

The Relationship Between Investment Dealer and Margin Client: A Canadian Perspective

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(I) INTRODUCTION

THE CANADIAN SECURITIES INDUSTRY is an essential component of our country's economy. It plays a pivotal role in gathering and directing the capital required to finance the industries and governments of Canada. By necessity, it is a highly regulated field, yet, unlike the United States, we do not have a federal Securities Act and federal legislation in the industry continues to be minimal.¹ Since 1932², the trend has been for the provincial powers in the area of securities legislation to broaden³ through liberal interpretation of the Section 92 "property and civil rights" provisions of the Constitution Act.⁴

Several provincial regulatory bodies oversee the investment industry. Perhaps the most important of these are the Toronto Stock Exchange, of which most Canadian Investment Dealers are a member, and the Ontario Securities Commission, whose policies form the basis

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1 W.T. Pashby, *Pertinent Legal Aspects of the Canadian Securities Industry*, (Toronto: The Canadian Securities Institute, 1984) at 7:

Federal legislation in this field has been minimal, being largely confined to corporation law provisions applicable to federal companies and criminal law provisions dealing with fraud.

2 *Lymburn v. Mayland*, [1932] 2 D.L.R. 6 (P.C.) at 12 Lord Atkin. *The Security Fraud Prevention Act 1930*, S.A. 1930, c.8, which dealt with the licensing of securities personnel and the distribution of securities, was found to be *intra vires* the province.

3 B. Welling, *Corporate Law in Canada*, (Toronto: Butterworths, 1984) at 17. Refer to the authority he cites to support the opinion.

4 *Constitution Act, 1867*, (U.K.) 30, 31 Vict. c.3 s.92(13).

for legislation in all jurisdictions. The goal of regulators is to create an environment which ensures both the efficient functioning of the Canadian capital markets and the protection of the individual investor.⁵

In 1986, over 3 million Canadians owned shares in a publicly-traded company or in a stock mutual fund.⁶ Although this figure is expected to increase, close to 2/3 of non-shareholders say that they do not participate in the stock market because they do not know enough about how it works.⁷ Presumably, even many of the people who do invest in the stock market lack the appropriate understanding to do so effectively.

But understanding the stock market itself is something quite different from understanding the legal dimensions of the relationship between stockbroker and client. It is something that probably neither party fully grasps.

This paper briefly examines some aspects of that relationship in the context of margin clients. For the purposes of this study, a "margin client" is anyone who borrows from an investment dealer to finance some portion of the investments he holds with that firm. The term "stockbroker" refers to the individual employee that the client deals with; the term "investment dealer" is used as the label for the firm which employs the stockbroker. Specifically, this is a study of the potential complications that arise in the relationship between a margin client and the stockbroker or investment dealer with whom he does business.

Very basically, a margin account functions as follows. Investment dealers are authorized, and usually eager, to finance the transactions of their clients. When a client makes a purchase, he must provide a

5 *Report of the Ontario Securities Commission to The Minister of Consumer and Corporate Affairs: A Regulatory Framework for Entry into and Ownership of the Ontario Securities Industry* (Toronto: The Commission, 1985) at 20 and 22 (Chair: P.S. Dey). It is interesting to note that although achieving these goals is a balancing act, the Commission does not see the two goals as mutually exclusive: (at 22)

. . . The Commission wishes to emphasize that in achieving the efficient functioning of the market there is one constant, and that is an acceptable level of investor protection. It is obvious that investors make capital markets and if investors do not feel that they will be treated fairly in participating in the capital markets, the efficient functioning of the markets will be in jeopardy. Fair treatment of investors through an acceptable level of investor protection is the principal ingredient in achieving efficient markets.

6 "Toronto Stock Exchange Shareholders" (Toronto: Toronto Stock Exchange, 1986) at 7. This figure represents 18% of the Canadian adult population. Only equity and equity-related products are included. A complete product breakdown is shown on page 9 of the report.

7 "Toronto Stock Exchange Shareholders", *supra*, note 6 at 22.

"margin" deposit⁸ and leave the securities in the possession of the investment dealer. The amount of financing that the investment dealer is prepared to give to the client is based almost exclusively on the attributes of the security, and rests only to a token degree on the financial capabilities of the client.⁹ For example, a common practice of many large Canadian investment dealers is that the firm is prepared to initially put up 50% of the purchase price of listed stocks with a market price of greater than \$2.00 per share.¹⁰ As the market price of the margined investment fluctuates, the client must continuously provide the investment dealer with margin deposits such that the firm always provides the same proportion of the market value of the securities so margined.¹¹ "Margin calls" are issued by the investment dealer to inform the client of the amount that must be deposited to maintain this position.

8 Note that this margin is security only, and does not constitute either partial or complete satisfaction of the debt the client owes for his security transactions. See C.H. Meyer, *The Law of Stock Brokers and Stock Exchanges* (New York: Baker, Voorhis & Co., 1931) at 402. [Hereinafter referred to as Meyer].

9 It is the opinion of the author that in reality, once the initial New Client Application form is completed (which, among other information, outlines the financial background of the client), very little regard is held for the ability of the client to pay for his purchases. Once a pattern of trading has been established by a client, only a transaction which is extraordinarily large by comparison to this norm would draw attention. No offence is meant to the compliance officers of the investment dealers; this is simply a reflection of the huge volume of daily trading that goes on, and the enthusiasm of stockbrokers who are compensated through an activity-based commission structure.

10 The minimum amount of margin which must be collected from clients on all securities is specified in the *Toronto Stock Exchange By-Laws*, 5 Canadian Securities Law Reporter (CCH) para. 85-001, By-Law 16.15 at para. 85-xxx, Margin Account - Requirements. These minimums apply to all member firms, however, members are free to require that greater amounts be deposited.

11 For example, assume that the investment dealer is prepared to provide the client with 50% margin privileges. The client buys 1000 shares of ABC Co. at \$5.00 per share for a total of \$5000. Ignoring commissions, the client would deposit \$2500 and would leave the stock with the investment dealer; the firm initially would provide financing for the other half of the market value of the purchase. If the market price of ABC Co. fell to \$4.00 per share, then the total value of the stock that is held is now \$4000, of which the firm will provide 50%. The firm is now prepared to advance only \$2000, and therefore the client must provide the firm with an additional \$500 margin deposit. If the stock price fell further to \$2.00 per share than the value of the stock held by the investment dealer becomes only \$2000, and therefore the firm will provide \$1000; the client must provide an additional \$1000 deposit. At this point the client has now placed a total of \$4000 margin with the investment dealer.

In addition to the normal difficulties associated with our justice system¹², cases involving the stockbroker-client relationship have some special problems. For example, it is often imperative that the trier of fact make a judgement call as to the level of investment knowledge and experience possessed by the client so that the scope of duties to be placed on the stockbroker can be determined.¹³ This is virtually a question of determining the credibility of a witness with respect to his stance concerning his own level of sophistication.¹⁴ Also, both the terminology and concepts of the investment markets are foreign to all but those employed in the industry, and the multitude of documentation can only be understood if there is a foundation knowledge as to what the purpose of it is in the context of a particular investment.¹⁵

It is generally agreed that, but for its size, the Canadian securities industry is very similar to that of the United States.¹⁶ As a result, when dealing with questions of securities law, Canadian courts have expressed comfort in relying on American authority, rather than the norm of applying exclusively English precedent.¹⁷

12 For example, credibility of the parties, admissibility of evidence, etc.

13 The creation of a fiduciary relationship depends on the facts. See *Burke v. Cory* (1959), 19 D.L.R. (2d) 252 (Ont. C.A.).

