Court opens the door to a finding of fiduciary duty in relation to non-managed accounts

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Overview

In a post Client-Focused Reforms world, can a non-discretionary advisor owe a fiduciary duty to clients in a conflicts of interest scenario? The Ontario Court of Appeal says yes.

In *Boal v. International Capital Management*, 2023 ONCA 840, the Ontario Court of Appeal found that an investment advisors' duty to avoid material conflicts of interest may be a fiduciary one, even when a client has a non-managed account.

This decision is a message to the investment industry that regulatory guidance is playing an increasingly central role in the court's interpretation of professional duties toward clients with both managed and non-managed accounts.

The Court's decision in *Boal* reflects the impact of the Client-Focused Reforms (CFRs) which require securities advisors, dealers, and registered representatives to, among other things, address material conflicts of interest in the best interest of clients. This enhanced obligation includes the requirement to identify, and either make fulsome disclosure and control and manage the conflict in the client's best interest, or, to avoid the conflict altogether.

What you need to know:

- Following the Client-Focused Reforms, expect more findings of a fiduciary relationship between an investment advisor/dealer and clients with both managed and non-managed accounts, especially relating to conflicts of interest matters.
- Professional rules that require investment advisors to put their clients' interests above their own require advisors "to act in a way that a fiduciary must act".
- Despite the Court's emphasis on the impact of professional standards, findings of a fiduciary relationship remain fact specific.

Refresher on the CFRs

The Client Focused Reforms, a series of amendments to National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (31-103) are designed to strengthen the investor-client relationship. When the CFRs were first proposed, there was a vigorous debate amongst market participants and regulators as to the potential impact those reforms might have on the registrant/client relationship. Nowhere was that debate more pronounced than on the introduction of the best interest standard. As expected, we are now starting to see judicial interpretation of these provisions and the legal import of those provisions on the nature of the relationship of industry participants and investors.

In 2016, the Canadian Securities Administrators (CSA) consulted with stakeholders on the implications of introducing a "best interest" standard into 31-103. Stakeholders held the view that this "best interest" standard would not, on its own, establish a fiduciary duty.[1] Responses to the 2016 consultation evidenced divergent views on the impact such a standard might have on the duty of care owed by registrants to their clients, as well as divergent views as to whether this would be positive or problematic. For the most part, dealers and lawyers who acted for dealers held the view that the introduction of a best interest standard would necessarily result in the imposition of a fiduciary relationship in dealer/client interactions. In response, in the Notice of Amendments that implemented the CFRs, the CSA stated:

We stress that the Amendments to not impose a fiduciary duty on registrants as a regulatory standard of conduct. Of course, it will continue to be within the purview of the courts to determine whether a common law fiduciary duty applies in the circumstances of private claims by clients against registrants[2].

Boal v. International Capital Management

In *Boal*, two registered investment advisors, John and Javier Sanchez, were the principals of International Capital Management (ICM), an investment advisor corporation registered in Ontario with the Mutual Fund Dealers Association (MFDA) (as it was formerly known). Through ICM, the Sanchez brothers promoted and sold promissory notes in a factoring company, Invoice Payment Systems Inc. (IPS), to a subset of their clients. The Sanchez brothers allegedly failed to disclose to their clients, among other things, that they had family connections and a significant ownership interest in IPS, and that they were receiving a 2 per cent commission on each promissory note.

In 2014, John Sanchez presented the proposed representative plaintiff, Rebecca Boal, with an opportunity to purchase an IPS promissory note, with interest payable at the rate of 7 per cent annually. Ms. Boal had no discretionary accounts with ICM and was responsible for her own investment decisions. She was an accredited investor with net realizable assets exceeding $1 million and a medium to high risk tolerance. Ms. Boal purchased a promissory note for $101,224.26. Notably, none of the investors in IPS notes suffered any investment losses.

The proposed class action

In 2016, Ms. Boal learned that the MFDA was seeking to disqualify the Sanchez brothers as accredited financial dealers and to stop them from selling the IPS promissory notes. Two years later, the Sanchez brothers entered into a settlement with

the MFDA, in which they admitted to selling or facilitating the sale of $25.8 million of investments in IPS, and that they failed to cooperate with MFDA investigations into their conduct.

Ms. Boal commenced a class action against the Sanchez brothers and ICM (the Sanchez defendants) for breach of fiduciary duty, among other things, due to their failure to disclose their non-arm's length relationship with IPS. The proposed class is seeking disgorgement of the commissions earned from the sale of the IPS notes, which amounted to around $3 million, among other remedies.

