FRAUD AND MISCONDUCT BY FINANCIAL INTERMEDIARIES

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1. Introduction

Fraud or its synonyms "dishonesty, infidelity, faithlessness, perfidy, unfairness etc..."[3] is the direct antithesis of "trust, good faith, fidelity, fiduciary etc..." which are the hallmarks of the relationship between a financial institution and its clients.

The financial intermediary is most often the link between the institution and its client.

The financial intermediary, whether a bank or trust company employee/officer, an insurance or stock broker or an insurance agent, is in a unique position because often he/she is selling products to which the client cannot accurately attach a value and which the client may not fully understand. When this is the case, the client is particularly vulnerable to the actions of the intermediary.

With the growing number of participants and transactions in the financial services industry, it is more important than ever for financial institutions to protect themselves, their clients and their reputations from the effects of fraud or misconduct by the financial intermediaries they employ. Exacerbating the situation is the increasing complexity, speed and volume of financial transactions and the supervisory and monitoring difficulties which they imply.

In Canada, the 2007 CSA Investor Study on "Understanding the Social Impact of Investment Fraud"[4] revealed that more than one million Canadians, that is one in five Canadians, have reported having been a victim of investment fraud.

White-collar crime costs corporations billions of dollars annually, damages the wealth and health of individual victims, and undermines the integrity of markets through eroding investor confidence. Securities regulators face high consumer expectations regarding the prevention of financial fraud. In response to these expectations, the *Autorité des marchés financiers* and other Canadian securities regulators have greatly bolstered their efforts in recent years to deter financial crimes.

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[3] Black's Law Dictionary quoting from *Joiner v. Joiner*, Tex.Civ.App., 87 S.W. 2d 903, 914, 915.

[4] Innovative Research Group Inc., 2007 CSA Investor Study: Understanding the Social Impact of Investment Fraud, Report prepared by the Canadian Securities Administrators Investor Education Committee, p.4

The Canadian justice system has in the past earned the reputation of being "soft" on investment fraud. However, it now has the tools to "get tough" on investment fraud as a result of the coming into force of recent amendments to the Criminal Code which provide for stiffer penalties for white-collar crimes such as fraud. In the future, more significant consequences or sanctions are expected to be imposed by judges on those who are convicted of fraud.

Implementing an effective prevention and protection program is an important safeguard to protect institutions against the kind of financial, business and reputational cost arising from a conviction or damage to reputation.

2. What Constitutes Fraud?

2.1 Criminal Fraud

The essence of fraud is dishonest deprivation. Section 380 of the Criminal Code makes fraud a criminal offence punishable by up to fourteen years imprisonment. The following individuals are guilty of fraud:

(1) Every one who, by deceit, falsehood or other fraudulent means defrauds the public or any person whether ascertained or not, of any property, money or valuable security.

(2) Every one who, by deceit, falsehood or other fraudulent means with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public.

There are three leading Supreme Court of Canada (SCC) cases that establish the elements of criminal fraud: *R. v. Olan* (1978), 41 C.C.C. (2d) 145 (S.C.C.); *R. v. Théroux* (1993), 79 C.C.C. (3d) 449 (S.C.C.); and *R. v. Zlatic* (1993), 79 C.C.C. (3d) 466 (S.C.C.). The case of *Olan* expanded the interpretation of the offence of fraud, and indicated that dishonest deprivation must be established to support a conviction of fraud. Actual economic loss is not an essential element to the offence. *Zlatic and Theroux* clarified what is required for the *mens rea* element for the offence of fraud. The *mens rea* element requires proof evidence that the accused's conduct was deliberate and there was knowledge of the relevant facts of the crime.

The Quebec Court of Appeal in *Regina v. Lacombe*[5] disallowed an appeal by a stockbroker charged with fraud under section 380 of the Criminal Code. In

[5] (1990), 60 C.C.C. (3d) 489

confirming the guilt of the stock broker, the Quebec Court of Appeal discussed the elements of the offence of fraud.

> "Under our present law of fraud, the ultimate burden of proof being on the Crown, there can be no conviction where the trier of fact is left with a reasonable doubt (a) as to the element of deprivation, in the sense of detriment, prejudice or risk of prejudice to the economic interests of the victim; (b) that this deprivation was caused by conduct of the accused which, '...by the ordinary standards of reasonable and honest people…' would be regarded as dishonest, and (c) that the accused acted knowingly and intentionally, in the sense that he was aware his conduct would be ordinarily considered 'dishonest' and would result in 'deprivation'."

The court found that the stockbroker had defrauded his employers by knowingly putting their economic interests at risk for the purpose of recouping the loss he had dishonestly caused in the account of his brother-in-law.

A finding of criminal fraud specifically requires proof of an intent to defraud.

However, the fact that a person does not know "for certain" that an act is "dishonest" or that it creates a risk of deprivation does not necessarily provide a defense against a charge of fraud. Criminal intent for fraud can also be established through proof of "recklessness" or "wilful blindness".

On November 1, 2011, important changes to the Criminal Code came into force following the adoption of Bill C-21 (*Standing up for Victims of White Collar Crime Act*), which was introduced in response to a number of high-profile fraud cases. One of the most important amendments is the creation of a two-year mandatory minimum sentence for fraud over $1 million minimum under section 380(1) of the Criminal Code. The White Collar Crime Act also makes important changes to the aggravating circumstances that are to be considered at sentencing (such as the magnitude, complexity, duration or degree of planning of the fraud), it allows for a new type of prohibition order (such as banning the offender from working in the financial services industry on a permanent basis) and it allows the courts to consider the "community impact statement" in sentencing.

2.2 Civil Fraud and Misconduct

While it is relatively difficult to get a conviction under section 380 of the Criminal Code, it is much more likely that a financial intermediary engaged in improper conduct will be liable in a civil action and found to have violated the standards of regulatory authorities.

