

# Fiduciary Rules

## As investment performance gets litigated, the bar rises for advice

**BY SCOT BLYTHE**

Is 10.7% a reasonable rate of return? Perhaps not, if you're prone to litigation. To be sure, it is in line with the long-term return on equity markets. But for one client, it wasn't.

A lawyer, retired from practice and heading a mining company, made a sizable investment with an

investment counsellor: \$6 million, in 1993. He earned \$8.2 million on his holdings and closed out his account in 1998.

The lawyer was knowledgeable about investments, sophisticated, and experienced. But he sued for \$7 million.

What's to litigate?

The investment portfolio was unsuitable – because half of it was in cash. The investment manager operated under the guidance that the client wanted a cash reserve for his business dealings. Without written confirmation of such instructions, the judge, deciding on behalf of the now-deceased lawyer's estate, awarded almost a \$1-million judgment against the portfolio manager. The judgment is under appeal.

That's an example Ellen Bessner, a securities law litigator at Gowling Lafleur Henderson, uses to illustrate the real world of investment litigation. A little-known world, too, she says, since almost all cases are settled before going to trial. And not with a touch of irony, either. Her constant advice: with every client, write it down while the conversation is going on. It's a lesson she had to teach her own advisor, she noted at a seminar on compliance for portfolio managers sponsored by Raymond James and Highview Financial Group.

“If we're not careful enough,

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and if we're not diligent and if we don't incorporate compliance into our everyday lives, then what will happen is it won't be a question of if, it will be a question of when," she says. "When we get the letter from a client complaining, with a statement of claim."

And a letter may not be the end of it. "A licence is not a right; it is a privilege," which securities regulators can revoke, she notes.

Revoking a licence is the last recourse – in many senses, because by then, the business is dead. "What's the good of building all this revenue if all it's going to do is attract client complaints and litigation?" Bessner asks. She notes that 99% of the cases she sees involve the suitability of the investment recommendations. What's left are discretionary trading, and issues around understanding and communicating the risks of the invest-

ment product.

"You cannot afford to be in the newspaper with regard to any allegation of impropriety," she says. But staying out of the papers means understanding the risks to the portfolio manager: to their licence, their business and their reputation.

When clients are angry that their life-savings have been threatened, the advisor's livelihood is on the line too. "There's nothing more important than reputation," Bessner warns, and, indeed, reputation is often circulated among a connected group of people: clients referred by other clients on the basis of reputation. All to the good of building a business, she says, with a caveat. When a complaint arises, it's usually not just

**But what do you do with those risks once you've identified them?**

one complaint from one client, and it isn't fuelled by a class-action suit. Instead, complaints arise from people who know one another. "How do they know one another?" she asks rhetorically. "Referrals."

When the regulators intervene, or the courts, Bessner says, "they, of course, go right to the investment managers' bottom line: their assets." On this hangs the investment manager's fate, because the biggest bottom line is reputation, which is perhaps more important than their skill. More pertinent, however, is that with investments, "if you can identify the risks you're halfway there. But what do you do with those risks once you've identified them?"

Bessner offers an exercise. Using a "triangle of suitability," she plots the client, the KYC and the investment. Sometimes, the client jumps that process, moving to investments that are not part of the KYC.

The danger, she says, "is that

the KYC is no longer reflective of the client, but of the investment." What advisors need to do is to return to the client, and adjust the KYC to the client's risk profile, not to the risk profile of the investments they have chosen.

And that means listening. Clients are often loath to disclose much about themselves, such as whether they have changed jobs or what jobs they held in the past. All may be important in determining what is suitable for the client. "Clients," she says, "don't know what they want. They may have an idea of what they want." By contrast with an investment advisor, who may need simply to get a signature to make an investment, discretionary managers "have to guide clients to what they need."

Consider the court case. The resolution depended on the following indemnity: "You shall not be liable for any error of judgment or any other act or omission, providing that you act in good faith

and exercise due care." While the portfolio manager said the client needed cash to complete a transaction, not only was there no written instruction to be found, the judge also found that the cash was held for an inordinate length of time. He ruled that due care should have meant 8% of the holdings in cash and a reasonable length of time in which to invest the remainder would be no more than nine months.

"If you are going to get special instructions from your client that are outside the realm of reasonable," Bessner advises, "if there is someone who wants to hold money in cash or if there is something unusual about the instructions that you are receiving that might make it look like you're earning money for doing perhaps less than you should be, then put it in writing." And be prepared. "A waiver is not a life jacket. Your client will be measuring your performance."