The certification judge dismissed the certification motion, finding that Ms. Boal's claim for breach of fiduciary duty did not plead sufficient material facts for a finding of an *ad hoc* fiduciary relationship.

Divisional Court decision

A majority of the Divisional Court agreed with the certification judge and dismissed the appeal.

In a dissenting opinion, Justice Sachs found that the certification judge failed to appreciate the professional standards of the MFDA and the Financial Planning Standards Council. She held that representative plaintiff's claim was not just based on the allegation that John Sanchez gave her investment advice, but that Sanchez did so when he was subject to professional rules that required him "to act in a way that a fiduciary must act".[3] In other words, the Sanchez defendants "were required by their professional organizations to put their clients' interest above their own".[4]

Justice Sachs also found that in a professional advisory relationship, the client may have a reasonable expectation that their advisor will put the client's interests above their own, and will not profit from the relationship except to receive the expected level of remuneration for a financial advisor, unless the conflict is disclosed and addressed. In other words, the investor, no matter their wealth or sophistication, has the right to implicitly trust that their advisor is not making secret profits at their expense.

The Court of Appeal decision

The Court of Appeal allowed the appeal, substantially for the dissenting reasons of Justice Sachs, and found that the claim disclosed a cause of action in breach of fiduciary duty. The Court remitted the matter back to the Superior Court of Justice for fresh consideration.

The Court began its analysis by stating that industry standards are an important factor in determining whether there is an *ad hoc* fiduciary relationship between a professional investment advisor and their client.

The Court applied the indicia of a fiduciary relationship between a financial advisor and their client, namely 1) the degree of the client's vulnerability, 2) the degree of the client's trust and confidence in their advisor, and the extent to which the advisor accepts that trust; 3) the client's reliance on the advisor's judgment and advice, and whether the advisor holds themselves out as having special skills or knowledge upon which the

client can rely; 4) the extent to which the advisor has power or discretion over the client's account; and 5) the applicable professional standards or professional codes of conduct. The Court emphasized the following facts:

1. **Vulnerability**: The class members were vulnerable due to the information imbalance between them and their advisors regarding IPS. They relied on the Sanchez defendants for the accuracy of the information they received.
2. **Trust**: Informed by professional standards, the class members had the right to expect that the Sanchez defendants would act in their best interests, to the exclusion of all other interests. In other words, the proposed class members had the right to trust their investment advisors.
3. **Reliance**: The Sanchez defendants had long-standing advisory relationships with the class members.
4. **Discretion**: The Sanchez defendants solicited investments in the IPS notes and used their discretion to recommend to certain clients that they purchase the IPS notes.
5. **Professional standards**: The knowledge that the Sanchez defendants were bound by professional rules and codes of conduct requiring them to act in their clients' best interest created reasonable expectations on the part of the clients and created an environment in which they were vulnerable.

The Court of Appeal limited its decision somewhat, by emphasizing that not the entire relationship between the Sanchez defendants and the proposed class members was at issue – the claim only alleged that there was a fiduciary relationship between the Sanchez defendants and the proposed class members in relation to the sale of the IPS notes.

Takeaways

As noted by Justice Sachs of the Divisional Court, "regulators…may choose to enhance the credibility and reputation of their professions by imposing [fiduciary] duties on their members.[5]For this reason, use of the *Boal* decision in subsequent caselaw will be important to follow going forward.

The *Boal* decision also reinforces the recent regulatory spotlight on full disclosure of material conflicts of interest. For securities advisors, dealers, and registered representatives, this decision is a warning to address material conflicts of interest in a fulsome manner, as the professional requirement to resolve material conflicts of interest in the best interest of the client may give rise to a fiduciary obligation.

For a refresher on conflicts of interest following the Client-Focused Reforms, see BLG's previous bulletin on the Client-Focused Reforms here.

Footnotes

[1] CSA Consultation Paper 33-404 – Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients.

[2] ni_20191003_31-103_reforms-enhance-client-registrant-relationship.pdf (osc.ca) at page 18

[3] *Boal v. International Capital Management*, 2022 ONSC 1280 at para. 40 (Div. Ct.) (Dissenting Judgment of Justice Sachs).

[4] *Ibid* at para. 44.

[5] *Ibid* at para. 55.

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