In Common Law Jurisdictions

Financial intermediaries and their employers may be liable to compensate their clients for losses under the tort of deceit or for breach of fiduciary duty or negligent misrepresentation.

The concept of fraud is captured in the civil cause of action of deceit. "In an action of deceit the plaintiff must prove actual fraud. Fraud is proved when it is shown that a false representation has been made knowingly, or without belief in its truth, or recklessly, without caring whether it be true or false."[6]

Unlike in the case of criminal fraud, in the civil action it is not necessary to show that the intermediary intended to defraud. It is sufficient to show that the intermediary made a representation which he knew to be false and that injury ensued. The motivation behind the false representations (i.e., an intent to defraud) is irrelevant.

When a client is suing for losses suffered attributable to alleged misconduct by a financial intermediary, the court will often examine whether a fiduciary relationship existed between the parties. If a fiduciary relationship is found to have existed at the relevant time, the intermediary is obligated:

- to act in the best interests of the client;
- to refrain from placing himself or herself in a position where a client's interests conflict with those of the intermediary;
- not to secretly profit from the relationship with the client; and
- to always place the client's interests above the intermediary's own.

The relationship between a financial intermediary and client is not *per se* a fiduciary relationship such a relationship must be found. As it is unusual for the parties to have specified a fiduciary relationship by contract the court looks for indicia which include the level of trust, confidence and reliance placed on the intermediary's skill, knowledge and advice present in the relationship.[7] The less financially sophisticated or the more vulnerable the client, the more likely that trust will be found to have been placed in the financial intermediary. Therefore, the experience and sophistication of the client are also important factors

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6 *Derry v. Peek* (1899), 14 App. Cas. 337

7 *Varcoe v. Sterling* (1992), 7 O.R. 204

considered by the courts in determining whether or not a fiduciary relationship exists. Forsyth, J described the broker-client relationship to be a spectrum – on one end it was a relationship of full trust and advice, and on the other end, the broker does not provide any advice and acts as an "order-taker" for the client.[8]

The case of *Hodgkinson v. Simms*,[9] sets out the relevant factors that must be considered when determining whether a relationship between a broker and client is a fiduciary relationship. La Forest, J summarizes the guidelines to determine whether a fiduciary relationship exists as follows:[10]

> (1) scope for the exercise of some discretion or power; (2) that power or discretion can be exercised unilaterally so as to effect the beneficiary's legal or practical interests; and, (3) a peculiar vulnerability to the exercise of that discretion or power.

La Forest, J identified the following five interrelated factors to consider, when determining whether a financial intermediary and client are in a fiduciary relationship, (i) vulnerability of the client; (ii) degree of trust and confidence in financial intermediary, (iii) reliance on financial intermediary's judgment, (iv) discretion or power over client's account; and (v) profession rules or codes of conduct to determine the duties of the financial intermediary.[11]

The client in *Ryder v. Osler, Wills, Bickle Ltd.*[12] was a widow with no business experience and the stock broker alleged to have breached her fiduciary duties had been entrusted to follow the investment instructions of the widow's children. The Ontario Court of Appeal accepted that whether or not a fiduciary relationship exists depends on the facts of each case. The Court went on to find a fiduciary relationship between the broker and her client based on the fact that the client was unsophisticated as to financial affairs and had placed her complete trust and confidence in the decisions of her broker. As there was a fiduciary relationship between the parties, the Court held that the broker had a duty to advise her client "carefully, fully and honestly and to comply with the instructions concerning investment that had been given to her." By changing the character of the account without instructions and by "churning" (i.e. trading with unjustified frequency) in order to earn substantial commissions, the broker was in clear breach of her fiduciary duty.

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8 *Kent v. May* (2001), 298 A.R. 71 at para 51.

9 [1994] 3 S.C.R. 377.

10 *Supra* note 9 at 30.

11 *Hunt v. TD Securities Inc.,* (2003) 175 O.A.C. 19 at para 40.

12 (1985), 16 D.L.R. (4th) 80

Similarly, Kelly Peters & Associates ("KP&A")[13], a financial counselling business was held liable to its clients for breach of fiduciary duty for failing to make full disclosure of an interest in an investment recommended by the company. The Court found that the long-term relationship between KP&A and the clients involving a high level of confidence placed by the clients in KP&A created a fiduciary relationship with the result being that the clients were awarded the amount they would have had if they had not invested in the condominiums.

In the case of *Hunt v. TD Securities Inc.,*[14] the court did not find a fiduciary relationship between a stockbroker and his clients. The clients were an elderly couple investing their retirement funds and alleged that their stockbroker sold their shares without their authorization. The clients found out about the sale ten days later, but continued to use the stockbroker for other transactions. The Court of Appeal found that although the stockbroker was in a position to carry out unauthorized sales of shares, that discretion did not create a fiduciary relationship. The stockbroker was not authorized to act on his own, and had not done so, except for the one authorized transaction.

Although the tendency of the courts has been to find that the relationship between client and a financial intermediary is a fiduciary one, even if a fiduciary relationship between an intermediary and client is not found, the client may nevertheless be compensated for the intermediary's misconduct.

By contrast, in the decision of *Campbell v. Sherman*,[15] the court distinguished the case from *Ryder* because the victim was a sophisticated investor. The victim in *Campbell v. Sherman* was a promoter who alleged that the registered stock broker representative wrongfully converted shares into other accounts. The court also found that the relationship between the stock broker and alleged victim was one of a daily working relationship; and it would have been difficult for the stock broker to mislead the alleged victim. The court dismissed the action, finding that the victim was not a beneficial owner of the shares and thus could not claim a loss.

