggressive/conservative) will not be able to address the suitability of the portfolio to the client's main risk preferences. As such the management of expectations regarding these key risks cannot be effectively conducted.

This leaves the advising company exposed to suitability risks, irrespective of whether the relationship is advisory or discretionary. It also implies that the company has taken responsibility for the management of this risk themselves, which implies a fiduciary duty. Indeed this applies to any component of suitability which is not explicitly explained to the client or managed by the advisor.

It is therefore important for organisations where rule 1 is not assessed and where attitudes to the risks associated with rule 1 are not addressed, that they specifically explain that these risks are not addressed within the construction, planning and management of assets.

> This fiduciary risk is particularly important where investors are depleting capital over time and where inappropriate portfolio structures and costs will impact on the ability of the proposed transaction solution to meet needs and protect against risks.

Sadly the industry does not consider itself responsible for managing these risks. Unless a firm specifically states that it will not manage these risks and explains the consequences to investors of not managing these risks, it should be responsible. Otherwise the advisor will be asking individuals to manage risks they do not understand and are incapable of assessing or compensating for while recommending transactions that are unsuitable, without structure and proper risk management.

It is paradoxical that in the absence of statements to the contrary, minimum industry standards that do not satisfy rules 1 and 2 are effectively forcing a higher level of fiduciary responsibility onto the companies themselves.

After all fiduciary duty, rightly or wrongly, implies the existence of discretion over issues which the investor is ignorant and incapable of managing on their own, which the individual has implicitly devolved to the advisor and, for which the advisor has implicitly accepted responsibility. This responsibility is not assessed within the legal system or the complaints process because of ignorance over suitability and its structure.

Indeed, within an advisory relationship the only decision which an individual has retained control over is the acceptance or not of the transaction initiated and understood in the first instance by the advisor and, to which less information than is needed to develop the recommendation is provided to the investor. Again, a significant level of discretion is retained over the decision by the advisor in advisory relationships.

2.4 Rule 3 – Must relate to all existing investments

All recommendations should take place within an asset allocation framework determined by financial needs, risk preferences, the manager's investment style and valuation/risk relationships.

The individual security selection should relate to the recommended asset allocation and security selection for a given client return/yield/risk/liability profile.

A broker cannot just phone you up and say, "I have this great investment" nor can a discretionary manager include the flavour of the month investment without being able to relate it back to the portfolio construction, planning and management framework.

The justification for a security recommendation cannot be your profile as suggested by the "know your client form". If this were the case any investment on its own would be suitable.

The suitability of an investment can only be viewed by its position within the portfolio, its affect on asset allocation, valuation and on risk and return over time relative to financial needs. As discussed later the "Know Your Client" form does not actually provide a structure for the management of assets and needs. It is a transaction profile wholly inappropriate for the proper management of assets and financial needs.

The only time a broker should be recommending a single transaction is where the client is in a transaction relationship. Such a relationship should only exist where the client has knowingly taken full responsibility for the management of their assets. Indeed a great many advisory relationships are actually relationships in which the individuals wholly rely on the advisors expertise.

2.5 Rule 4 – Must relate to current risk/return relationships in the market place

If suitability relates to the management of risks likely to affect the ability of assets to meet financial needs over time, then the initial investment decision is important.

The current valuation of an asset is material to the suitability of the asset and the management of expectations.

It is not enough to say that an asset is high risk/high return, since valuation is the biggest factor in risk at a point in time. Most risk statements do not cover the current valuation risk material to understanding the investment decision.

If the current valuation and hence the valuation risks of an asset are not being taken into consideration then advisors are in breach of their fiduciary duty irrespective of whether they are operating under a discretionary or an advisory mandate. Indeed, those operating under an advisory mandate have discretion over the parameters of the initial investment decision if they fail to disclose current valuation risks and only disclose historical risk/return relationships.

Whether you are in an advisory or discretionary relationship the initial investment decision is material and both discretionary managers should go through the same risk assessment process with regard to this risk and need to disclose the process in which these risks are assessed and managed.

2.6 Rules 5 – Suitability and education

If a client has not been educated over the portfolio construction, planning and management process used by the advisor and cannot relate this to the management of their financial objectives, it is unlikely that they can realistically have accepted the recommendation.

If a client has not been educated over the basics of investment or the risks of investment, then the advisor is taking discretion over the suitability of an investment and the resulting transaction recommendation irrespective of the client relationship, whether it be advisory or discretionary.

Education and communication is important in terms of determining where in the universe the client is in relationship to the investment advisor. Communication (reporting) is important in confirming the rationale for all material decisions and for communicating the rationale for the management of the portfolio and the attendant risks of the strategy. Quite how an investor is bound to accept the risks of an investment transaction without clear and formal communication is of enormous concern. Investments should not be considered only as transactions unless the client has specifically requested and self initiated a transaction request and has confirmed responsibility for the suitability components.

Further information on the communication process (reporting, education, risk assessment) can be found on the TAMRIS web site.

2.7 Responsibility and suitability in the transaction environment

The only time a transaction can be clearly assessed as a stand alone transaction should be when an experienced and sophisticated investor uses his or her investment advisor to solicit a security or a trade idea. In this sense, the individual investor is assumed to have taken full responsibility for the consequences of the transaction and for all issues of suitability.

Individual investors who do not have the expertise to be initiating transaction decisions, but do, are also taking responsibility for issues of suitability and relieving their investment advisors of their fiduciary duty. All the investment advisor has responsibility for in this instance is that the trade recommended matches the suitability profile of the individual, although even here advisors are allowed to execute unsuitable trades if the client specifically requests this.

Investors relying on their investment advisor for advice and are inexperienced in investment must note that it is important that they do not start initiating transaction decisions. Although, making sure you actually have a proper mandate and agreement as to how the account will be managed is an important prerequisite.

In terms of suitability, once an individual investor starts to initiate their own transaction decisions they may negatively impact the portfolio construction, planning and management framework instituted by their advisor. Individual investors without the necessary expertise are going to be making trades that do not meet the rules of suitability and that will violate the structure of the portfolio. An advisor should not be held responsible for this, although they should be responsible for informing the individual of the risks they are taking.

The current know your client form is more or less appropriate for transactions initiated by the individual investor.

It is important that the mandate for the advice and the framework in which the relationship will be carried out is agreed in advance so that issues of responsibility, suitability, duty of care and fiduciary duty are covered.

2.8 Two types of transaction

What is also important to understand is that there are two types of transaction within the wider environs of suitability. There is the transaction between securities designed to reduce risk and or enhance return and there is the transaction initiated by the relationship between financial needs and assets.

An investor can initiate the second type of transaction without violating their mandate or the advisor's fiduciary duty towards them as long as it is the manager that makes the transaction decision. For example, I need to spend C$30,000 in two years time, please provide me with the capital at the time.