In *Ryder v. Osler, Wills, Bickle Ltd.* (1985), 49 O.R. (2d) 609 (H.C.), the client was an unsophisticated investor who did not even know the difference between a stock and a bond. A fiduciary relationship was created by virtue of the complete trust and confidence she placed in the stockbroker. Contrast this with *Mataris Restaurants Ltd. and Bouzetos v. Richardson Greenshields of Canada Ltd.* (1984), 52 A.R. 223 (Q.B.) at 233, where the client, an active and experienced trader in stocks was denied any claim against the investment dealer for a loss that occurred from a transaction which he entered into entirely on his own initiative based on personal research with no consultation with the stockbroker as to the merits of the transaction.

14 E.g. *Betcherman v. Pierce & Co.*, [1933] O.R. 505 (C.A.), where Latchford C.J. refuses to find that the clients were as verdant as they claimed to be.

15 The author feels particular sympathy for McBain, J. of the Alberta Court of Queen's Bench in the case of *Blair v. Merrill Lynch Canada Inc.*, [1987] A.J. No. 613. See also *Huff v. Price and Continental Carlisle Douglas Ltd.* (1988), B.C.J. No. 644 (S.C.), per Taylor J. at 8:

It is, of course, futile to expect that a trial judge, particularly one working under the pressures of today's trial list, will be able without expert assistance to find his way through the sort of financial maze presented by such a case as this when counsel are unable to do so.

16 J.D. Honsberger, "Failure of Securities Dealers and Protective Devices", Canada, Department of Consumer and Corporate Affairs, *Proposals for a Securities Market Law for Canada*, vol. 3 (Background Papers) (Ottawa: Queen's Printer, 1979) at 1503.

17 E.g. *Clarke v. Baille* (1912), 45 S.C.R. 50 at 76, aff'g (1910) 20 O.L.R. 611 (C.A.), per Anglin, J. [S.C.C.]; *Re Stout and Toronto*, [1927] 2 D.L.R. 1100 (Ont. C.A.) at 1105,

The topic of the stockbroker-client relationship, and specifically margin account investments, is plagued with gaps in Canadian legal literature. Although there is a substantial amount of case law on point, specific reference material is virtually non-existent. The structure of this paper will be to discuss the relevant legal tenets that have been asserted in both American and English jurisprudence, and then to collectively examine Canadian case law to illustrate the extent to which our courts have either supported or rejected these doctrines.

(II) THE STOCKBROKER-CLIENT RELATIONSHIP

THE RELATIONSHIP between a stockbroker and a margin client has been described as follows:¹⁸

The broker acts in a threefold relation: first, in purchasing the stock he is an agent; then, in advancing money for the purchase, he becomes a creditor; and finally, in holding the stock to secure the advances made, he becomes a pledgee of it.

Before delving into each of these roles we must examine the prime foundation of the relationship: the contract on which it is based. Depending on the situation, a stockbroker's duty to his client may or may not be defined by tort law (for example, negligence). However, at least part of a stockbroker's duty is always contractual.¹⁹

Investment dealers who provide customers with margin privileges require the customer to sign an agreement which details the terms that are to govern the relationship. A typical margin agreement would include reference to the rights and obligations of both parties. However, it is common that the bounty of rights are bestowed on the investment dealer, and most obligations rest with the client.²⁰ The principles gov-

per Ferguson J.A.; *In Re Stobie-Forlong-Matthews Limited* (1931), 12 C.B.R. 313 (Man. C.A.); *Re Ord, Wallington & Co. Ltd.* (1971), 15 C.B.R. 66 (Ont. S.C.); *In Re R.P. Clarke & Co. Ltd.* (1931), 13 C.B.R. 118 (B.C.S.C.).

18 Leonard A. Jones, *A Treatise on the Law of Collateral Securities and Pledges* (Indianapolis: The Bobbs-Merrill Company, 1982) at 496. [Hereinafter referred to as Jones].

19 R.A. Percy, *Charlesworth on Negligence*, (London: Sweet & Maxwell, 1977) at 612. The opinion is expressed that the stockbroker's duty is strictly contractual, and any liability to the client results from breach of obligations undertaken by the contract. The author provides some tentative challenges to this stance, beginning at page 10.

20 E.g. in the Canadian Securities course a sample Customer's Margin Agreement Form includes the following clauses that must be agreed to by the client:

1. I agree to advance the amount of margin as determined from time to time by you, to keep such good margin according to the fluctuations of the market, to take the shares so purchased on my order whenever required by you, and to pay the difference

erning the investment industry originate from general legal doctrines, and no specific accommodation has been made for the unique needs of the industry.²¹ As a result, many of the concessions that the client makes by signing the margin agreement are justified by legitimate needs of the investment business, and are essential to the investment dealer's ability to carry on business efficiently, profitably, and with protection from penal or civil actions.²²

Although this express written agreement is the most straightforward component of the contractual relationship between the parties, many areas of difficulty have arisen from it. To further complicate matters, the terms of a contract are always a question of fact, and therefore

between the percentage advanced by me and the amount paid therefore by you together with commission and interest on debit balances.

2. Every transaction contemplates and intends actual delivery and is subject and in accordance with the constitutions, by-laws, rules, regulations and customs of the exchange, market or other institution (and its clearing house, if any) where executed, including margin requirements, commission, interest and other charges.

3. Whenever and so often as I am indebted to you, all securities and other assets held by you for me or my account shall be held as collateral security for the payment of such indebtedness as the same may exist from time to time, which indebtedness I acknowledge as my responsibility, and without notice to me you may raise money on such securities and assets, carry such in your general loans, pledge, repledge, and loan such in such manner and to such amount and for such purpose as you may deem advisable,....

5. Whenever you shall deem it necessary for your protection by reason of insufficiency of margin or otherwise, then you may, without any demand for additional margin, without advertisement, without any tender and without any notice to me all of which are hereby expressly waived: (a) sell any or all securities and other assets held or carried for my account; (b) purchase any or all securities necessary to repay loans or securities in connection with short sales for my account, or buy in any commodities or contract for commodities, of which my account may be short; if after such action by you there remains any indebtedness due by me I hereby undertake to pay to you such indebtedness on demand...

7. I consent that the monthly debit balance in my account shall be charged in accordance with your usual method and custom with interest at the customary rate charged by brokers, and any extra rate caused by market stringency together with a charge to cover your services.....

The Canadian Securities Course, (Toronto: The Canadian Securities Institute, 1979) at 207.

²¹ Meyer, *supra*, note 8 at 436.

²² E.g. clients agree that the investment dealer may, whenever it considers it necessary for its own protection, sell their securities (or otherwise close out the account) without demand for additional margin or notice of the impending sale. If this waiver were not granted by clients, inability to contact the clients in a serious downturn in the market would mean that the investment dealer risks either being sued for conversion (if it sold the shares) or possibly becoming insolvent (if it did not sell because its clientele collectively had not consented to the waiver of notice).

precedent cases are usually of little assistance in resolving disputed interpretations of the terms.²³

Fortunately, many basic common law principles are so ingrained that they rise above challenge, and have not been altered despite the unique demands of the securities industry. Some examples follow.

Margin account documentation reflects the high level of complexity of securities industry operations, yet very often client accounts are hastily opened so that a securities purchase can be made within minutes of the first handshake between stockbroker and client.²⁴ There are, however, no reported cases of a margin client escaping liability through the defence of *non est factum*.²⁵

When technically a term of the contract has been breached, the doctrines of ratification, repudiation and estoppel are fully applicable to the stockbroker-client relationship. There is ample Canadian authority to support the premise that when a stockbroker buys or sells securities on an Exchange, he is generally doing so as an agent for his client.²⁶ When a client's behavior indicates that he has ratified an unauthorized transaction, either expressly, or through a delay in repudiating such, or by his subsequent conduct with respect to his account or the investment dealer, Canadian courts will not hesitate to uphold the action of the

23 *Clarke v. Baille*, *supra*, note 17 at 614 [O.L.R.], *per* Meredith J. - dismissing the binding effect of *Connree v. Securities Holding Corp.* (1907), 38 S.C.R. 601 and other cases of superior jurisdiction.