It has long been the case that when a person with special skills undertakes to give advice which he knows will be relied upon, he is under an obligation to do so with care. On occasion a court will find misconduct by a financial intermediary without regard to whether or not the indicia of a fiduciary relationship are present. In *Rhoads v. Prudential-Bache Securities Canada Ltd.*[16] the British Columbia

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[13] *Burns et al. v. Kelly Peters & Associates Ltd. et al.* (1987), 41 D.L.R. (4th) 577

[14] (2003) 175 O.A.C. 19, 36 B.L.R. (3d) 165.

[15] *Campbell v. Sherman*, 2 C.C.L.S. 156.

[16] [1992] 2 W.W.R. 630

Court of Appeal found that a stockbroker who had disregarded his client's investment objectives when giving his investment advice was liable. The court stated that brokers represent themselves as professional advisors and therefore must "give careful and objective advice having in mind the goals described by their customers and all the options open."[17]

Under Quebec Civil Law

The Quebec`s legal system is based on the Civil Code of Québec ("CCQ"), whereas the systems in the rest of Canada are based on the principle of common law. Individual and class actions in damages against financial intermediaries and their employers are permitted under both systems.

Under Québec civil law, actions may be brought against financial intermediaries and their employers under breach of contract[18] or for extra-contractual liability (comparable to common law tort liability) as a result of the injury caused to the client by reason of their faults.[19] The determination of the type of civil action to choose will depend on the particular facts of each case.

As for the concepts of "fiduciary duty" and "fiduciary obligation", they are used in common law jurisdictions in Canada and in the United States. However, in Québec, the 1994 reform of the CCQ led to the introduction of standards of civil rights similar to fiduciary duty. For example, the contractual rules of mandate impose obligations on financial markets participants that are similar to fiduciary duty. The main obligations are good faith, loyalty and honesty. The nature and the scope of these obligations vary depending on the legal context of the relationship between the market intermediary and the client. The extent of the obligation is proportionate to the relationship between the parties: the more unequal the trustee-beneficiary relationship, the greater the trustee`s obligation.

For example, in *Laflamme v. Prudential Bache-Commodities Ltd*[20], the Supreme Court of Canada found that the relationship between the securities dealer acting as a portfolio manager and his client was governed by the rules of mandate. In discussing the content of the obligations of the portfolio manager, it recognized explicitly the intensification of the obligations of the portfolio manager in light of the vulnerability of the client. The court explained:

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17 Ibid., at p. 637

18 S. 1458 of the CCQ. For example, a contract of services (s.2100 of the CCQ), application of the rules of mandate (s. 2130 of the CCQ) or application of the rules of administration of the property of others (s. 1299 of the CCQ)

19 S. 1457 of the CCQ (injury to others) or s.1463 of the CCQ (faults of agents and servants).

20 (2000) 1 S.C.R. 638

> This spirit of trust is reflected in the weight of the obligations that rest on the manager, which will be heavier where the mandator is vulnerable, lacks specialized knowledge, is dependent on the mandatary, and where the mandate is important. The corresponding requirements of fair dealing, good faith and diligence on the part of the manager in relation to his client will thus be more stringent.[21]

In the case of *Markarian v. CIBC World Markets Inc.*[22], the Québec Superior Court recognized that many factors can contribute to the high degree of trust and confidence that a client may have in the financial intermediary. The Court also stated that the existence of such a bond of trust involves a correlative reduction, protected by law, in the vigilance expected of the client.

The Markarian case involved a retired Canadian couple of Armenian descent, the Markarians, who had entrusted their assets to a fellow Armenian financial advisor Harry Migirdic, who worked at CIBC World Markets Inc. The Markarians wanted safe, no risk and non-speculative investments, both for themselves and for their company. Over the years, as a result of the fraudulent actions of Migirdic, the couple guaranteed, unbeknownst to them, the trading losses of people they did not know. CIBC World Markets had invoked the guarantees to seize $1.4-million from the Markarians in 2001, leaving almost nothing in their accounts -- even though Migirdic had admitted to CIBC prior to his 2001 termination that the Markarians were the subject of his fraud and that they were totally unaware.

The Markarians had absolute trust in Migirdic because he had been introduced to them by CIBC as an honest and knowledgeable man, because he was Armenian like them and had a "Vice-President" title.

The Court awarded more than $3-million, including $1.5-million in punitive damages, to the Markarians. It also ordered CIBC to reimburse the Markarians' legal fees. The Court called CIBC World Markets' conduct "reprehensible," saying it "cruelly failed" in its duty to protect its clients. The Court held that the defendant CIBC was under a heightened duty to supervise Migirdic because of the latter's past questionable conduct. Further, it noted that civil law mandataries have a duty to act faithfully, honestly and with integrity, and must subordinate their interests to those of their clients.

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[21] Ibid., para 28

[22] (2006) QCCS 3314

3. Why Intermediaries Engage in Fraud or Misconduct

Financial intermediaries who engage in fraud or misconduct, are usually motivated by greed or need and act on these motivations when given an opportunity to do so. Because of the nature of the work performed by financial intermediaries and sometimes their clientele, the opportunity and temptation are often present and if the intermediary succumbs, the results are usually unfortunate for the client, the institution and the intermediary. Often the compensation structure established by the financial institution provides an additional impetus for intermediaries to engage in misconduct or fraudulent behaviour.

3.1 Compensation Structure

In *Ryder, supra,* the stock broker, "churned" the client's account and in doing so was able to earn $124,220 in commissions over an eleven month period. The fact that a broker earns a commission every time a trade is made creates an incentive for the broker to maximise the number of trades on a given account. In addition, some stock brokers receive varying commission rates, depending on the type of securities they trade. This also creates an incentive to alter the character of the account towards those investments which generate higher commission payments. This type of compensation structure can place the interests of the broker and those of his or her client at odds from the outset of the relationship.

To attempt to compensate for this conflict, a stock broker is obligated to disclose the commission and bonus structure in place to clients and to ensure that, in carrying out the instructions of the client, the broker is careful to consider only the best interests of the client.