It is important to realise that whatever the relationship mandate, advisory or discretionary, where the client is reliant on the advice of the advisor that the advisor will be initiating the recommendation and the reasons for the recommendation. Because of this it is therefore important that suitability lies behind all decisions irrespective of the mandate (advisory or discretionary).

2.9 The prerequisites of suitability

An organisation must have the necessary expertise, investment discipline, resources, business and services processes and systems needed to deliver personalised wealth management in order to be able to deliver suitability.

If you are recommending an asset class but do not know how to value it, manage it or to incorporate it within a portfolio suitable to client financial needs and risk preferences, then are you being negligent and in breach of an implicit fiduciary duty. Most clients have to trust their advisors and because of this most clients are vulnerable if their advisors do not have the expertise, systems, resources or business and service processes to deliver.

2.10 Suitability conclusion

Suitability is a framework, not a transaction. It is unlikely that a client could ever fully ratify suitability without knowledge of the rationale for the transaction and structure in which the risks and returns of the investment are managed. In this sense even an advisory relationship is operating with discretion over the framework governing suitability.

It is also unlikely that a client who has not been properly educated about the construction, planning and management process will be able to understand whether something is suitable or not and therefore is unlikely to ever fully be able to mitigate unsuitable or inappropriate advice successfully[6].

Since it is the responsibility of all advisors, whether they be discretionary or advisory, to ensure that all transactions and structures are suitable, even a discretionary relationship should have structures developed by interaction with the client.

In fact we need to assess the true nature of suitability in order to fully understand the responsibility that all advisors are taking and, the duty of care they are responsible for providing. Most clients are vulnerable in the face of the complex world of portfolio personalisation.

Just what is the difference in duty owed by an advisor who works on a discretionary basis to one who works on an advisory basis? For investors who do not possess the expertise and who rely on their advisors, next to no difference whatsoever

Suitability is a cornerstone of all portfolio management. It is where the management of assets meets the management of financial needs and where the approach and discipline of the manager is tailored to the risk and performance preferences of the individual. All factors noted above also apply to the management of discretionary portfolios.

[6] Implied in Laflamme versus Roy.

3 Minimum industry standards

The industry's minimum standards are defined by the "know your client" form. The other minimum industry standard is that no advice/recommendation need be in writing, although all trades need to be confirmed in writing.

3.1 "Know Your Client" form

The standard industry Know Your Client form as exemplified by the Mutual Fund Dealers Know Your Client form stipulates that only the following are needed before advice can be given.

Individuals may also not realise that you do not actually need to sign this form in order to validate its use within the organisation. In fact, you do not even need to receive a copy of it.

- Investment knowledge; extensive, moderate, none.
- Risk tolerance; low, medium, high
- Time Horizon; 1 to 3, 4 to 5, 6 to 9, 10 plus
- Investment Objective; income, growth (short/long term), balanced.
- Individual income
- Household net worth

Does the Know Your Client form collect the information needed to satisfy suitability requirements as stated in section 2?

No.

The KYC was only ever intended to assess the suitability of individual transactions and not the suitability of a portfolio or the suitability of a transaction within a portfolio. Indeed, this presumption is supported by securities case law.

3.2 Investment knowledge

As discussed in suitability and education (section 2.6), merely asking a client's investment knowledge is insufficient to communicate the necessary information needed to establish suitability within the wider context.

Merely asking the extent of an individual's investment knowledge is sufficient to assess whether a client who is initiating a transaction request, and who may not rely on their advisor to assess suitability, has the expertise needed to initiate the transaction; although, even here, investment advisors can effect client initiated transactions that are not suitable within the parameters of the KYC.

3.3 Risk tolerance

A general statement of risk tolerance is insufficient to assess suitability in the wider context. Indeed many investors make an assessment of their risk aversion based on their perceived need for security; how a portfolio is structured, planned and managed to meet financial needs over time and how that portfolio is designed to manage significant risks is key to the individual's ability to assess their attitudes to risk.

For suitability to be confirmed, investors need education over the basics of investment and of the advisor's investment discipline and risk management process. If the risk assessment process does not educate the client over the risks likely to impact the ability of their portfolio to meet their financial needs over time, then logically, it is unlikely that the recommendations can be proven to be suitable. In this case, there are two conclusions.

- The first is that the KYC can only be used to assess the efficacy of a transaction on a transaction by transaction basis by someone who understands risk and who is initiating the transaction request.

- Secondly, where a KYC is used for clients who are relying on their advisors for their expertise to provide a portfolio solution, the advisor is taking a fiduciary responsibility with regard to the provision of a wealth management solution.

Moreover, if the risk assessment process does not assess all the key risks likely to impact on the ability of the portfolio to meet financial needs as well as the performance risks of an investment style, then the advisor will have failed to properly satisfy their fiduciary duty. Most risk assessments fail to educate the client over risk, fail to properly assess risk and fail to provide the client with a meaningful illustration of the impact of their risk preferences[7].

3.4 Time horizons

Time horizons are rarely singular and are more likely to be multiple and relative. All transactions impact on the risk/return relationship of all assets and on the relationship between all assets and all financial needs. For this reason, service processes that rely on singular time frames cannot manage the suitability of the transaction.

Only the individual that can break down their needs and objectives into multiple time frames and multiple individual allocations per time frame (meaning they will have needed to carry out a complex asset and liability analysis), can initiate transactions on a transaction by transaction basis.

Because of this, the "know your client" form has little or no relationship with the fundamental precepts of suitability and is an inappropriate foundation for delivering wealth management solutions that need to address the total portfolio management problem.

3.5 Investment objective

The investment objective approach noted in the "KYC" is at best an antiquated approach to selecting broad portfolio options. It provides no information about the size and timing of financial needs over time and hence no information as to the actual structure of the portfolio needed to meet actual needs.

The objective of the client can only be determined by the relationship between financial needs over time and the size and disposition of assets over time. Broad objectives, while sometimes useful for delivering broad model portfolio options, are totally unsuitable for defining the suitability of individual security transactions. Likewise, broad, fixed, model portfolio options are inefficient in providing personalised solutions.

Unless an advisor has knowledge of the disposition of all assets and all financial needs it is impossible to work out from a broad objective just what asset class and specific security the individual is deficient in. Additionally and, logically, if the advisor does have an idea of disposition of assets and needs over time, without written communication of the rationale for the allocation and the asset class, security selection is actually a discretionary decision; if one assumes that suitability is the framework and the transaction merely an allocation within it.

As with many of the other components of the KYC, the only way the "investment objective" can work on an individual security transaction is for the client to take responsibility for the rationale and reason. Perversely, this implies that the investor has significant ability to structure, plan and manage allocation, which is far from the truth.