24 From 1980 to 1985 the author worked as a stockbroker with individual investors. During these years it was her experience that not a single client read the margin agreement before signing it.

25 Only one reported case was found where a client pleaded *non est factum* as a defence against an investment dealer's action for payment. The defence was unsuccessful. See *Canarim Investment Corporation Ltd. v. Rotaro*, [1986] B.C.J. No. 1602 (Co. Ct.). There are several cases that deal with the banking industry; however it appears that *non est factum* is also a futile defence in these situations. See *C.I.B.C. v. Dura Wood Preserves Ltd.* (1979), 14 B.C.L.R. 338 (S.C.); *C.I.B.C. v. Grenkow* (1986), 39 Man. R. (2d) 309 (Q.B.); *Bank of Montreal v. Taurus Transport Ltd.* (1981), 22 B.C.L.R. 154 (S.C.).

26 Supporting the premise that stockbroker and client are in an agency relationship are the following Canadian cases:

Picavet v. Bache & Co. Inc., [1973] 1 O.R. 8 (C.A.) at 14; *Betcherman v. Pierce & Co.*, [1933] O.R. 505 (C.A.); *Higgins v. Edington and Richardson Greenshields of Canada Ltd.*, [1988] B.C.J. No. 1787 (C.A.); *Maghun v. Richardson Securities of Canada Ltd.* (1987), 34 D.L.R. (4th) 524 (Ont. C.A.); *International Futures Ltd. v. Chow*, [1986] B.C.J. No. 2760 (S.C.); *Midland Doherty Ltd. v. Rohrer* (1985), 20 D.L.R. (4th) 188 (N.S.C.A.) at 218; *McLaughlin v. Solloway and Mills*, [1936] S.C.R. 127.

See also *Jones*, *supra*, note 18, as approved by *Re Stout and City of Toronto* (1927), 60 O.L.R. 313 (C.A.).

stockbroker as a valid transaction.²⁷ Similarly, Canadian cases have estopped both stockbrokers and clients from later denying a state of affairs which had been supported by their conduct or by representation.²⁸

A final area where investment industry authority has not deviated from basic common law principles is in the role of mitigation in damage award assessments. Here, the most interesting cases wrestle with mitigation from the client's perspective. Canadian courts collectively seem prepared to impose on the client a duty to mitigate, based on the notion that the investment dealer should not be responsible for losses which could have been prevented by "reasonable" action on the part of the client.²⁹

Such examples, though of passing interest, are merely direct applications of well-developed common law tenets to a specific relationship,

27 *A.E. Ames & Co. v. Sutherland* (1905), 9 O.L.R. 631 (Div. Ct.), aff'd (1906) 11 O.L.R. 417 (C.A.), aff'd (1906) 37 S.C.R. 694. The client remained silent for six months after he became aware that his margin account had been liquidated (wrongly, without notice). He was found to have ratified the sale and was liable for the resulting loss in the account. See also

Patterson v. Branson, Brown & Co. Ltd., [1930] 4 D.L.R. 222 (B.C.S.C.); *Solloway v. Blumberger*, [1933] S.C.R. 163 at 169. In an act for wrongful conversion, the court found:

(the client) received the 'sold notes' without taking exception to them. More than that, he acquiesced in them and he acted upon them. He gave orders to buy on the basis of the credits standing in his name in the appellant's books as a result of the sales made pursuant to his orders to sell. He went on, in that way, for a year and a half....

McLaughlin v. Solloway and Mills, [1936] S.C.R. 127 at 133, *per* Dysart J. In this case, upon discovery of the fraudulent activity by the investment dealer, the client elected to retain possession of the share certificates, thus ratifying the action:

...in other words (he) would acknowledge that in so buying the shares the company acted as agent for him under some authority, which, if not previously given, would then be conferred so as to relate back to the time of purchase.

28 *Picavet v. Bache & Co. Inc.*, [1973] 1 O.R. 8 (C.A.). An investment dealer issued erroneous confirmation slips and monthly statements, leading the client to believe that the firm was unable to complete a buy order he had placed with them. In fact the stock had been purchased as ordered. The firm was estopped from holding the client responsible for the resulting debit balance in his account. *International Futures Ltd. v. Chow*, [1986] B.C.J. No. 2760 (S.C.). A client knowingly allowed another person to give the stockbroker instructions for her account. She was not able to later deny that person's authority; the doctrine of "agency by estoppel" was applied.

29 *Moss v. Richardson Greenshields of Canada Ltd.*, [1988] 53 Man. R. (2d) 117 (C.A.) *per* Darichuck J. aff'd 56 Man. R. (2d) 230 (C.A.); *Robertson v. McLeod Young Weir Ltd.*, [1986] A.J. No. 502 (C.A.); *Burke v. Cory* (1959), 19 D.L.R. (2d) 252 (Ont. C.A.); *Dominion Securities Ltd. v. Glazerman* (1984), 29 C.C.L.T. 194 (Man. C.A.); *Langer v. Yorkton Securities Inc.*, [1986] O.J. No. 927 (S.C.); *Mataris Restaurants Ltd. v. Richardson Greenshields of Canada Ltd.* (1984), *supra*, note 13; *Deep v. Greenshields Inc.*, [1986] O.J. No. 1445 (H.C.).

and these results would be confidently anticipated by legal professionals. In addition, though, there are many unique and less resolved issues which have arisen in Canadian courtrooms concerning the contract between the investment dealer and the margin client:

- (1) Is the client's written waiver of demand for margin or notice of impending sale always binding on him? What other extrinsic factors will be considered? How can the course of dealings between the stockbroker and the client alter the terms of the written contract?
- (2) To what extent are the customs, usages and by-laws of the appropriate stock exchanges and related bodies incorporated into the relationship? Do these become part of the contract?
- (3) What are the parameters of the lien that the investment dealer has on the client's securities? What are the limitations placed on the firm with respect to the pledging of client securities for its own purposes?

In an attempt to begin filling the void in our legal literature, the author now provides tentative answers to each of these issues, based strictly on Canadian authority.

1. Margin Agreement Waiver of Demand for Margin and Notice of Impending Sale

The margin agreement that a customer signs will have a clause which authorizes the investment dealer to close-out the margined position when his account becomes under-margined.³⁰ In the absence of any

30 Mark Browning and William A. Jackson, "Brokers Beware! Private Cause of Action May Exist Under Margin Account Disclosure Rules" (1985) 13 Securities Regulation Law Journal at 3. At page 14 the writers caution investment dealers from boilerplate clauses in their documents:

'Additional collateral may be required whenever the Broker may determine, in its sole discretion, that the nature and prices of the securities in the margin account justify the obtaining of additional collateral to secure margin loans,' and 'We retain the right to require additional margin anytime we deem it desirable'. A broker whose margin account disclosure document contains provisions similar to the forgoing should carefully review its internal manuals and memoranda to determine if there are specific, standard internal guidelines for determining when additional collateral will be required, such as a rule that additional collateral should be required when the value of securities in a margin account falls below a certain percentage of the loan amount. If such a rule exists, a disclosure document indicating that the broker may exercise absolute discretion in making collateral calls may prove to be only an illusory bit of protection. ...The existence of specific credit guidelines for margin accounts is more the rule than the exception.