The compensation package commonly found in the insurance industry can also provide incentives for misconduct by placing the financial interests of the agents potentially in conflict with the interests of the insurance company and the client. Turning to the insurance industry, "rebating" is an illegal practice by which an insurance agent induces a customer to apply for an insurance contract by promising to pay all or a portion of the customer's premiums. As the commissions paid to the agent during the first few years are sometimes greater than the premiums for the same period, the agent can make a profit at the expense of the insurance company. Once the policy has reached the point where the commission payable to the agent is less than the premiums owed by the insured, the agent either cancels the policy or allows it to lapse, depending on the applicable compensation structure. Once again, the insurer employing the insurance agent has established an incentive for the agent to behave improperly through the compensation and commission structure.

Rebating was employed by a Crown Life insurance agent[23] that obtained, for his own benefit, commission payments and bonuses on account of 297 life insurance policies issued to members of the public without payment of consideration or any kind. The agent accomplished this either by reimbursing the person in whose name the policy was issued immediately after paying the premium or by simply paying the premium directly to Crown Life. The commission and bonus structure then in force at Crown Life enabled the agent to pay at least three years worth of premiums out of its compensation and still make a profit. The agent intended to pay the premiums for three years and then allow the policies to lapse.

Another example of a scheme made possible by the commission and bonus structure payable to an insurance agent was the subject of proceedings taken by the province of British Columbia against Don Baxi Agencies lnc.[24] An insurance agent employed by North American Life submitted false insurance applications for the purpose of generating commissions. The agent maintained premiums on policies which clients had declined or allowed to lapse, keeping them in force and as a result earning substantial commissions from North American Life to which he was not entitled. The agent was charged with, and pled guilty to, having breached provisions of the *Financial Institutions Act*.[25]

The practice of "churning" in the insurance industry, an activity which occurs when an agent induces a policy holder to replace an existing one with one sold by the agent, is also considered misconduct. Churning or "replacement" can be severely disadvantageous to the policy holder and can result in the total loss of insurance coverage, for instance, because of the current health of the insured, imposition of new waiting periods and less favourable terms and returns. Often the insurance agent's motivation is to generate commissions for himself/herself and not the best interest of the client.[26] Most jurisdictions have enacted extensive life insurance replacement legislation which prohibits this type of improper activity but nevertheless a number of life insurance companies have experienced agents for whom the temptation of an "easy buck" is too hard to avoid. When a life agent changes insurers, there may be an added incentive to engage in "replacement".

3.2 Vulnerable Clientele

The lack of sophistication and dependency of a financial intermediary's clientele can also present an alluring temptation. New immigrants unfamiliar with the

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[23] *Crown Life Insurance Co. v. American Home Assurance* (1991), 77 D.L.R. (4th) 11

[24] Provincial Court of British Columbia, Oct. 7, 1996

[25] R.S.B.C. 1996, c. 141.

[26] Norwood on Life Insurance Law in Canada, p.45

language and financial products are especially vulnerable to unscrupulous financial intermediaries of the same ethnic group. One insurance broker "sold" a number of automobile and home insurance policies to members of his ethnic community and pocketed the premiums without either forwarding the application to any of the insurance companies that he represented nor issuing any policies to the clients. He fielded and dealt with inquiries from the clients who trusted him and relied on his good faith. The scheme came tumbling down when the first major claim arose. Since he represented a number of insurers and issued no policies, no coverage was found and the clients were left out in the cold. The criminal investigation is yet to be concluded.

An insurance salesman was convicted with a strong sentence of four years imprisonment and an order to pay restitution.[27] He was charged with 20 charges of fraud, and was found guilty of defrauding vulnerable clients. The court emphasized that the victims trusted and relied on the expertise of the accused. These victims were on the cusp of retirement or already retired, and were convinced to invest their life savings with the insurance salesman. Further, the accused often arranged for the victims to obtain loans to supplement their investments. The decision examines each victim's situation in order "to understand the depth and damage of the ongoing breach of trust."[28]

3.3 Firm Culture

Another factor which undoubtedly influences whether a financial intermediary is likely to engage in fraud or misconduct is the culture of the firm employing the intermediary. As financial intermediaries often find themselves in situations where opportunities and incentives to engage in misconduct are prevalent, it is imperative that the firm employing them have adequate policies and, equally importantly, an effective and well known procedure for aggressively enforcing internal policies and maintaining a compliance-oriented atmosphere.

If deviations from internal policies, codes of ethics or external standards are felt to be condoned or the perceived "operating norm" and if infractions and misconduct are not expected to be treated with severity in a given institution, there is a greater likelihood that an employee will engage in misconduct or fraud. In a number of situations where financial intermediaries have been fraudulent or dishonest, the transaction could not have been successful if the safeguards and policies in place at the institutions involved had been strictly adhered to and questionable activities reported and dealt with.

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[27] *R. v. Wheeler,* (2007) 215 Man. R. (2d) 127.

[28] *Supra* note 27 at para 10.

Rachar, a partner and director of Gordon Capital Corporation ("Gordon"), participated in transactions for profit which violated many internal policies of Gordon, the rules of the Toronto Stock Exchange ("TSE") and those of the Ontario Securities Commission ("OSC") rules. The discovery of these transactions ultimately led to serious sanctions by the OSC against, among others, Rachar, Gordon, Gordon's most senior officer, Gordon's compliance officer.[29]

The transactions in question were able to be carried out in part because of the failure of Gordon personnel to question the unusual conduct of the intermediary who initiated the transactions and the failure of the compliance officer to properly monitor these transactions. According to the OSC Settlement Agreements, Gordon, in breach of its own policy against a borrower posting its own obligations as collateral, accepted certain instruments as collateral for the transactions in question. In the settlement agreement, Gordon's Chief Executive Officer acknowledged that:

> "The controls normally applied by Gordon with respect to pricing of securities were overridden by Rachar on more than 90 occasions within 9 months. Until June 1991 neither the employee responsible for entering prices nor anyone else at Gordon questioned the discrepancy between the prices supplied by Rachar and prices from other sources."[30]

Also, the failure of Gordon officers to appreciate the nature of the transactions and to understand the true effects of contracts and letters which they signed on Gordon's behalf enabled the improper transactions to occur.