3.6 Individual income/household net worth

Both important pieces of information, yet the KYC totally ignores the importance of finding out the size and disposition of financial assets (key to working out where the gaps are in the portfolio structure and what to

[7] The TAMRIS website provides further information on the risk assessment process plus a detailed analysis of the weakness of retail risk assessment questionnaires in the technical section.

buy and/or sell) and the actual financial outgoings key to determining the relationship between assets and financial needs.

3.7 Why do minimum standards exist, what are their objectives?

Within a transaction led industry, minimum standards were designed to provide structure to the process in which transactions were recommended. They were not designed to provide minimum standards for the delivery of transactions within a portfolio construction capable of managing the ability of assets to meet financial needs over time. As such, they do not cover suitability for individuals relying in their advisor for their expertise in crafting wealth management solutions.

Is the objective of a transaction industry to provide total wealth management solutions?

No, it is not!

Is it possible to raise standards within a transaction driven industry so that transactions are suitable to financial needs, reflect total assets and the relationship between assets and financial needs and risk preferences?

No, it is not!

The only way you can do it is to change the objective of a transaction driven industry. This is difficult if regulation is still focussed on managing a transaction led process and, the arbitration and legal system one which assesses the parameters of a transaction driven framework in determining fault.

At the present moment in time minimum standards are important because they keep the status quo in check. It is debatable whether the industry could actually move to a service led business process that would be demanded by raising the minimum standards governing suitability of advice.

While it is in the industry's interest to keep standards at a minimum, if legal precedent were to start looking at wider standards governing suitability, current minimum standards could become a liability.

3.8 Conclusion KYC

The "Know Your Client form" is an archaic form appropriate to a transaction driven industry. While it may still be appropriate for basic client initiated trades, it is clearly inappropriate for individuals looking for financial advice.

What makes the "KYC" of greater relevance is the extent to which it is used to determine fault in arbitration and within the legal system. One could conclude that the industry and those charged with policing the industry have little or no understanding of suitability and erroneously consider the KYC to fulfil basic suitability requirements.

By keeping minimum standards, is the industry in breach of its fiduciary duty?

If the service it is providing is below the service it is capable of providing, given its resources and expertise, if the individual investor relies, in good faith, on the industry to manage their assets and needs, and the industry accepts this trust, knowingly, then by keeping standards low it is consciously in breach of its fiduciary duty to the individual investor. Yes.

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4 Responsibility & Fiduciary Duty

A fiduciary is someone in whom another places a great deal of trust and a great deal of power to act in their best interests. It normally relates to issues of great significance to the individual, issues which if mismanaged would cause significant financial, physical or emotional consequence. In all cases, an individual hands a fiduciary a great deal of discretion over decisions that are made in the interests of the individual. Generally, these decisions are handed to the fiduciary because of the individual's relative ignorance of the area in question.

One should also conclude that it is not just the conduct of the relationship but whether or not an organisation is fit to undertake the fiduciary responsibility. Judging by standards in the industry, a great many organisations are incapable of delivering either the service that is promised or a solution that is supported by the necessary, expertise, resources and the efficient application of both.

The problem with the financial services industry is that the scope of fiduciary duty is often defined by the minimum standards in the industry. If the standards of suitability are limited then so will the standards of care defining fiduciary duty. Moreover, if the standards defining the suitability of a transaction are limited, then so will the prerequisites of suitability. This means that there is little or no duty of care as to the level and the application of expertise, systems and resources with regard to the delivery of wealth management solutions for the individual.

> How many times has one seen an advisor but not the institution blamed for the standard of advice, when in reality an organisation's quality control and organisation of service delivery should have prevented the transgression in the first place?

Furthermore, for some reason, the existence of a fiduciary duty is "supposedly" dependent on the existence of a discretionary authority over the management of assets.

A client with an advisory relationship does not appear to be protected by fiduciary responsibility and duties. For some reason it is assumed that they are making the decisions over transactions. These individuals, in the event of bad advice or inappropriate transactions, are forced to adhere to higher standards that require them to mitigate these transactions once they become aware of them. TAMRIS believes that most advisory relationships are actually ones in which a fiduciary relationship exists and that it is the definition and scope of the fiduciary relationship that has failed to keep up with the times.

4.1 Historical precedent for fiduciary duty

Within the securities industry there has always been two main types of service; the discretionary and the advisory relationship.

The discretionary relationship is where authority and responsibility for all decision making is transferred to the portfolio manager and no confirmation is required by the individual. Such a relationship, where complete power for all trades rest in one person's hands, has historically been very important in defining a fiduciary duty.

> In the early days a fiduciary was a person who had complete control over the management of a portfolio. It is unlikely that any real communication over investment knowledge, understanding of risk and explanation of strategy and investment discipline was ever conducted. The fiduciary had complete control and in most instances the individual was in complete ignorance. Historically this relationship was a **"given",** if you wanted your money managed this is what you did.

The other relationship is the advisory relationship where the portfolio manager[8] or investment advisor requires the authority of the individual client to make any transaction.

[8] Please note that a portfolio exists whether it is managed under a discretionary or an advisory mandate and therefore the advisor is effectively a portfolio manager irrespective of whether his or her recommendations need confirmation.

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In the old days you either had someone manage your money or you did it yourself. The traditional stock broking relationship was very much limited to providing advice on specific securities for clients requesting specific securities recommendations. The problem today is that the rules governing fiduciary responsibility assume that this is the relationship that exists between the client and the advisor. In the majority of instances it is not.

4.2 Today's advisory relationships

Today's financial service's industry is different from the one in which the concepts of fiduciary duty and responsibility "within the financial services industry" were developed.

In today's financial services' market place the advisory relationship serves two client profiles; the one that depends on their advisors to manage their money as well the client who only relies on their advisor to provide securities recommendations appropriate to their own initiated requests.[9]

The former is wholly relying on the advisor's expertise when authorising the recommendations initiated by the advisor. More often than not the client will not understand the necessary investment arguments behind the recommendation, nor would they be able to construct a recommendation or transaction from the information they have received.

> Given the complexity of the suitability decision matrix and the complexity of valuation and risk/return relationships most clients are effectively deferring the decision to the advisor. If this is true then every advisor[10], whatever the agreement (advisory or discretionary) has a fiduciary duty to base all decisions on what is suitable for the client, on sound portfolio principles and with a good understanding of the current risk and return relationships in the market place, including valuation relationships[11].

There is a big difference between an account specifically set up by the client to initiate trades and trade recommendations and an advisory mandate set to provide wealth management services. The legal system and the minimum standards set by the industry fail to take this into consideration.

Importantly there are an insufficient number of individuals with the necessary expertise to actually be responsible for all the investment decisions that comprise the portfolio decision. For example you need to be able to value stocks and fixed interest investments, you need to understand the economic cycle, you need an investment discipline an independent mind, you need to be able to relate asset allocation to financial needs over time. Indeed, even those who are qualified to provide discretionary management may not possess all the expertise needed to properly construct, plan and manage a portfolio to meet financial needs over time. Most organisations possess all in sum.