Although this is an American article, Canadian dealers would be well-advised to ensure that a logic connection exists between the wording of their documentation and the internal policies to be exercised under the rights granted in the document.

further agreement, the investment dealer is required to first make a demand for margin before closing a transaction due to default of margin.³¹ The client must also be given notice of the impending sale. This is because the securities of the margin client are collateral, and a pledgor ordinarily has the right to notice of time and place of sale.³²

The client's right to demand for margin and notice of sale can be lost by either agreement or waiver.³³ The waiver may be either express or implied.³⁴ It has been suggested by American authorities that there may be a difference between a client's waiver of demand for margin payment and a waiver of his right to be informed of an impending close-out sale.³⁵ If the rights to notice of margin deficiency and sale have been waived by the client, it is generally agreed that the investment dealer thereby has a right to sell out the position that is undermargined, but it is not an obligation.³⁶

These are the basic legal tenets that have been accepted and applied in England and the United States. Canadian authorities have done a fairly thorough examination of the doctrines, and in most cases accepted them.

For a Canadian example, see *Dominion Securities Ltd. v. Glazerman* (1984), 29 C.C.L.T. 194 (Man. C.A.) at 207, where O'Sullivan J.A. substituted the provisions of the *Interest Act* R.S.C. 1970, c. I-18, s. 3 for the nebulous wording of the margin agreement clause dealing with interest payable by the client on his account. The result was that an annual rate of 5%, rather than 12.25%, was applied to the award made to the investment dealer.

31 Samuel P. Gilman, *Stock Exchange Law* (New York: The Ronald Press Company, 1923) at 157. [Hereinafter referred to as Gilman].

Jones, *supra*, note 18 at 732.

32 John R. Dos Passos, *A Treatise on the Law of Stock-Brokers and Stock-Exchanges*, (New York: Greenwood Press Publishers, 1968) at 169. (First published in 1882 by Harper & Bros.) [Hereinafter referred to as Dos Passos].

See below page 17 and note 91.

33 Meyer, *supra*, note 8 at 396; Jones, *supra*, note 18 at 732 - 733; Gilman, *supra*, note 31 at 165 - 166; Dos Passos, *supra*, note 32 at 188.

34 Meyer, *supra*, note 8 at 396; Dos Passos, *supra*, note 32 at 204. Where there has been no notice or insufficient notice, the transaction can be ratified by the acts of the pledgor.

35 Dos Passos, *supra*, note 32 at 169-170 and 196; Gilman, *supra*, note 31 at 158-160; M. Van Smith, "The Custom of Margin Calls and Closing Out Futures Accounts Lacking Sufficient Margin - The Rule of Unwritten Law" (1985-86) 13 *Securities Regulation Law Journal* 99 at 111.

36 Meyer, *supra*, note 8 at 401; Dos Passos, *supra*, note 32 at 199. See also *Richardson Securities of Canada v. Feder et al.* 31 *Canadian Securities Law Reporter* (CCH) para. 10.088 (Ont. H.C.), per O'Driscoll J. However, M. Van Smith, *supra*, note 35 at 104, expresses the opinion that the investment dealer has a duty to sell which arises out of custom.

In cases where the investment dealer makes requests for margin and advises the client of the potential for sell-out, it appears that the courts will allow the investment dealer to collect from the client for any shortfall resulting from the closing of the account, providing the measures taken by the investment dealer were reasonable.³⁷

The pledgor's ordinary right to notice of time and place of sale has been upheld by the Supreme Court of Canada in *A.E. Ames & Co. v. Sutherland*.³⁸ In this leading case, there had been no waiver of these rights by the client, and therefore the investment dealer's actions of selling the client's margined stock without notice amounted to a breach of contract.³⁹

The tradition of having a client consent to the investment dealer's right to sell without providing notice or calling for a margin deposit has existed in Canada since the early 1900's.⁴⁰ Today probably all of Canada's major investment dealers incorporate such a waiver into their standard margin agreement, and such will generally be upheld by the courts.⁴¹

In addition to having the client waive his rights of notice by signing the margin agreement, investment dealers today will usually spell out the same waiver on their confirmation slips.⁴² The provincial Securities Acts mandate that the confirmation slip must be sent to every client promptly after each transaction⁴³, detailing the specifics of

37 *Zachs v. Gentles*, [1939] S.C.R. 45; *Garret v. James Richardson & Sons Ltd.*, [1942] O.R. 59 (C.A.); *Maloof v. Bickle & Co.* (1919), 50 D.L.R. 590 (S.C.C.); *A.E. Ames & Co. v. Sutherland*, *supra*, note 27; *Betcherman v. Pierce & Co.*, [1933] O.R. 505 (C.A.); *George & Miklovic v. Dominick Corp. of Canada*, [1973] S.C.R. 97 aff'g (1970), 15 D.L.R. (3d) 596 (B.C.C.A.); *Hoeftle v. Bongard & Co.* [1945] S.C.R. 360; *Merrill Lynch Royal Securities Ltd. v. Blum* (1983), 23 B.L.R. 260, (Ont. H.C.); *Patterson v. Branson, Brown & Co. Ltd.* (1930), 4 D.L.R. 222 (B.C.S.C.).

38 *Supra*, note 27.

39 However, in this case, the client's delay in asserting his rights was deemed to be a ratification of the sale.

40 As evidenced by the 1919 case of *Maloof v. Bickle & Co.*, *supra*, note 37.

41 *Patterson v. Branson, Brown & Co. Ltd.*, *supra*, note 37 where Murphy J. simply expresses the opinion that the investment dealer's decision to sell must be reasonable. *Hoeftle v. Bongard & Co.*, *supra*, note 37 where a client failed in an attempt to have a letter he had written override the waiver granted by him in the margin agreement (customer card). Judgment for the investment dealer. *George & Miklovic v. Dominick Corp. of Canada*, *supra*, note 37.

42 The term "bought note" is frequently used in cases. The contents of the confirmation slip is further examined, see *infra* note 71 and accompanying text.

43 Each province's Securities Act details the mandatory contents of the confirmation slip, see for example *The Securities Act*, R.S.M. 1988, c. S50, s. 67(1). See also *Toronto Stock Exchange By-Laws*, *supra*, note 10 at para. 803-307, By-Law 16.07, "Confirmation".

the trade that has been executed. Agreement to waive notice may be inferred from the acquiescence of the client to the contents of the confirmation slip. With one notable exception⁴⁴, Canadian courts have consistently held that the confirmation slip forms part of the contract between the broker and the client.⁴⁵

Incorporating the terms of the confirmation slip into the general contract between parties normally works against the client with respect to notice of margin default and sale, but the examination of other extrinsic factors has worked to the client's advantage in several situations. For example, it has been held that where a stockbroker accepts and records the telephone number of a client for the purpose of contacting him if margin were required, this arrangement will override the contents of any prior written agreement between the parties, including the client's waiver of such notice.⁴⁶ In another case the client had signed an agreement waiving his right to notice of sale, however the investment dealer was held liable for the damage that resulted when it liquidated one of the client's positions without notice. The judge found that the firm's prior tolerance of the client's chronically

44 *Connie v. The Securities Holding Company and A.E. Ames Company, supra*, note 23, per Duff J. Meyer, *supra*, note 8 at 444, provides a rationale which supports the *Connie* stance. Although he believes that the terms on the confirmation slip can form part of the relationship between the parties, he cites American authority for the premise that the confirmation issued for a specific trade cannot be binding on that trade:

...the confirmation of the first order that the broker executes for the customer cannot be binding on him with respect to that order, because the order must necessarily have been given before the confirmation was received. Since the printed conditions constitute at most an offer which the customer can accept or reject, they cannot create a contract until after they have been communicated and a reasonable time for acceptance or rejection has elapsed.

45 See *Clarke v. Baille, supra*, note 17. The contents of the bought note are an essential part of the contract and help to explain what is largely a tacit agreement between the client and the investment dealer. *Nelson v. Baird & Botterell*, (1915) 25 Man. R. 244 (K.B.), per Metcalfe J. The contents of the bought note protect the investment dealer if its actions were reasonable. *Maloof v. Bickle & Co., supra*, note 37; *Patterson v. Branson, Brown & Co. Ltd., supra*, note 37; *McLaughlin v. Solloway*, [1936] S.C.R. 127; *Garret v. James Richardson & Sons Ltd., supra*, note 37.

