

Landmark Verdict on Trading

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Everyone in the securities industry will want to give Superior Court Justice Thomas Lederer a big hug after reading this article describing the March, 2008, decision in which he dismissed a client's claim when he sought to have his advisor (Leach) and investment dealer (Merrill Lynch) reimburse him for losses after seeking high returns in a risky investment strategy.

Judge Lederer made the effort to understand this industry and had insight into aggressive clients who want to take risks and enjoy returns but sue their advisors and their investment dealers intending for them to absorb the losses.

In this case, the client, Ron Parent, opened several accounts over many years at Merrill Lynch. The 50 pages of reasons for the decision, which include a description of the options trading plan, is too long to review in detail. However, the salient features of this case are:

The witnesses, Leach, Carey (the investment advisor who assumed responsibility for Parent's accounts after Leach retired from the industry), and Chalmers (the branch manager), warned Parent of the risks associated on several occasions. There was ample documentation to support their testimony, including letters delivered, one of which was received with Parent's signature and returned to Merrill Lynch. Judge Lederer, unlike some of his brethren on the bench, didn't accept the oft-used excuse provided by Parent that Leach told him the letter was unimportant and that he should disregard the content but sign and return it as required; hats off to the branch manager who corresponded directly with the client! Allegations of discretionary trading were unsubstantiated. Leach, and later Carey, had notes of discussions with Parent over decisions made in regard to the opening of accounts and specific trades so that when evidence differed, Leach's evidence was preferred over Parent's, who denied regular contact with Leach. The Option Account Agreement, signed by Parent, was accepted as evidence of what was told to Parent. Attached to the agreement was a list of the risks associated with option trading.

Judge Lederer expressly acknowledged that Parent was "directed by the natural tendency of people to see things in a light that benefits their perspective -- and is not accurate." Judge Lederer states that Parent's evidence was "self-serving." Parent didn't follow the investment plan supplied by both Leach and Carey, instead opting for a strategy with significantly more risk. And then there was the excellent review of the law and application of the facts to arrive at conclusions which, I believe, will withstand any appeal, some of which are summarized as follows:

Judge Lederer reviewed the leading cases in this industry to determine the standard required of an advisor to "know your client" (KYC) and made an observation concerning the Conduct and Practices Handbook (CPH). First, let me say that it is my view that while it is an important text, it is not more than a text -- the CPH is neither law nor a statement of the standard required by law. While Judge Lederer didn't go so far as to say that it had no application to establishing the standard, he came close when he said: "Much was made of the fact that, on its face, this handbook is referred to as a textbook for the use of students seeking registration allowing them to deal in securities." While he confirms that the CPH is referred to in other cases, he adds that it "does not help in understanding its [the duty to know your client] meaning and proper application."

That while advisors have a duty to warn clients of investment risks, the extent of that duty depends upon the nature of the relationship with the client and the sophistication of the client, and accordingly, is a question of fact in each case. Judge Lederer writes that "the duty to warn is not absolute but flexible, depending upon the particular situation." He reviews the leading Canadian cases and concludes that the duty to warn depends on the client's particular experience and whether the investment risk is beyond the risk previously experienced by the client.

Judge Lederer concludes that Parent pursued a risky strategy, beyond what his advisors recommended. It was Parent's decision to choose such a risky strategy that was "the cause and only cause of his losses." If this wasn't enough salt in the client's wounds, the Judge stated, "It is about taking responsibility for the actions we take and the decisions we make."

Judge Lederer found that the advisor did not have any obligation to save the client from himself. In other words, no such duty exists: "The broker may have a duty to warn the client, but this does not extend to the responsibility to see that the client stops what the broker may assess as imprudent trading."

On the issue of suitability, Judge Lederer reviewed the following facts to support his conclusion: that Parent made all trading decisions and received warnings. Moreover, Parent experienced significant losses over the years which did not discourage him from continuing the strategy, and received a margin call that required inclusion of a cross-guarantee.

Judge Lederer concluded that Parent could not blame his losses on Leach or Merrill Lynch as there "were too many warnings and too many opportunities to make the necessary changes" which Parent chose not to do. Eloquently stated: "Parent was the author of his own misfortune."