The truth is that in the industry today it is possible to centralise the portfolio decision making (asset allocation, valuation, security selection, economic analysis, risk management) and deliver this to the individual via systems that manage the short and long term asset and liability management relationships. Therefore it is possible for client relationship managers and financial planners and registered representatives to deliver personalised portfolio management solutions without being responsible for the security selection, market timing and portfolio construction

[9] Indeed, the changing nature of the Canadian financial services' industry was recognised by the Fair Dealing Model in its recommendations

[10] With the exception relationships where clients initiate trades.

[11] Whether the investment advisor themselves has completed the valuation analysis or asset allocation decisions is not important. Someone or some function in the organisation needs to take responsibility for this.

But, what is happening is that portfolio management is actually being delivered within an advisory framework by individuals without the expertise and by organisations with the power to deliver but are unwilling to do so. Yet, who is responsible, the individual investor without the expertise to know otherwise?

It appears that it is the industry that does not want to make the transition from a transaction led to an advice led service industry. It has the ability and the resources and presumably the fiduciary responsibility to do so.

Is the industry in breach of its fiduciary duty by continuing its decentralised, transaction orientated wealth management service process and does it have a fiduciary duty to deliver the best available advice given its resources and expertise?

4.3 Advisory v Discretionary, is there a difference

Just what is the big deal about a discretionary relationship? There is no statutory requirement to provide a comparative performance analysis, in fact no requirement to even post performance statistics. There is also no requirement to justify strategy or suitability. So, even if you were not being managed appropriately, it is unlikely that you would find out.

> Is not a relationship where the advisor is forced to justify their decisions a more rationale one for the individual investor?

What is the main difference between an advisory account and a discretionary account <u>where a client relies on the manager's expertise to manage their money</u> to meet their financial needs over time?

Both relationships **<u>should</u>** have had to have undergone an education and risk assessment process to assess suitability.

> Why? Because the portfolio needs to represent both the asset and liability relationship and the interaction between the advisor's investment universe and the client's investment universe. Otherwise suitability has not been justified or communicated.

Both advisors should therefore theoretically start off with the same portfolio and the same rationale. The client should start off with the same expectations and the same understanding of the rationale in which the portfolio will be constructed, planned and managed. Both relationships effectively start off with confirmation of all trades, one implicitly and one explicitly.

From that point on, the main benefit of a discretionary relationship for the advisor is that they do not have to seek client confirmation of a trade. Where the advisor is actively buying and selling, then discretionary authority is important as would be instances where portfolio transactions are automated. If there is a duty to justify suitability and communicate rationale and reason, then this is the only difference between a discretionary and an advisory relationship. Note, that a discretionary relationship should justify all decisions and outcomes after the fact. The fact that this is not a requirement should not be used as a characteristic to identify the positive fiduciary aspects of a discretionary relationship.

In an advisory relationship each transaction confirmation is effectively ratifying the relationship and rationale agreed (periodically) and not the transaction itself. Obviously within a process that properly addresses the issues of suitability and communicates these issues to the client, the old concept of the fiduciary relationship no longer applies. While there are indeed clients who place total trust in a wealth manager and who are unable to understand and relate to a suitability process, and therefore fall under the old definition of a fiduciary investment relationship, this is not the way forward for the industry.

> Is total vulnerability, total ignorance and total delegation of decision making authority a necessary prerequisite before an advisor is accorded a fiduciary duty and the client the benefits from such? No, it should not be for a number of reasons.
>
> Are there enough advisors out there capable of taking a total fiduciary position and, why should an individual accept a position of total ignorance about the management of their assets? Today, it

would seem foolhardy for an individual to place old fashioned fiduciary responsibility into the hands of the first person they met.

Many advisory agreements are effectively de facto discretionary management agreements given the limited decision making process a client goes through when confirming a decision.

So why are advisory relationships considered outside the realms of fiduciary duty? Part of the problem is the outdated rule that an advisory relationship is a transaction relationship and not a wealth management relationship.

If it is obvious that most of the information needed to assess a transaction is excluded from the recommendation and justification, then an advisory relationship should be afforded the same level of fiduciary protection as a discretionary relationship? After all, a fiduciary duty should imply a direct relationship between the standard of output and the duty of care with regard to the production of that output.

> An organisation has a fiduciary duty to clearly state the realms and limitations of its services and the rights and responsibilities of its clients. If its advisory service is to be construed as one where the individual is taking all the responsibility for the decisions, this needs to be clearly stated. It is hard to see how the industry could operate if individuals were not able to view their advisors as individuals capable of advising them.

To restrict the fiduciary benchmark in today's financial services industry to archaic discretionary financial relationships ignores the complexity and the reality of the components and processes involved in the delivery and management of the wealth management solution.

All investors who are not qualified (by profession, experience or expertise) to research, value and select and manage securities within a portfolio construction capable of planning and managing the ability of assets to meet financial needs are placing their trust and their financial security in the hands of their advisor, irrespective of whether the arrangement is advisory or discretionary.

4.4 Legal definitions of fiduciary duty

In Frame v Smith, Justice Wilson gave three rules that would imply a fiduciary duty.

1. The fiduciary has scope for the exercise of some discretion or power;

2. The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests; and

3. The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.

In Lac Minerals Ltd. v. International Corona Resources Ltd, Justice Sopinka stated that a fiduciary relationship may "…be found although not all of these characteristics are present, nor will the presence of these ingredients invariably identify the existence of a fiduciary relationship.".

Justice Sopinka further stated that of the three rules stated by Justice Wilson, the need for "dependency or vulnerability" was indispensable. He quoted Justice Dawson from "Hospital Products v. United States Surgical Corporation (1984)".

> *"There is, however, the notion underlying all the cases of fiduciary obligation that inherent in the nature of the relationship itself is a position of disadvantage or vulnerability on the part of one of the parties which causes him to place reliance upon the other and requires the protection of equity acting upon the conscience of that other".*

Yet, in Laflamme V Roy, the Supreme Court of Canada stated the following.

> *There is nothing to indicate that the parties stopped to consider changing the mandate by terminating discretionary management. In that case, Roy would have been obliged to inform the Laflamme family, who were not knowledgeable investors, of the effects of this change on the management of the account, to ensure that an informed decision was made. This stems from his obligation to act in good faith.* ***He would then also have been required to advise them concerning the implications of that decision and, at the very least, tell them clearly that they alone would now be responsible for all aspects of management of the portfolio****"*

Even in this landmark ruling by the Supreme Court of Canada, there appears to be much confusion over just what constitutes responsibility and where does responsibility and hence "fiduciary duty" start and finish.