46 *Moscovich v. McLeod, Young Weir Ltd.*, [1987] M.J. No. 59 (C.A.). Over a period of several months, whenever a margin call was necessary, notice had been given to the client, even though he had waived the right to such in the account documents he had signed. Before the client left for a holiday overseas the stockbroker recorded a number where he could be reached. O'Sullivan, J.A. said that this arrangement would supersede any arrangement set out in written documents for the purpose of the transactions that were in place at this time.

under-margined account amounted to a waiver by the investment dealer of strict compliance with the terms of the written agreement.⁴⁷

In contrast to these situations, it appears that the courts will normally be reluctant to let a single conversation between stockbroker and client supercede the terms of the written agreements between the parties.⁴⁸

To summarize, where a stockbroker liquidates an under-margined account without first demanding a further margin deposit and/or providing notice of the impending sale, he will not be liable for breach of contract, because none of the consensual terms of the margin agreement have been broken. In providing the comprehensive definition of the contractual dimension between the parties, the margin agreement clearly gives the stockbroker complete latitude concerning action deemed necessary to protect the interests of the investment dealer.⁴⁹

Theoretically then there should be no such thing as stockbroker liability for a premature sell-out. We have seen however that the course of dealings between the parties can expand or change the confines of the margin agreement. Two other potential exceptions exist. First, the role that custom plays may alter the terms of the express contractual relationship.⁵⁰ Also, in the case of a cash account, the client does not sign a margin agreement, but simply agrees to settle his account within five business days of any transaction. The stockbroker will be liable for con-

47 *Langer v. Yorkton Securities Inc.*, [1986] O.J. No. 927 (H.C.) at 6, *per Steele J.*:

In other words, the company was willing to tolerate the failure (of the client) to strictly comply with the margin deficit. I find that this tolerance was within the ambit of the written agreement and that it was unreasonable and improper for the company to liquidate the treasury bills immediately thereafter without notice, and the company is liable for the damages suffered...accommodation was granted, and then improperly withdrawn without notice.

48 *Merrill Lynch Royal Securities Ltd. v. Blum*, (1983) 23 B.L.R. 260 (Ont. H.C.). Prior to liquidation the client was given notice of a margin call and management of the investment dealer had discussions with the client about the financial arrangements he would be making; however, the written contract between the parties gave the firm the right to liquidate the under-margined position without notice, and they were entitled to collect from the client for the shortfall that resulted. See also *Patterson v. Branson, Brown & Co. Ltd.*, *supra*, note 37 at 225, where Murphy J. rejects the submission of the client that a conversation between he and the stockbroker amounted to a fresh contract. *Russell v. Canada West Grain Company Ltd.*, [1925] 3 W.W.R. 508 (Sask. C.A.) at 510 where Turgeon J.A. perhaps leaves the door open by noting that the situation may depend on the content of the conversation; however he finds that the discussion that took place between the stockbroker and the client did not amount to extension of any protection for the client which was not found in the written agreement between them.

49 *Supra* note 20, especially Clause 5.

50 See separate discussion beginning at Part 2.

version if he closes-out a cash account transaction before this period has expired.⁵¹

Even where the stockbroker apparently protects himself by acting within the parameters of the margin agreement, an action can be founded in tort when there is a failure to fulfill a duty of care arising from the relationship rather than from the imperfect performance of the terms of a contract.⁵² Thus the existence of a contract between the parties does not preclude liability for tortious acts. If we look to the realms of negligence, agency, and fiduciary duty, the definition of "premature sell-out" then becomes greatly expanded, and stockbroker liability in such situations is a possibility.

In a negligence action, the successful plaintiff will fulfill the burden of showing that the defendant owed him a duty of care, the standard of care for that duty was breached, he suffered damage as a result, and it was reasonably foreseeable that such damage would occur. A margin client may be able to demonstrate these constitutive elements even where his stockbroker liquidated a position in his account in a way that none of the terms of the margin contract were breached.

As an agent⁵³, the stockbroker owes a duty of care to his client.⁵⁴ Specifically, the client (principal) is entitled to expect that care and skill will be used in the handling of his account and that his interests will be placed above those of his agent. Could this duty extend to the stockbroker's treatment of an under-margined position?

It is important to realize that there is an inherent conflict of interest created by the compensation structure of the investment industry. Stockbrokers (and the firms that employ them), receive payment for their services only when there is activity in the client's account. All advice, counselling, and research is provided without compensation unless the client actually buys or sells something in his account. When he does so, a commission is charged based on the monetary size of the transaction. The amount of commission charged to the client does not relate to whether the investment is a successful one. Key to all of this is that when there is a unilateral sell-out to cover an under-margined po-

51 *E.g. Dominion Securities Ltd. v. Glazerman* (1984), 29 C.C.L.T. 194 (Man. C.A.). The investment dealer initiated an unauthorized sale of shares three days prior to the settlement date, then attempted to sue the client for the shortfall in his account. The action failed, and on cross action the client was awarded an amount equal to the market value at the date when the shares could have been replaced, less the amount credited to him as a result of the tortious sale.

52 *Smart v. Fowler and Merrill Lynch Royal Securities Ltd.*, (1984) 61 N.S.R. (2d) 170 (S.C.) at 175 - 176, *per* Nathanson J.

53 *Supra*, note 26.

54 G.H.L. Fridman, *The Law of Agency*, (London: Butterworth & Co. Ltd., 1971) at 123 [hereinafter Fridman].

sition, the client is charged commission on that transaction, just as though he had placed the order himself. The practise of charging commission on broker-instigated liquidating transactions is not spelled out specifically in the margin agreement, or in any other client document.

When we consider that in an agency relationship self-interest of the agent should play at best a secondary role to the interests of his principal, the potential for conflict in closing-out of margin accounts is obvious. It is incongruous that the party vested with discretion is rewarded according to how he exercises that discretion. As the closing-out of an account rarely, if ever, works to the client's monetary benefit (as he will be charged with any loss that the investment firm suffers from the transaction), the client may be able to argue that the agent-stockbroker acted with his own desire for commission in mind, therefore breaching the duty of loyalty to his principal.

To counter this, one could argue that once the client's specific order is carried out, the agency relationship ends and the stockbroker carries on merely as creditor-pledgee until he receives another order from the client. If this were so, it would mean that in a sell-out of a client's position the stockbroker is acting as an agent for the firm, not the client, and it is the firm's interests which are paramount.⁵⁵

Apart from the basic agency relationship, if a fiduciary relationship is found to exist between the stockbroker and the client, this not only carries with it a separate duty of care, but the standard of care will be elevated beyond that associated with a normal agent-principal relationship or the express and implied duties covered by the margin contract.⁵⁶ The higher standard applied to a stockbroker with fiduciary responsibilities would increase the potential for breaches of duty being found for margin account sell-outs.

There is strong argument to suggest that perhaps the stockbroker-margin client relationship should be labelled generally as a fiduciary

55 *Merrill Lynch Royal Securities Ltd. v. Norman Manning Ltd. and Holme* (1984), 52 B.C.L.R. 103 (C.A.). This case contains an interesting discussion of how the stockbroker bounces between being an agent for the client and an agent for the investment dealer.