> "The Credit Policy Committee [of Gordon] did not monitor Rachar's progress, nor did they review or understand the nature of the transactions involved despite their concern regarding the Citibank exposure."[31]

The OSC found that, with respect to the transactions in issue, the internal controls in place at Gordon were deficient in that:

- there was not adequate segregation of duties;

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[29] Settlement Agreement between Ontario Securities Commission and Eric Rachar; Settlement Agreement between Ontario Securities Commission and James Connacher

[30] Settlement Agreement between Ontario Securities Commission and James Connacher, at p.11

[31] Ibid., at p. 13

- Gordon personnel failed to ensure that the instruments were reviewed or that they sought advice with respect to the instruments' unique characteristics;

- six officers or employees of Gordon did not read or understand the implications of agreements they co-signed;

- Gordon's procedures in respect of withdrawals by the client from his account were not followed;

- Gordon's employees accepted inflated prices provided by Rachar on numerous occasions without independent verification;

- Gordon failed to have procedures in place to implement policies established by the Credit Policy Committee; and

- Gordon's officers and employees failed to react to internal reports which could have identified Gordon's overexposure to risk.[32]

In defence of his actions, Rachar stated in his settlement agreement[33] that

- in carrying out these transactions he believed he was doing his job at Gordon for Gordon's benefit as expected of him; and

- had not received formal training from Gordon in connection with the regulatory requirements applicable to these transactions and did not fully appreciate the seriousness of the regulatory implications at the time.

Rachar further stated that it was clear to him during his employment at Gordon commencing in 1983 that the Gordon culture sacrificed compliance for profits and that his conduct was a by-product of the Gordon culture.

Whenever a lawyer is faced with giving advice on how to deal with what appears to be fraud or misconduct involving a financial intermediary, one of the first questions and concerns is "was this approved and condoned by the intermediary's superiors or by the institution's culture?". If the answer is yes, it will be much more difficult to pin liability on the intermediary. It is certainly likely to be more embarrassing and potentially harmful to the reputation of the institution.

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[32] Ibid., at pp 18-19

[33] Settlement Agreement between Ontario Securities Commission and Eric Rachar at pp 23-24

In *Millican v. Robinson*[34], a trustee had misappropriated the trust funds of his clients and used some of the funds in satisfaction of accounts receivable of other clients of the firm. The firm had been pressuring the trustee employee to collect these accounts receivable and he had made these payments to the firm by issuing personal cheques. The beneficiaries of the trust funds sued the firm for the return of their money.

The Court held that the firm was liable to compensate the beneficiaries because the firm should have been alerted to the intermediary's questionable conduct by the fact that he was making payments on behalf of client's overdue accounts.

> "In our view, the strength of the signal to an employer receiving cheques written by an employee on his personal account for the payment of batches of client accounts payable to the firm, cannot be overestimated. At the very least it would notify the employer that its employee was pocketing into his own account monies payable to the firm. In the circumstances here it should have put the employer on a path of inquiry which would have led to discovery of the thefts from the trust.[35]

The pressure to collect payment on overdue accounts coupled with the institution's willingness to overlook signs of questionable behaviour created a corporate culture in which misconduct could occur and survive unnoticed for a period of time.

In *BPI Resources Ltd. v. Merrill Lynch Canada Inc.*[36], Merrill Lynch Canada ("Merrill") was found liable for damages caused by an employee who wrongfully manipulated the shares of BPI Resources ("BPI") on the Vancouver Stock Exchange. Although the employee was convicted of fraud, Merrill was also found liable to BPI because the Court found that its failure to comply with certain industry rules and procedures and certain internal corporate policies had allowed the employee to carry out his manipulations.

The influence of corporate culture on the fraudulent or improper conduct of financial intermediaries can bring severe reprimand and censure from the bench. Recently a United States Federal Court judge, in sentencing a former money adviser employed by Lazard Freres & Co. ("Lazard") who was convicted of fraud and conspiracy in connection with his ties to Merrill Lynch & Co., criticised Lazard and Merrill Lynch for their "corporate criminal culture". The judge stated

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34 [1993] A.J. No. 436 (Alta. C.A.)

35 Ibid., at p.8 (QL)

36 (1986), 34 B.L.R. 105

that he saw nothing to indicate that the improper relationship between Lazard and Merrill Lynch was contrary to the corporate culture of either firm. This finding is easily accessible on the Internet[37] and undoubtedly is severely embarrassing and of concern to the institutions involved.

While one would expect financial institutions to avoid hiring persons who are associated with let alone convicted of fraud, this is sadly not always the case. In one case that we were involved with the terminated employee was quickly hired by a competing financial institution and upon being convicted of fraud apparently allowed time off to serve his sentence. Can you imagine what type of firm culture this represents to other employees of that institution? Sometimes errant intermediaries are kept on because they are "good producers" with the hope that they have mended their ways or that increased vigilance will protect the institution. This is a very dangerous gamble not only with respect to that intermediary but with the message that it gives to others in that organisation.