Importantly there does not appear to be a clear rationale as to why an advisory relationship should not constitute a "fiduciary type" duty on behalf of an advisor. The only explanation is that the advisory relationship is only considered a transaction relationship and, transaction relationships are ones initiated by the client. But is this really the case? Also, is the definition or understanding of the fiduciary, an archaic function of a bygone era, no longer as appropriate or as encompassing a definition of responsibility?

4.5 Reassessment of Frame v Smith

If we look at Frame v Smith, an advisor in an advisory relationship actually satisfies all three of Justice Wilson's rules.

- If the reason and rationale for most if not all trades are initiated by the advisor then there is discretion in the selection and recommendation process that is not open to the individual with limited knowledge. Most individuals do not posses the expertise needed to construct, plan and manage portfolios nor to value, allocate and manage securities.

- The advisor does not need the client's permission to initiate transaction recommendations, indeed this is why the client has chosen the advisor. The advisor can unilaterally recommend transactions that affect an individual's financial security and it is part of the implied relationship that the client will accept the recommendations. Note Justice Wilson does not state that the power in question is the power to transact.

- Most individuals are vulnerable because bad advice can significantly affect their financial security and because they do not possess the expertise to question the validity of transactions in their entirety.

Critically, if we assess suitability as a framework, the transaction is not the only component of discretion, indeed it is the least important component of suitability and hence discretion. The reason, the process, the valuation, the allocation and management framework are all areas to which the client does not understand or, most likely, is not being given access to or information on.

4.6 Suitability of the transaction within an advisory relationship

Is there an underlying fiduciary responsibility within an advisory relationship?

- Yes if we look at the wider environs of suitability and, yes if appreciate that most individuals defer to their investment advisors for the management of their assets to meet their financial needs.

- No, if the client is only relying on the advisor for individual transaction recommendations based on specific requests initiated by the client.

- No if we rely on minimum standards and archaic definitions and relationships used to identify responsibility and duty.

To date there is little or no legal precedent for establishing a fiduciary relationship within an advisory relationship.

Most legal cases are actually to do with transactions that should not have been made, but were. In **Hunt v TD Securities** an advisor had sold a security without authorisation and the client, an elderly gentleman, who was not unsophisticated failed to deal with the transaction in good time, even though he was aware of the transaction at the time. As far as Hunt v TD Securities was concerned, the issue taken to trial was not one of suitability, or fiduciary duty.

> Individuals must remember that they still have a responsibility to complain about transactions they did not authorise, if and when they become aware of the transaction.

It is debatable whether suitability has effectively been used to assess a breach of fiduciary duty within an advisory relationship.

What is more important for the individual in an advisory relationship, are transactions that are unsuitable and inappropriate and therefore relate directly to a fiduciary duty to recommend transactions that are suitable to the clients financial needs and risk preferences and, that took due care and attention of the risk and return relationships of the security at the time of the recommendation.[12]

The trouble is that transactions that are unsuitable will have been made with the formal consent of the client and will therefore have been ratified by the client. Quite often, by the time the client suffers the consequences of an unsuitable investment, it is too late.

> Note that just because an investment falls in value after purchase does not mean that it was unsuitable. A general lack of education and endemic mismanagement of expectations has led to many investors complaining about issues that are simply not issues of suitability or fiduciary responsibility. Suitability has more to do with structure and the management of expectations through education and risk assessment than whether a transaction on its own is suitable or not.

Indeed, an investment that falls in value unexpectedly may well have been suitable at the time of the recommendation and, may still remain appropriate and suitable. Yet, how is the client to differentiate between the investment that is unsuitable and the investment that is suitable? A duty to mitigate a further loss, which individuals are unreasonably obliged to do, may end up forcing the client to sell something that still has value, that is actually suitable and the sale of which will end up upsetting the balance of the portfolio.

> Indeed, the duty to mitigate implies a superior knowledge that most individuals could not possibly posses. So why is a client in an advisory relationship presumed to have this superior knowledge? Mitigation can therefore only be effective if the client is knowledgeable, in which case there would not be a fiduciary relationship. As such, the only time when a client can have been deemed to have failed to mitigate a transaction is where they clearly knew of and understood that the transaction was unsuitable at the time it was recommended.

It is therefore important that advisors reconfirm the reasons for the suitability of an investment in response to concerns raised by clients and to explain events affecting security prices, asset allocation and overall performance. Indeed, one could consider this to be a fiduciary responsibility.

4.7 When a transaction is not a fiduciary responsibility

The only time a transaction can be clearly assessed as a stand alone transaction should be when an experienced and sophisticated investor uses his or her investment advisor to solicit a security or a trade idea. In this sense, the individual investor is assumed to have taken full responsibility for the consequences of the transaction and for all issues including those of suitability.

[12] This is not a statutory, regulatory or legal stipulation, but it is one which TAMRIS feels encompasses the suitability decision.

Individual investors who do not have the expertise to be initiating transaction decisions, but do, are also taking responsibility for issues of suitability and relieving their investment advisors of their fiduciary duty. All the investment advisor has responsibility for in this instance is that the trade recommended matches the suitability profile of the individual, although even here advisors are allowed to execute unsuitable trades if the client specifically requests this.

In terms of suitability, once an individual investor starts to initiate their own transaction decisions they may negatively impact the portfolio construction, planning and management framework instituted by their advisor. Individual investors without the necessary expertise are going to be making trades that do not meet the rules of suitability and that will violate the structure of the portfolio. An advisor should not be held responsible for this; although they should be responsible for informing the individual of the risks they are taking.

The current know your client form is more or less appropriate for transactions initiated by the individual investor.

It is therefore important that the mandate for the advice and the framework in which the relationship will be carried out is agreed in advance so that issues of responsibility, suitability, duty of care and fiduciary duty are covered in advance.

4.8 Two types of transaction

What is important to understand is that there are two types of transaction within the wider environs of suitability. There is the transaction between securities designed to reduce risk and or enhance return and there is the transaction initiated by the relationship between financial needs and assets.

An investor can initiate the second type of transaction without violating their mandate or the advisor's fiduciary duty towards them as long as it is the manager that makes the transaction decision. For example, I need to spend C$30,000 in two years time, please provide me with the capital at the time.

It is important to realise that whatever the relationship mandate, advisory or discretionary, where the client is reliant on the advice of the advisor that the advisor will be initiating the recommendation and the reasons for the recommendation. Because of this it is therefore important that suitability lies behind all decisions irrespective of the mandate.

4.9 Legal decisions regarding suitability

The one case where issues of suitability were addressed was In **Laflamme v Roy**. Indeed, the Court did acknowledge, albeit awkwardly, the complexity of suitability in its decision.