56 J.R.M. Gautreau, "Demystifying the Fiduciary Mystique" (1989), 68 Can. B. Rev. 1 at 14:

...it is submitted that the certainty of the written contract is not the only consideration and it should not be used to hide the realities that exist in the parties' relationship. There is no reason to view the co-existence of fiduciary duties in a contractual setting any differently than one views the co-existence of tort duties in a contractual setting. In both cases, there is simply additional duties, or duties that differ in quality, over and above the contractual duties. (Footnotes omitted).

category.⁵⁷ However, the finding of such still depends on the facts of each case.⁵⁸ Canadian courts today seem ready to find that a fiduciary relationship exists between the stockbroker and the client when the stockbroker undertakes to advise and act for the client (thus inducing his reliance on the broker)⁵⁹, and especially when the client is inexperienced.⁶⁰ Extrapolating from the latter group, could it not be argued that even a seasoned investor who had never had a margin account in the past is in this regard a novice, and therefore a fiduciary duty is owed to him by the stockbroker?

Where the stockbroker has acted within the contractual terms of the margin agreement (and we assume that the agency relationship ends when the client's order is filled and a fiduciary relationship is not found on the facts of a case), a duty of care can still arise by virtue of the proximity of the relationship between the parties⁶¹, and the stockbroker can be found liable under the general law of negligence.⁶² In past cases, the resulting duties that have been imposed on the stockbroker range from a general duty of care⁶³, a duty to advise the client fully,

57 The author suggests that the stockbroker-margin client relationship, specifically with respect to the ability of the stockbroker to initiate a closing-out of the client's account in accordance with the power granted to him in the margin agreement, possesses all of the general features that Wilson J. itemizes as characteristic of a fiduciary relationship (*Frame v. Smith*, [1987] 2 S.C.R. 99). M. Gautreau described these in "Demystifying the Fiduciary Mystique" *supra*, note 56 at 5, as follows:

(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.

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

58 *Burke v. Cory* (1959), 19 D.L.R. (2d) 252 (Ont. C.A.); *Laskin v. Bache & Co. Inc.* (1971), 23 D.L.R. (3d) 385 (Ont. C.A.).

59 *Burke v. Cory*, *supra* note 58; *Maghun v. Richardson Securities of Canada Ltd.* (1986), 34 D.L.R. (4th) 524 (Ont. C.A.); *Burns v. Kelly Peters & Associates Ltd.* (1988), 41 D.L.R. (4th) 577 (B.C.C.A.); *Laskin v. Bache & Co. Inc.*, *supra* note 58; *Franklin v. Richardson Greenshields of Canada Ltd.*, [1988] 3 W.W.R. 205 (Sask. Q.B.). The investment dealer firm was found to be negligent and in breach of its fiduciary duty to the client for failing to adequately supervise the activity of one of its brokers.

60 *Ryder v. Osler, Wills, Bickle Ltd.*, (1985) 49 O.R. (2d) 609 (H.C.).

61 This is the infamous "neighbor principle" from *Donoghue v. Stevenson*, [1932] A.C. 562 (H.L.).

62 *Reed v. McDermid St. Lawrence Ltd.*, [1989] B.C.J. No. 339 (S.C.); *Central B.C. Planners Ltd. v. Hocker et al.* (1970), 72 W.W.R. 561 (B.C.C.A.); *Glennie v. McDougall & Cowans Holdings Ltd.*, [1935] 2 D.L.R. 561 (S.C.C.); *Midland Doherty Ltd. v. Rohrer* (1985), 20 D.L.R. (4th) 188 (N.S.C.A.).

63 *Central B.C. Planners Ltd. v. Hocker et al.*, *supra*, note 62.

honestly and in good faith⁶⁴, a duty to follow customer instructions⁶⁵, a duty to warn of extraordinary risks associated with an investment⁶⁶, and a duty to disclose any interest beyond usual commissions attached to a transaction.⁶⁷

Finally, one could argue that where a stockbroker takes action on an under-margined account, he should exercise discretion only over the amount that is necessary to bring the account "on side." The sale of excess securities could amount to a negligent breach of duty. Canadian case authority has stated that the decision to close-out a client's account must be reasonable.⁶⁸ In the client's mind, the unilateral closing-out of his under-margined account is not in his best interests, as is evidenced by the fact he did not request the transaction. If, subsequent to a margin sell-out, the client finds that there is a substantial cash balance in his account, he may have a cause of action in negligence. He would simply allege that the stockbroker carelessly liquidated a bona fide securities position without cause.⁶⁹

The elements of damage and foreseeability would not present difficulty for a client asserting stockbroker negligence in a margin sell-out. For example, if a stockbroker fails to advise the client that he is under-margined, or supplies him with erroneous information concerning the status of his account, then it is foreseeable that the client will be sold-out in accordance with stock exchange regulations. The client will likely suffer either an immediate loss or a lost opportunity if the investment in question appreciates after the sell-out. The broker could be liable for the actual or potential loss in these situations.⁷⁰

From a policy standpoint, we must realize that as we expand the duty placed on the stockbroker, we force the firm to assume more and more of the risks of transactions that actually belong to the client. The preceding discussion is necessarily speculative, as these areas of potential stockbroker and investment dealer liability have not been fully ex-

64 *Glennie v. McDougall & Cowans Holdings Ltd.*, *supra*, note 62; *Central B.C. Planners Ltd. v. Hocker et al.*, *supra*, note 62.

65 *Glennie v. McDougall & Cowans Holdings Ltd.*, *supra*, note 62; *Laskin v. Bache & Co. Inc.*, *supra*, note 58; *Higgins v. Edington*, [1988] B.C.J. No. 1787 (C.A.).

66 *Reed v. McDermid St. Lawrence Ltd.*, *supra*, note 62; *Midland Doherty Ltd. v. Rohrer*, *supra*, note 62.

67 *Burns v. Kelly Peters & Associates Ltd.*, *supra*, note 59.

68 *Nelson v. Baird & Botterell* [1915] 25 Man. R. 244 (K.B.); *Patterson v. Branson, Brown & Co. Ltd.*, [1930] 4 D.L.R. 222 (B.C.S.C.).

69 *Finkle v. Bache Securities Inc.*, [1986] M.J. No. 394 (Q.B.). Although the sale of an excessive amount of stock was not at issue in this case, it is interesting to note that the client did not object when he received a cheque for over \$4,600.00 representing the excess liquidation.

70 *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*, [1964] A.C. 465 (H.L.).

plored by the courts. As the Canadian courts determine in which direction the responsibility for margin sell-outs should be skewed, it is hoped that the judges involved will not lose sight of the macro-objectives of the investment industry. The initiative of and incentives for all parties must be maintained so that efficient movement of capital from owners to users continues in our economy.

In conclusion, once the client of a Canadian investment dealer has signed a margin agreement, waiving his right to demand for margin and notice of sale, it is unlikely that he will have a cause of action against the firm for the closing-out of a delinquent account without notice. If the client has received at least two confirmation slips (containing similar descriptions of relinquishment of rights to notice) the investment dealer's position is further bolstered. The reasonableness of the decision to sell-out the client's account may or may not be considered by the court. One important threat to the investment dealers' right to liquidate a position without notice is an examination of the course of dealings between itself and the client. If over the course of the relationship with the client, business is conducted in a way that ignores the rights granted to the investment dealer, this pattern could be construed as a waiver by the investment dealer of those rights.

2. Customs, Usages, By-Laws

Typically, a margin agreement will contain a clause which reads something to the effect of: Every transaction is subject to and in accordance with the constitutions, by-laws, rules, regulations, customs and usages of the Exchange, market or other institution where executed.⁷¹ This creates a vast realm of implied terms in the relationship between stockbroker and client. By comparison, the impact of this clause makes the waiving of notice to a margin sell-out seem like a minute concession by the client!

The generally accepted legal tenets with respect to this area are as follows: the constitution, rules, regulations, by-laws, customs and usages⁷², etc., of an Exchange form the basis of the contract between the

71 The confirmation notice will also have this type of clause on it.

72 Meyer, *supra*, note 8 at 155 defines customs and usages as follows:

A usage is a practise which, by reason of knowledge of its prevalence or otherwise, contracting parties are deemed to incorporate in the terms of their contract, unless its incorporation is expressly negated. A custom is a usage which is so notorious and so long established that it has acquired the force of law.