In contrast to the cases discussed above, where the corporate culture lent itself to breaches of internal policy and external rules, the appeal pursued by the Bank of Montreal in *Bank of Montreal v. Ng*[38] demonstrates a culture which promotes compliance by prosecuting deviant behaviour to the fullest extent of the law even when the prosecution was an uphill battle and there was no chance of financial recovery. Ng was the bank's chief currency trader for Quebec, authorised to commit the bank in respect of foreign currency transactions up to a limit of $40 million per day. Ng, in breach of the bank's code of conduct, carried out transactions which enabled him to realise secret profits for his own account, although not at the expense of the bank. The Bank of Montreal sued Ng, claiming the profits he had made as a result of his wrongdoing. The bank lost at trial and at the Court of Appeal. Ng went bankrupt. Notwithstanding this, the bank pursued its appeal to the Supreme Court of Canada where it finally received a favourable judgement. Mr. Justice Gonthier, writing for the Court stated that an employee, such as Ng, who enjoys control over large sums of the employer's money, must be held accountable for his disposition of those funds and is required to turn over to the employer profits made through the abuse of his position. The Bank of Montreal received a judgment against Ng for more than $660,000 for having fraudulently obtained the same. Even though it could not collect on the judgment, the principle involved was important to the bank as undoubtedly was the message that it gave to other bank employees and officers about that bank's resolve to pursue wrongdoers to the end.

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[37] Municipal Bond Reform Site

[38] (1989), 62 D.L.R. (4th) 1

3.4 Volume and Speed of Transactions

Even if the corporate culture is compliance-oriented, sometimes problems can arise because the transactions entered into on behalf of the institution by the financial intermediary are extremely complex and are not fully understood by those in supervisory positions. As seen in the cases involving Barings and Daiwa, the inability of a supervisor to properly monitor the transactions entered into by those whose activities he or she supervises, is neither an effective defence nor acceptable to the regulatory authorities. An individual in a supervisory position may be held personally liable for a failure to properly supervise. In *Gordon, supra,* Gordon Capital Corporation, its president and its compliance officer were found to have failed to fully or properly *supervise* Gordon employees and to ensure their compliance with the TSE requirements and were sanctioned as a result.

The volume and speed of transactions can also pose a serious monitoring problem for banks and other financial institutions. With the number of daily transactions being performed and the amount of data and persons involved, it becomes increasingly difficult to attribute actions to individuals within a bank. In general, more and more reliance is placed on information technology sitting as watchdog over the flow of transactions and identifying unusual conditions for more detailed monitoring. As we know, human ingenuity matched with dishonesty can prove a potent combination in finding ways around or overriding technology including security and safeguards. Alterations to programs can be difficult to detect and even more difficult to trace to a particular individual. With the diffusion of responsibility for any particular transaction, controls are sometimes circumvented. Quite often the circumvention of controls begins as simply as one employee saying to another (more junior) employee "I need you to do me a favour."

Banks and other financial institutions have sought by means of contracts to shift the responsibility of checking and reconciling statements to their customers by providing, for example, an onus to report errors within a certain period after the statements are delivered, failing which there is no further recourse to the institution.

These "Verification Agreements" have often been used successfully by banks as a defence to claims by customers on defrauded accounts. The courts have allowed banks to rely on these agreements when an account has been defrauded through no fault of the bank or one of its employees. However, any finding of negligence or fault on the part of the bank or its employees can override these agreements.

In *Kelly Funeral Homes Ltd. v. Canadian Imperial Bank of Commerce*[39] Kelly's general manager had defrauded the company by, among other means, drawing cheques in favour of named payees and then endorsing the payees' signatures. The general manager was authorised by Kelly to sign cheques drawn on the company account, therefore CIBC had not been negligent in accepting the cheques. The Ontario High Court of Justice held that the verification agreement between CIBC and its customer, Kelly Funeral Homes, constituted a complete defence to Kelly's action against the bank for having accepted fictitious cheques.

The British Columbia Court of Appeal in *Cavell Developments Ltd. v. Royal Bank of Canada*[40] viewed the negligence of the bank as precluding RBC from relying on the verification agreement. In *Cavell*, the bank had negligently permitted the company's president to write cheques on the company account despite the absence of a proper director's resolution. The court found that the verification agreement entered into by Cavell should be construed strictly so that it did not relieve the bank from losses caused by its own negligence.

The same position was taken by the Alberta Court of Appeal in *239199 Alberta Ltd. v. Bank of Montreal*[41] when the Bank of Montreal, whose employee had negligently failed to require two signatures for the transfer of funds in accordance with the customer's banking resolution, was not allowed to rely on the verification agreement. The court found that the agreement was not sufficiently broad to apply to negligence by the bank.

Although no cases have been found that considered the situation where a deficiency in an account was caused by the fraud or misconduct of a bank employee, the cases cited above indicate that in such a situation the bank would not be able to rely upon the provisions of a verification agreement as a defence. Certainly, verification agreements relied upon in the context of intentional misconduct or fraud by a bank employee will not provide much of a shield for a bank.

4. Consequences of Fraudulent Behaviour

4.1 Responsibility of the Institution

Courts and regulatory authorities have shown their willingness to look beyond the intentional misconduct of the intermediary to the shared responsibility of the

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[39] (1990), 72 D.L.R. (4th) 276

[40] (1991), 78 D.L.R. (4th) 512

[41] (1993), 105 D.L.R. (4th) 739

institution that employed the intermediary and those in charge of monitoring him or her.

In many of the cases discussed above, the institution employing the dishonest intermediary was liable to the customer or the regulatory authority for the action of its employee/intermediary. The liability arises either directly, because the institution has itself become a fiduciary to the client, or indirectly, because the institution is vicariously liable for the acts of its employee/intermediary. In addition, as was the case in *Gordon*, individuals within the company may be subject to sanctions for not having adequately performed their supervisory functions to the detriment of the public or the integrity of the industry.

In *Ryder, supra,* the firm was held liable for the actions of the registered representative it employed. In finding the firm liable, the court found that a fiduciary relationship existed between the firm and the client. This was the case because "[t]he advice given by [the broker], when the account was opened, was detailed and complete and the letter giving this advice formed part of the company file. It was clear from this letter that the client was expected to repose trust and confidence in [the broker] and her employer."[42]

The company breached the fiduciary duty owed to the client by failing to adequately supervise its employee. At trial, an expert testified that a margin account of the size involved should have been brought to the attention of an officer of the brokerage firm weekly to ensure that the investments met the objectives of the client. The court found that the brokerage firm took a chance in relying on their employee without properly supervising the account and its handling and, in failing to do so, was in breach of its fiduciary duty to the client.