> *"The faults committed by the respondent Roy are apparent from the record. He failed to comply with the conduct required of a prudent and diligent manager, in that he failed to construct an organized and diversified portfolio, carried out transactions that were inconsistent with the client's general instructions, acquired speculative securities and failed to have regard to his client's investment objectives. As a mandatory, the respondent Roy also failed to deal fairly and honestly with his client, as he was expected to do. There could be no clearer illustration of that breach than his failure to comply with the Laflamme family's instructions concerning the amounts to be invested in the stock market and the immediate cessation of transactions on margin."*

At the court of appeal the Judge had ruled that the clients had failed to mitigate the transactions, in response the Supreme Court ruled.

> *"……….. in view of the nature of the damages in this case, which resulted not from losses caused by an easily singled out act, such as an unauthorized transaction or the failure to act on the client's instructions to buy or sell a particular security, but rather from the on-going mismanagement of a portfolio whose value fluctuates continuously with the prices of the securities of which it is made up""*

It is rare to see a legal decision which is fully conversant with the structural framework of suitability. Portfolio construction, planning and management is a complex area and becoming ever more complex while the principles behind suitability remain as nebulous as ever.

4.10 Fiduciary responsibility more than just discretion over the transaction

As the introductory section on suitability shows, constructing, planning and managing portfolios to meet financial needs requires more than just security selection expertise.

Because of the nature of risk and return, the number of investment styles available and the range of financial needs, most portfolios can only be managed with a mandate developed between the client and the portfolio manager. This mandate is important in both a discretionary and an advisory relationship and should cover the same ground.

A mandate means that the investor takes part in the decision over asset allocation and investment strategy by setting important parameters (financial needs, risk and performance risk preferences) that determine the relative asset allocation and strategy.

The manager and organisation is at all times responsible for the expertise, resources and systems needed to actually construct plan and manage and to support the constructs that manipulate financial needs and risk preferences.

Note the investor does not determine the actual allocation. It is the organisation's process that adjusts their asset allocation to suit financial needs and risk profiles. Likewise, the investor does not select the individual stocks or securities; only endorses them in an advisory relationship.

4.11 Shades of grey

Why should a discretionary relationship be the only one in which an implied fiduciary duty exists. If all the information needed to make a professional decision was easily available and easily computed by the average individual and all components of suitability were easily assimilated and actionable by the individual, this would be the case.

Indeed, given the complexity of the transaction decision, let alone the complexity of the portfolio construction, planning and management decision, most advisory relationships display the same amount of trust, vulnerability and reliance on the expertise and professionalism of the advisor as the discretionary relationship.

There are indeed many shades of grey. There are discretionary relationships which are closer in nature to advisory relationships and there are advisory relationships that are closer to the discretionary than the transaction. But it is worth while noting that a grey area is only an area where the rules and principles governing the relationships are not known, but do exist.

4.12 Conclusion

An advisor who is only responsible for executing an individual's trades, but checks to make sure those trades are within broad parameters of suitability before executing the trade, is not in a position of great responsibility or trust and as such, they cannot be considered to have a fiduciary or fiduciary type duty.

An advisor upon whom the client relies to initiate transaction decisions to provide a portfolio and wealth management solution is in a position of great responsibility since the consequences of mismanagement will have a significant impact on financial security.

In most advisory relationships, just as with discretionary relationships, it is the advisor that initiates the transaction, purportedly on grounds of suitability. A such, in most advisory relationships, most individuals defer to the advisor when confirming that a trade can proceed.

In reality, one should be able to argue that given the complexity of the suitability equation, that it does not matter much whether the client retains the authority to confirm transactions or not. What is important is the effective discretion behind the decisions that is important.

Until standards in the industry require clear mandates as to the nature, structure and responsibilities of a service, issues of fiduciary duty will remain vague and legal precedent stuck without guidance. Clearer standards would no doubt enforce a fiduciary type relationship in most advisory relationships.

5 The future of fiduciary responsibility

There are two things that are clear from the issues surrounding fiduciary responsibility.

- The first is that much of the decision making process is obscured from the individual and, it is the responsibility of the advisor to make sure that these processes provide recommendations that are suitable and appropriate to needs and risk preferences and reflect the market risk/return relationships.

- The second is that if an advisor has fully complied with issues of suitability that they have also complied with their primary fiduciary duties and responsibilities.

As such, this means that the more an advisor can educate a client about fundamental areas and the better they can assess risk and the better they can communicate their rationale and strategy relative to the client's needs and preferences, the less chance a client will need to take issue with advice.

Indeed, the more knowledge an individual has of the way in which their portfolio will be run and of the risks of investment, the less fiduciary risk an advisor is taking. This is because there will be a direct relationship between portfolio structure, planning and management and the individual's financial needs and risk preferences. The fundamental structure and risks will have been agreed upon in advance. Issues of suitability should rarely if ever arise and with a centralised structure (as opposed to a decentralised loosely organised sales led organisation) rogue traders and advisors will no longer be able to operate.

This still leaves a number of key areas over which the advisor or company has a fiduciary type responsibility, irrespective of the nature of the relationship and irrespective of how professional the delivery of the communication. An organisation needs the expertise, the resources, the systems and the business and service processes, properly applied, to properly construct, plan and manage assets to meet financial needs over time.

If an advisor has a valid rationale and, the client understands the valid rationale and accepts this valid rationale but, the allocation to the securities represent an inappropriate strategy because it fails to adequately assess current risk return relationships in the market place, then the advisor is in breach of their fiduciary duty.

However, the old idea of the fiduciary being someone who manages on behalf of an individual who is effectively in total ignorance of what is happening cannot be a benchmark for responsibility or duty of care going forward. In an industry that must engender higher levels of suitability, client interaction in the wealth management process is critical. A fiduciary type duty still exists, nevertheless, but it is not the old concept of fiduciary type responsibility, but a structured and deliberate assessment of the prerequisites of a service, the delivery of the service and the components of suitability covered by a service.

5.1 How do we define the "fiduciary type" responsibility

The "fiduciary type" duty depends on the manager's service offering and their statements defining their offering including its limitations.

Services whose objective is to manage all of an investor's assets, or a portion of their assets, to meet a specific set of financial needs over time have the following duties and obligations.

- To develop or have in place specific investment planning disciplines that relate the structure of individual portfolios (asset allocation and security selection) over time to the size and timing of financial needs over time.
    - A service must either be able to directly relate the structure of the portfolio to the actual size and timing of financial needs over time through cost and risk effective management of liquidity needs irrespective of market and economic risks or, to be able to demonstrate the ability of their structure, if not directly related, to do the same.

  - The service must also be able to relate their investment discipline to the universe of yield and liquidity requirements over time and, to be able to adjust where practical their asset allocation, yield and risk/return profile for both the universe of financial needs and risk and performance preferences, or to specifically define and limit their management brief to individuals with compatible liquidity, yield and risk/return objectives.

- To develop or have in place a specific risk assessment and education process that defines the basic investment risks, educates the client over their investment discipline and portfolio construction methodology and that communicates the rationale of this structure relative to financial needs and, to allow the investor to adjust the level of security as well as the relative risk/return profile of the portfolio as part of the risk assessment and education process. All risk assessment should be based on a personalised portfolio solution.