...However, custom and usage, although technically different, are in common legal parlance ordinarily used as equivalent terms. See also Dos Passos, *supra*, note 32 at 232, 233, and his excellent chapter on Usages beginning at 341.

For a Canadian example see *Jones v. Davidson Partners Ltd.*, [1981] 1 P.P.S.A.C. 242 (Ont. H.C.) at 257 where Parker A.C.J.H.C. discusses the stockbrokers' lien:

Exchange and all of its member investment dealers and their employees.⁷³ An investment dealer can only execute orders in conformity with these, and thus when a customer employs a broker to transact business for him, he must be deemed to consent that it be carried out in the only manner in which it can be executed.⁷⁴ Accordingly, all of these conditions apply to the business dealings between investment dealer and client, and the client will be bound by them even if he is ignorant of them.⁷⁵ In conclusion, all of the rules, regulations, by-laws, customs and usages that the firm is bound by become implied terms of the contract between the client and the investment dealer, and the client is so bound, even though he is not directly a member of the stock exchange.⁷⁶

In Canada, it is doubtful that there exists a stockbroker who is familiar with even a fraction of what is referred to in such a clause.⁷⁷ Yet, the client, who is so obviously uninformed, must agree to be bound by all such terms. Ignorance on the part of either stockbroker or client of the specifics of any provision so assented to is generally irrelevant.⁷⁸

Canadian courts have accepted that, unless there is evidence to the contrary, the terms of the contract between the investment dealer and the Exchange are incorporated into the contract defining the relation-

The evidence ... establishes to my satisfaction that in ... Canada the usage of the stockbrokers trade is that when accounts are not paid by the settlement date the stockbroker is entitled to sell the clients' securities. It is also part of the custom that no notice is required of the intended sale ... The universality of the usage is made all the more obvious by its codification, as it were, in the rules and regulations of stock exchanges across Canada.

73 Meyer, *supra*, note 8 at 152; Gilman, *supra*, note 31 at 149.

74 Dos Passos, *supra*, note 32 at 353; Meyer, *supra*, note 8 at 157-159.

75 Meyer, *supra*, note 8 at 153 and 159; Gilman, *supra*, note 31 at 147; Dos Passos, *supra*, note 32 at 232, 341 and 351; *Halsbury's Laws of England*, 3d ed., vol. 36, Stock Exchange at para's 761, 763 and 786.

76 *Greenshields Inc. v. McDonough*, [1968] 1 O.R. 297 (H.C.); *Deep v. Greenshields Inc.*, *supra*, note 29.

77 *Greenshields Inc. v. McDonough*, *supra*, note 76; the stockbroker was not familiar with *Toronto Stock Exchange By-Laws*, *supra*, note 10 at para. 80-xxx, By-Law 26, Sec. 5(b), which outlines the restrictions on cancellations of orders in the case of a delayed opening for a stock. *George & Miklovic v. Dominick Corp. of Canada* *supra*, note 37, where the stockbroker was not aware that special margin requirements had been issued by the American Stock Exchange for short sales of the stock in question.

78 *Malooof v. Bickle & Co.* *supra*, note 37; *Greenshields Inc. v. McDonough*, *supra*, note 76; *Richardson Securities of Canada v. Feder*, *supra*, note 36; *Clarke v. Baille* *supra*, note 17; *Union Securities Ltd. v. Terbogt* (1984), 28 B.L.R. 81 (B.C. Co. Ct.) *per* Sheppard J.; *International Futures Ltd. v. Ford* (1981), 31 B.C.L.R. 209 (S.C.) *per* Fawcus J.; *George and Miklovic v. Dominick Corp. of Canada*, *supra*, note 37; *Garrett v. James Richardson & Sons Ltd.*, *supra*, note 37, *per* Fisher J.

ship between the investment dealer and the client.⁷⁹ However, where the customs and usages of the investment industry conflict with the actual content of the contract between the client and the investment dealer, the express contract provisions will prevail.⁸⁰ Today, because the documentation of all of Canada's major investment dealers probably clearly and fully incorporates the customs and usages of the Exchanges into the client-investment dealer relationship, the importance of the latter premise is diminished.

As stated, investment dealers are bound to follow the rules of the stock exchanges. On occasions where such rules have been violated by the stockbroker, clients have sometimes tried to use this to their advantage. In Canada, failure of a stockbroker to comply with stock exchange rules does not constitute a defence to an action against the client for an unpaid account.⁸¹ Conversely, where a broker abides by the

79 *Forget v. Baxter*, [1900] A.C. 467 (P.C.) at 479, per Lord Strong:

Their Lordships think it a sounder principle to hold that when one employs a broker to do business on a Stock Exchange he should, in the absence of anything to shew the contrary, be taken to have employed the broker on the terms of the stock exchange.

Solloway v. Blumberger [1933] S.C.R. 163 at 166 per Rinfret J.:

This was an agreement for dealing in stocks on the Vancouver Stock Exchange. In the absence of evidence to the contrary, the respondent (client), who gave authority to the appellants to do business for him on the Exchange, should be deemed to have contracted subject to the rules and customs of the Exchange; and the nature of the powers and the duties of the brokers would be determined by the usage and course of dealing in transactions of this character between broker and customer in Vancouver.

80 *Honsberger*, *supra*, note 16 at 1505; *Cartwright & Crickmore Ltd. v. MacInnes*, [1931] S.C.R. 425 at 431 per Rinfret J.A.; *Laskin v. Bache & Co. Ltd.* *supra*, note 58, per Arnup, J.; *Gairdner & Co. Ltd. v. Naik* (1974), 2 O.R. 198 (Co. Ct.) per Rogers J. citing with approval *St. John Shipping Corp. v. Joseph Rank Ltd.*, [1956] 3 All E.R. 683 (Q.B.) at 690 per Devlin J.:

.... I think that a court ought to be very slow to hold that (a) statute intends to interfere with ... the ordinary law of contract. Caution ... is especially necessary in these times when so much of commercial life is governed by regulations of one sort or another which may easily be broken without wicked intent.

81 *Union Securities Ltd. v. Terbogt* (1984), 28 B.L.R. 81 (B.C. Co. Ct.). Contrary to exchange rules, the investment dealer did not demand that the client provide an adequate margin deposit before short selling was commenced in his account. This breach was not a defence and did not relieve the client of liability for the loss in the account. The following case was applied:

International Futures Ltd. v. Ford (1982), 31 B.C.L.R. 209 (S.C.). The client was being sued for a debit balance in his account. It was found as a fact that with respect to the client's account the investment dealer has breached the requirements of the commodities futures exchanges concerning margin requirements, discretionary trading and trading in accounts in a deficit position. The client claimed that by doing so the

rules, he is acting within the terms of the contract between himself and the client, and therefore the client is bound by his actions.⁸²

A possible exception to the proposal that a customer cannot receive advantage from an investment dealer's breach of Exchange rules might lie in the area of failure by management to adequately supervise a stockbroker's conduct.⁸³ Future decisions are required to clarify this point, as the small amount of authority that exists today is divided.

firm had breached their contract with him and that he therefore should not be liable for the loss in his account at 215 *per Fawcus J.*:

Although the plaintiff breached the rules of the exchanges as alleged, such breaches enabled the defendant to do exactly what he wished to do, that is, to trade actively in his account. The losses that occurred cannot, in these circumstances, be said to have been caused by the plaintiff's breach of its contract with the defendant. Furthermore, if the defendant was at all concerned about the magnitude of the risk to which he was exposed, then I would have expected him to ask Mr. Campbell (the stockbroker) whether further money was required. His failure to do so amounts to an *implied waiver* of the breaches with respect to the margin requirements and trades while the account was in a deficit position. (Emphasis added).