In addition, the company was vicariously liable for the breach of fiduciary duty by their employee as she was acting within the general scope of her employment. The Ontario High Court of Justice accepted the following test set out by Lord Phillimore in Goh Choon Seng v. Lee Kim Soo[43]:

> "[W]here the servant is doing some work which he is appointed to do, but does it in a way which his master has not authorised and would not have authorised had he known of it, the master is, nevertheless, responsible."

In Quebec, in the *Markarian* case, *supra*, the Court ruled that CIBC failed in its duty to monitor and control Migirdic`s activities, especially in the light of the fact

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[42] (1985), 16 D.L.R. (4th) 80, at p.88

[43] [1925] A.C. 550 at p.554

that Migirdic had committed a plethora of fraudulent and illegal acts over the years. The Court rejected CIBC`s arguments to the effect that the Markarians were the authors of their own misfortune, that they had ratified the guarantees and that they should have uncovered the fraud well before and alerted the CIBC to it. The Court underligned that even CIBC, better equipped than the Markarians, had not been able to detect Mirgidic`s fraud.

In the class action lawsuit of *Nelles v. Royal Bank of Canada*[44], the Quebec Superior Court approved on March 14, 2012, the $17 million out-of-court settlement reached by the Royal Bank of Canada with dozens of victims of Montreal convicted scam artist Earl Jones, who pleaded guilty in 2010 to two counts of fraud totaling roughly $50 million in connection with scams that spanned nearly three decades.

The plaintiffs originally sought $40 million in the class-action lawsuit which claimed the RBC Montreal West Island branch was aware that Jones – a former non-registered financial adviser – was exploiting his personal account for his fraudulent dealings with his clients. Lawyers for the victims came across an internal message from a bank employee sent in 2001 that warned superiors that Jones was using his personal account improperly. Jones was made to change the account to a commercial "in trust" account only in 2008. The 158 plaintiffs alleged that the RBC branch could have done more to stop Jones**,** who regularly deposited cheques with double endorsements and forged signatures. The Royal Bank of Canada denied any wrongdoing.

The RBC class action is just one of dozens of lawsuits victims have filed in Québec in the wake of Earl Jones's actions.

In a separate case, Barbara MacLeod, another victim of convicted fraudster Earl Jones, filed a $1.5 million lawsuit in the Quebec Superior Court against RBC Dominion Securities and two of its brokers, alleging that RBC Dominion Securities did not do enough to protect its clients and through omission, allowed Jones' fraudulent business practices to go unnoticed for more than a decade.

In another case, the plaintiff, Electa McMaster, is suing Industrial Alliance and Linda Frazer, the notary used by convicted fraudster Earl Jones. McMaster alleges that Jones finagled a loan without her knowledge and put the money in his large slush fund. McMaster was saddled with a $367,000 mortgage on her Montreal home in 2006. She maintains she never authorized this mortgage and that Jones used his power of attorney - granted 15 years before - to sign on her behalf. She is seeking a refund of that loan taken on the equity of her home and says neither the notary nor the insurance firm ever contacted her regarding the home.

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[44] Quebec Superior Court decision dated March 14, 2012 no. 500-06-000500-104

4.2 Regulatory Impact

In *Gordon*, the OSC sanctioned the broker who initiated the improper transactions by revoking his registration rendering it difficult for him to work as a broker anywhere in Canada. In addition, the Ontario Securities Commission imposed sanctions on Gordon, certain of its officers in supervisory positions, and the client for whose benefit the transactions occurred. These sanctions ranged from a large fine on the company to a temporary suspension of the registration of Gordon's Chairman and CEO. The decision to reprimand the individuals charged with the responsibility of monitoring the broker, despite their lack of knowledge of the fraudulent activities, was perhaps, the start of a trend towards making individuals personally liable for the corporate culture of the companies they control, oversee or supervise.

The Court in *Merrill, supra,* stated that the relationship between an investment dealer and its sales representative is one of principal and agent. Because the employee's wrongful acts were within the scope of his authority from Merrill, Merrill was vicariously liable. Merrill through its responsibility for its agent, owed a duty of care to its client.

The court accepted that the publicity surrounding the suspension of trading and the charges and convictions relating to the Merrill sales representative damaged the reputation and good name of the client in the minds of investors and shareholders and that this damage was foreseeable by Merrill.

In *Millican, supra,* the Court found that Deloitte, the company employing the broker engaged in misconduct, was or ought to have been put on notice that it should institute inquiries. The inquiries, the court found, would have led to the discovery of the stolen monies paid to the employer. As Deloitte was presumed to have had notice of the origin of the stolen funds, the Court held that Deloitte was liable to the beneficiaries of the funds for the repayment of the stolen monies.

In the case of *Blackburn v. Midland Walwyn Capital Inc.*,[45] the Court of Appeal found that the two brokerage firms ignored their duty to protect their client. The brokerage firm had a regulatory duty to supervise client accounts and failed to do so. It was reasonably foreseeable that if the brokerage firms did not supervise their employee stockbroker, properly monitor accounts and did not issue any warning to their client, it would result in harm to the client.

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[45] 2 B.L.R. (4th) 201, 195 O.A.C. 181.

5. Prevention and Protection of Institution

To protect itself and its clients against fraud and misconduct by the financial intermediaries it employs, a financial services institution should carefully monitor the activities of its intermediaries and should create a corporate culture where straying from established policies is not tolerated.