- To be able to assess the specific point in time valuation risks of each investment class, any given security or market allocation and to be able to manage these risks within portfolio construction, planning and management.

- To have a service process that provides detailed supporting written communication of all material rationale and all material reasons for recommendations and changes made either ex ante for advisory or ex post for discretionary.

- To provide suitable relative performance, risk and liability management benchmarks that assess not only performance and risk adjusted performance relative to competitive benchmarks, but also the effectiveness of asset and liability management.

- To have a well defined business and service process capable of efficiently delivering all the component functions of the wealth management solution. It is impossible to deliver personalised solutions that deliver total suitability without an integrated and efficient business and service process. The old transaction business model cannot deliver this.

Essentially, an advisor/company has a "fiduciary type" duty to use their expertise to the best of their ability to manage assets to meet their client's financial objectives, in a manner which is compatible with the client's financial needs/liabilities over time, risk and performance preferences and the risks inherent in the market and economic environment.

In this sense, the fiduciary type duty is the mirror image of suitability. It is therefore important that the expertise needs to be appropriate to the management of the objective at hand and the resources sufficient to support the business and service processes required to meet the objective

Actions, advice or transactions which are unsuitable given the client's financial needs, risk and performance preferences and current market risk/return relationships (including valuation analysis) would contravene a fiduciary type duty/relationship.

5.2 Prerequisites of fiduciary responsibility

Satisfying your fiduciary duty is more than just going through the motions. Investment advisors and portfolio manager's must have the necessary expertise, the resources and the system's and business processes to be able to achieve the client's investment and financial objectives and, this is also a fiduciary type duty.

- An advisor who lacks the expertise to manage portfolios yet still does, or institutions that allow advisors that lack the expertise to manage assets without the necessary oversight and or quality control are in breach of a fiduciary type duty.

  - Why? Because a client' assets can only be effectively managed with the appropriate application of expertise. Any acts or omissions resulting from a lack of expertise or experience would be a breach of such duty.

- Likewise an organisation that lacks the resources to adequately research the securities used to allocate, the markets and economies to which they allocate, are in breach of a fiduciary type duty to the client.

    - Why? Because valuation and its risks is key to both the determination of asset allocation and the management of risk and return. If you cannot manage risk and return then you cannot manage risks to the ability of assets to meet financial needs.

- An organisation that lacks the business and service processes and the necessary systems to manage the complex relationships and to deliver central asset management expertise cannot safely manage risk and return nor can it adequately manage the relationship between assets and financial needs.

    - In fact, this is both an organisational issue and a suitability issue. Technology allows us to integrate the components of the wealth and asset management processes and these processes ultimately come to embody an organisation's business and service processes. From an organisation's systems and structure you can infer their attention to suitability and the efficiency of the application of their resources and, the control and management of their service process.

- Importantly, because investment in any asset poses a risk and because this risk has many components, an organisation that cannot communicate the nature of its investment processes and portfolio construction, planning and management methodology will not be able to manage client's expectations of risk and return. This is also a breach of a fiduciary type duty.

    - Why? Careful education, communication and assessment of risk and performance preferences will allow the client to decide what approach is best for them. It will also allow the portfolio manager to implement risky strategies for clients who understand and truly accept the risks, with clear confirmation from the client of the strategies to be pursued.

5.3 Conflicts of interest & honesty

Organisations need to be aware of the limitations of their expertise and the boundaries in which they can effectively apply it as well as the limitations of their portfolio construction planning and management methodologies as it affects suitability.

Too many organisations misrepresent the abilities of their portfolio construction, planning and management to meet financial needs over time while managing risk and return. This is clear a breach of a fiduciary type duty in that the investor assumes a certain level of care and attention and is in fact receiving a lower level of care and attention.

Additionally too many organisations fail to be honest about the risks and costs of individual investments. If material risks regarding an investment are not disclosed, this is also a breach of a fiduciary type duty where clients depend upon the honesty and integrity of their advisors as well as their expertise to manage their assets.

> Obviously, within a transaction only relationship, failure to disclose remains negligent, but those who only want a transaction relationship should be aware of the material components of an investment decision.

Many individuals who rely on their advisors for advice and security recommendations are sold investments with limited explanation of the risks with only the prospectuses to provide them with more detailed information. Unfortunately many of these prospectuses are too complex for the average individual to understand and many fail to clearly point out the risks of the investment. Importantly prospectuses do not cover the ground necessary to address wider issues of suitability, so advisors relying for disclosure and communication of the risks on a prospectus should be in breach of their fiduciary duty.

A prospectus cannot relate suitability to financial needs over time, it cannot relate suitability to the disposition of all other assets, their interrelationships and their relationship with financial needs, nor can it relate to current risks in the market place.

The conflicts of interest within a transaction led industry, where transaction returns dominate remuneration and hence security selection and wealth management solutions, creates its own paradox.

Is it possible to be able to satisfy fiduciary duty within a transaction led industry structure? No, it is not because the structures needed to satisfy a fiduciary type duty are too involved and unnecessary for a transaction objective.

5.4 The fundamental rights of the individual investor

It is impossible to fully assess fiduciary responsibility without being aware of the basic investment rights of all those individuals seeking the management of their assets to meet their financial needs over time. These are as follows.

- The right to have their assets managed to meet their own personal financial needs over time and, for their individual portfolios to reflect the size and timing of their own individual needs.
- The right to be told the imitations of the service they receive and the extent of personalisation provided.
- The right to a portfolio structure and planning capable of ensuring that planned financial needs can be met irrespective of natural and significant market and economic risks.
- The right to the expertise and systems needed to structure plan and manage portfolios to meet personal financial needs over time.
- The right to full disclosure of a company’s investment style and the risks of that investment style.
- The right to an assessment of the key risks likely to affect the ability of their assets to meet their financial needs over time.
- The right to full disclosure of the portfolio construction, planning and management methodology and how this methodology manages risk and financial needs over time.
- The right to full disclosure of all charges and costs of both service and investments and the justification of those costs.
- The right to accountability of decisions regarding portfolio structure, planning and management relative to financial needs and risk profile via full and regular written communication.
- The right to regular and comprehensive assessment of the value added by the wealth manager.
- The right to be able to compare companies’ and individuals’ services and service quality across the universe of wealth and asset managers.
- The right to have access to information regarding the structure of the asset and wealth management service process and, the resources applied to research, investment strategy and systems.
- The right to demand that the quality and value of the service they receive is a prime objective of their service providers.

6 Education & fiduciary type responsibility

Fiduciary type responsibility is the responsibility for actions over which the client has little or no information, knowledge or expertise. While there will always be aspects of the wealth management process over which the advising company will have a fiduciary responsibility, a great deal of fiduciary responsibility can be "communicated away" both at the start and during the wealth management relationship.

Greater education would help reduce the liability on the industry, would help the investor understand and be better able to make decisions while enhancing the overall suitability of the final portfolio solution. The downside of education and communication is that is requires a well disciplined portfolio construction, planning and management process. Again, if all you want to do is sell, this is over kill, but if you want to ensure suitability it is no more and no less than what is needed to do the job properly.

Few clients are ever going to be able value a security, a market or assess the economic risks to market valuations. Additionally few client clients are ever likely to be able to develop their own portfolio construction, planning and management methodology or even recreate those of their wealth manager.

However, it is possible for clients to assume responsibility for many of the major wealth and portfolio management decisions (the amount in low risk assets, the aggressive or conservative nature of the strategy, the initial investment decision), while the wealth managers will be responsible for the integrity of the process and their ability to implement it.

Establishing suitability requires a client's acceptance of what the advisor is doing at a fundamental level. As discussed, suitability for the individual investor is a much more complex process than merely recommending an individual transaction. A failure to educate is a liability and a cost.

However, it is important to note that there is considerable resistance in the industry to both accept fiduciary responsibility and the time and effort required to educate and communicate to the client. In the Registered Reform Project's working group minutes it was stated that it was not the industry's responsibility to educate the individual investor.

The TAMRIS website provides detailed information on the education and risk assessment process and the importance of communication in the client advisor relationship.

Critically, if the advisor is not communicating the complete rationale for a decision, they are taking discretionary responsibility over significant aspects of the decision making process. Since the appropriateness of the individual security is by far the least important component of the overall suitability process, most of today's advisory relationships actually have a significant discretionary and hence fiduciary element even if we use old benchmarks to judge the relationship.

7 Investor protection

Investors are protected against unfair, improper and fraudulent practises in the securities market. But this basically relates to the procedures and regulations for buying and selling securities, for companies that are issuing new shares and institutions that help these companies to raise capital.

Investors wrongly believe that they are protected against bad advice. While there exists a myriad of rules and regulations for the selling of securities, these relate primarily to the complex information that needs to be disclosed within sales documents. Information, one might add that is often couched in legal parlance that either confuses the individual investor with its numerous caveats or loses the investor with information that is often too complex to understand or insufficient to fully explain the real risks.

There are regulations that govern the procedures for recommending, buying and selling of investments for individuals, but these only provide, as discussed, minimum standards. These minimum standards reflect the industry's primary objective of selling products and generating transactions.

Regulation does not protect the individual investor against unfair, improper, negligent or inappropriate financial advice. Regulation does not protect the individual from those without the expertise to manage your money. Regulation does not protect you from those without the systems or the resources to do the job properly.

If you read the securities act which underpins the regulatory function of the Ontario Securities Commission you will not find anything regarding investor rights or any detailed principles constituting good or bad advice.

If you look at the investment dealers rule book, there is likewise nothing regarding bad or good advice, only procedures with regard to effecting and managing the transaction process.

While the industry's stated ethics and duty of care would suggest otherwise, investors need to be aware that they are responsible, rightly or wrongly, for ensuring that an advisor acts ethically and complies with the duty of care expected.

In reality, issues of suitability are capable of being sufficiently well defined that regulators should be able to institute specific principles determining conduct of service and standards regulating statements of the nature of the service being provided.

It is clear that current minimum standards are only sufficient for transaction requests initiated by a client that is taking responsibility for suitability and the framework in which suitability is being managed.

While no firm should be forced to deliver the very highest standards and any firm should be allowed to offer the minimum, firms should be forced to explain the nature as well as limitations of their service within the wider parameters of suitability noted. They should also be forced to take both the fiduciary risk and the fiduciary responsibility for delivering services deficient in key areas of either suitability or the prerequisites required to support and manage its delivery.

Investors need to be informed of their rights and the limitations of the services available. This is a market place for advice, different levels of service may have different costs and smaller clients may not be able to access the very highest standards of service for obvious reasons. Nevertheless, consumers need to be educated over the choices and the choices should be clearly differentiated in the market place.

8 Summary & Conclusion

The most important component of suitability is the framework in which the transaction is recommended and not the transaction. It is impossible to make a case for suitability on a transaction by transaction basis where a portfolio of assets is being constructed to meet financial needs over time.

The second most important component of suitability are the prerequisites; the expertise, the experience, the resources, the systems and the business and service processes that deliver suitability.

Today's minimum industry standards are insufficient to justify the suitability of a transaction. Minimum industry standards are only sufficient to justify suitability on a transaction by transaction basis, which does not satisfy the key rules of suitability. In particular the "Know Your Client" form is hopelessly ineffective in providing a foundation for meeting the real world needs of the individual investor. Indeed, any investment policy statement based on such will also be flawed.

Likewise, while the prerequisites of expertise and resources exist within many institutions, the systems and the business and service processes needed to deliver suitability do not.

The concepts of responsibility and duty of care appear to be outdated and do not take account of the fact that the industry is serving a largely vulnerable[13] client base looking for careful management of their assets to meet their financial needs. Legal decisions are also confused and constrained by antediluvian parameters of fiduciary duty that appear to treat advisory relationships as only transaction requests and the old discretionary relationship as the only benchmark for determining decisions. Indeed, advisory services, if we look at the wider environs of suitability, are largely discretionary relationships where transactions are merely endorsed.

The future of "fiduciary type" responsibility involves defining the broader parameters of suitability and ensuring that the definition is sufficient to protect the rights of investors against the self interests and conflicts of interest in the industry.

Suitability is indeed a complex area and the decision making process is beyond the vast majority of advisory clients to comprehend. However, it is also probably true that many advisors are only able to assess transactions on a transaction by transaction basis and are incapable of delivering a wealth management solution that meets the stricter definition of suitability as stated in section 2. If only individuals seeking advice were told this when they asked for advice!

The Canadian financial services industry is stuck in a time warp and needs to move forward. Current minimum standards of suitability are hurting the individual consumer of financial services while protecting organisations that should be exercising greater responsibility.

As discussed in the TAMRIS website, the financial services industry's problems are numerous. The Canadian industry remains a largely transaction driven industry and one that lacks the systems, the expertise and the business and service processes to deliver higher standards.

Many of the concerns raised in this document were implicitly addressed in the Fair Dealing Model. While the FDM had significant flaws it was by most measures an important step forward. In 2005 the Fair Dealing Model was dropped in favour of the much weaker Registration Reform Project proposals. The Registration Reform Project reports basically confirm that the industry wants to maintain the minimum standards of service, transparency, reporting, accountability and education to a minimum, all factors that would keep the current levels of suitability and fiduciary duty as they are.

[13] They are vulnerable because their financial security depends on the suitability of the advice and transactions recommended. They are vulnerable because knowledge of investments does not translate into the ability to make the complex decisions required to construct, plan and manage.