Finally, in the event that some intermediaries are still able to engage in misconduct despite reduced incentives, careful monitoring and a positive corporate culture, institutions normally maintain fidelity insurance. A fidelity policy covers the insured for loss incurred by a breach of fidelity on the part of an employee. Cover may be obtained against loss from fraud or dishonesty by the employee. It should be noted that a fidelity policy only provides coverage for losses due to dishonest or fraudulent acts by employees, there is no coverage for reckless or negligent acts.

However, a “standard” fidelity policy contains some traps for the unwary. Careful consideration should be given to ensure that the institution’s insurance broker works with the institution to ensure that these traps are eliminated. Some of them are discussed below.

A fidelity policy is designed to protect an employer from dishonest or fraudulent acts committed by an employee. The term “employee” is defined in the policy to include only those individuals employed when the claim’ is made. Often, by the time the employee misconduct is discovered or a claim is made to the insurer, the employment relationship has been terminated. If this is the case, the loss will not be covered by the fidelity bond. A prudent insured will negotiate with the insurance broker to have the definition of employee amended to extend coverage to those who were employed at least 30 days prior to the claim. Extensions of greater than 90 days are apparently not available at this time.

The definition of employee should also be amended to include contractors, service providers, and agents retained by the institution. This is of importance to life insurers as they face a major exposure to loss caused by their life insurance agents who may well not be employees.

To be covered under the standard form policy, the dishonest or fraudulent acts committed by the employee must be committed with the manifest intent to cause the insured to sustain loss and to obtain financial benefit for the employee. Fidelity bonds covering life insurance agents contain the further provision that “financial benefit” does not include employee benefits earned in the normal course of employment, such as salaries, commissions, fees and bonuses. Again, the insured should negotiate with the insurance broker to have this provision altered. A life insurer will want to amend the policy so that commissions and bonuses earned by fraud are not excluded under the definition of financial benefit

as frauds perpetrated by life insurance agents very often result in increased commissions or bonuses paid to the agent.

However, the Ontario Court of Appeal in *Crown Life Insurance Co. v. American Home Assurance*[46] addressed whether money advances to a Crown Life representative which were obtained by fraud fell within the exclusion provision in the fidelity insurance contract. The court disagreed with the decision of the British Columbia County Court in *Seabord Life Insurance Co. v. Wellington Insurance Co.*[47] and held that in order to qualify as "monies advanced" (in the exclusionary provision) the commissions in question must originate in a legitimate transaction of insurance. "In order for a payment to constitute an advance within such a definition, the agent must have had, at the time of the payment, a legitimate entitlement to receive and retain it at some time in the future. Where, as here, such payments were made on the basis of the agent's dishonest or fraudulent representations that policies had been sold to legitimate policyholders, the agent had no entitlement to receive and retain them at any time in the future, and they cannot properly be characterised as "monies advanced" by Crown Life."

In addition, the requirement that there be a manifest intent to cause loss to the institution and to benefit the employee is very onerous. The policy can be altered to change the "and" to an "or". This is known as the "Robin Hood Clause" as it provides coverage for individuals who intend to cause loss to the institution, but are not themselves the beneficiary of the misconduct. This amendment is unavailable for policies covering losses by traders.

Institutions should also be aware that a fidelity policy is automatically terminated if the insured is taken over by a receiver, a liquidator or another financial institution. In addition, coverage with regard to a particular employee is terminated as soon as the insured learns of a dishonest or fraudulent act. This means that any losses which occur after the company has "discovered" the fraud or misconduct, but before it has been reported to the insurer are not covered.

An amendment to the policy which alters the definition of insured for such "discovery" purposes to mean one or two individuals within the institution (e.g. the risk manager or CEO and the legal counsel) will greatly assist in providing full coverage for loss. For instance, the insured will not be deemed to have discovered a fraudulent act until it is known by one of the designated individuals.

A special rider may be included in the policy to cover losses resulting from a fraudulent entry into the insured's computer system. Under the Computer Systems

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[46] (1991), 77 D.L.R. (4th) 11

[47] (1987), 23 C.C.L.I. 265

rider, the misconduct need not be by an employee. This covers situations where, for example, an employee has used his or her password to access the computer system and transfer funds, where a terminated employee whose password has not been cancelled does so, and where an independent computer hacker is able to access the insured's computer system.

When there are any changes in the internal processes, a financial institution should be prudent and inform their policy issuer. In the case of *W.H. Stuart Mutuals Ltd. v. London Guarantee Insurance Co.*,[48] the licensed mutual fund dealer had updated their cheque issuing process, and failed to articulate this to the insurance company on their renewal application. A high level employee at the institution abused her position and misappropriated funds by issuing computer generated cheques and transferring funds into her own separate accounts. The insurance company denied cover under the fidelity insurance bond claiming that the institution had made material misrepresentations in its renewal application. The Court of Appeal found that the institution "was in breach of its general obligation to disclose all material facts within its knowledge relevant to determining the nature and extent of the risk, even in the absence of specific questions from the insurer."[49]

6. Conclusion

The cases indicate that a client of a financial institution pursuing a claim against a dishonest intermediary and his or her employer will usually succeed in obtaining compensation from one or the other or both. In addition, there can be regulatory sanctions and considerable damage to the reputation of a company associated with a claim for fraud or misconduct, regardless of the mental culpability of the corporation's directors and officers.

It is therefore advisable that companies within the financial services industry remain conscious of the temptations and opportunities which present themselves to the intermediaries they employ. Further, institutions should take steps to remove or at least minimize the incentives to engage in misconduct and to reduce the likelihood of success of any dishonest transactions through careful monitoring and fostering the appropriate corporate culture.

Voltaire is reputed to have said:

> "When it is a question of money, everybody is of the same religion."

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[48] (2004) 16 C.C.L.I. (4th) 192, 193 O.A.C. 201.

[49] *Supra* note 48 at para 11.

It is up to financial institutions to ensure that either Voltaire is wrong or that that "religion" he refers to is one of "trust, good faith, fidelity, fiduciary".