See also *Richardson Securities of Canada v. Feder et al.*, *supra*, note 36; *Gairdner & Co. Ltd. v. Naik*, *supra*, note 80; *Higgins v. Edington & Richardson Greenshields of Canada Ltd.*, *supra*, note 26.

NOTE: an exception was *Midland Doherty Ltd. v. Rohrer*, (1985), 20 D.L.R. (4th) 188 (N.S.C.A.) at 219 and 200 *per Matthews J.* A client was not held liable for the loss in his account where the investment dealer had failed to ensure that acceptable margin as dictated by the *Toronto Stock Exchange By-Laws*, *supra*, note 10 at 80-xxx, By-Law 22.26, was maintained for options trades. However, the judgment is based largely on the fact that there was a breach of duty by the stockbroker and the firm because they misled the client as to the sufficiency of his margin, and the client's trading activity was influenced by his belief in this fact.

82 *Deep v. Greenshields Inc.*, *supra*, note 29. The client's action failed because the broker was acting in accordance with the regulations of the Toronto Stock Exchange when he refused to execute an order for the client in an under-margined options account. *Merrill Lynch Royal Securities v. Blum* (1983), 23 B.L.R. 260 (Ont. H.C.). The firm applied U.S. Commodity Exchange Rules which say that a favourable turn in the market does not reduce or eliminate a margin call.

83 *Toronto Stock Exchange By-Laws*, *supra*, note 10 at para. 802-804, By-Law 8.34, Responsibility of Supervisors, reads:

Each member (firm), approved person or employee of a member or affiliated company who is a supervisor or who has authority or supervision over or responsibility to the member for any employee of the member, or an affiliated company of the member, shall fully and properly supervise such employee as may be necessary to ensure his compliance with the Exchange requirements.

See *Ryder v. Osler, Wills, Bickle Ltd.* (1985), 49 O.R. 609 (H.C.) at 619-621. The fact that the firm failed to properly supervise the client's account and "check on its handling" in accordance with T.S.E. By-Law 8.34, *supra*, was a contributing factor in finding the investment dealer liable to the client for damages. However, in *Grenkow v. Merrill Lynch Royal Securities Ltd.* (1983), 23 Man. R. (2d) 54 (Q.B.) the court refused to accept the submission of the client that the above section 8.34 was meant

3. Investment Dealers' Rights with Respect to Clients' Shares

Until he has fully paid for securities held by the investment dealer, the rights of the client are minimal. The margin agreement he signs will ordinarily include a clause which states that securities held in his account are collateral for the monies owed by him, and that these securities may be repledged or loaned as the investment dealer deems appropriate.⁸⁴ Also, as was earlier mentioned, one of the dimensions of the relationship between the investment dealer and the margin client is that the firm, in holding the stock to secure the advances made, becomes a pledgee of the stock.⁸⁵ Implicit in this statement is the suggestion that the investment dealer has a lien on the securities so margined.⁸⁶

All of these things bring up the questions of where the title to securities in a client's margin account rests, as well as what restrictions apply to the investment dealer's ability to deal with such property.⁸⁷

to impose an absolute duty on management, and no liability was imposed on the supervisor in this situation.

84 For a general clause see the example provided by the Canadian Securities Institute:

"Whenever and so often as I am indebted to you, all securities and other assets held by you for me or on my account shall be collateral security for the payment of such indebtedness as the same may exist from time to time, which indebtedness I acknowledge as my responsibility, and without notice to me you may raise money on such securities and assets, carry such in your general loans, pledge, repledge and loan such in such manner and to such amount and for such purpose as you may deem advisable, provided you may not use such securities for the purpose of making a delivery on an account of a short sale or for delivery on a sale made by you for your account or for any account in which you or any of your Directors is directly or indirectly interested. It is understood that all such securities and any other securities held by you for me may be held by you at your Head Office".

The Canadian Securities Course, supra, note 20 at 207.

85 See Page 4 and Jones, *supra*, note 18. See also Van Smith, *supra*, note 35 at 107. The pledgee-pledgor relationship is defined:

A pledge arises when the owner of property (pledgor) gives possession of personal property to another person (pledgee) as security for the fulfillment of a promise. The promise generally secured is the repayment of a debt.

86 Gilman, *supra*, note 31 at 238; Dos Passos, *supra*, note 32 at 118; Meyer, *supra*, note 8 at 313; *Halsbury's, supra*, note 75 at para. 892.

87 These questions are extremely important in the situation where an investment dealer goes bankrupt. Although the specific topic of investment dealer bankruptcies is beyond the scope of this paper, the author refers the reader to the following Canadian cases:

In re R.P. Clark & Co. (Vancouver) Ltd., (1931) 13 C.B.R. 118 (B.C.S.C.); *In re Stobie-Forlong-Matthews, Ltd.*, (1931) 12 C.B.R. 228 (Man. K.B.); *Re Nakashidze*, [1948] O.R. 254 (H.C.); *Re Ord. Wallington & Co. Ltd.* (1971) 15 C.B.R. 66 (Ont. S.C.).

Historically some general principles have developed. As an agent, the investment dealer has a lien on the property he holds for his client (the principal) for advances made to the client and for commissions.⁸⁸ In addition to agency, the relationship of pledgor and pledgee is created between the investment dealer and the client when securities are retained by the firm and carried on margin.⁸⁹ The stock belongs to the client, but is pledged to the investment dealer as security for the payment of the amount advanced by the firm.⁹⁰ Normally, a pledgor is entitled to have his property presented to him along with demand for payment before a sale can be carried out by the pledgee, and he is entitled to notice of the time and place that the sale will take place.⁹¹ As we have seen⁹², it is common that margin clients waive most of their rights as pledgors.

Canadian decisions have generally upheld these fundamental tenets. The existence of the pledgor-pledgee relationship has been acknowledged by our courts many times, and it is clear that an investment dealer has the right to use the pledged securities for his own purposes only to the extent that it is fair and reasonable in view of the indebtedness of the client.⁹³ Also, because of the common law rights of a

(NOTE: all of these cases look to U.S. principles and authority for guidance, favoring such over English parallels.)

88 Dos Passos, *supra*, note 32 at 711; Fridman, *supra*, note 54 at 151-52.

89 Jones, *supra*, note 18 at 495; Dos Passos, *supra*, note 32 at 111-114 and 711.

90 Jones, *supra*, note 18 at 495-496; Dos Passos, *supra*, note 85 at 108 and 659; Van Smith, *supra*, note 35, at 107.

91 Jones, *supra*, note 18 at 496-97; more specifically see Van Smith, *supra*, note 35 at 107:

At common law, there were several rules of law which applied to pledges.

Among these rules were the following:

- The sale of the property must be at an advertised public auction; the time and place of the auction must be reasonable.

- The owner (pledgor) must have had reasonable notice of the time and place of the auction.

- Prior to the sale of the pledged property, there must have been a demand on the pledgor for the payment of the debt.

- The auction must be conducted fairly so that the property sold brings a fair price.

92 See, for example, page 5* and note 20 above.

93 *Conmee v. The Securities Holding Co. and A.E. Ames & Co.*, (1907), 38 S.C.R. 601; *Clarke v. Baillie* *supra*, note 17; *Re Stout and Toronto*, [1927] 2 D.L.R. 1100 (Ont. C.A.).

See also *Toronto Stock Exchange By-Laws*, *supra*, note 10, at para. 803-820, By-Law 16.14, Pledge:

An agreement between a member and a customer authorizing the pledging of shares, bonds or other securities, does not justify the member in pledging more of such shares, bonds or other securities than is fair and reasonable in view of the indebtedness of the customer.

pledgor, it is imperative that the investment dealer receive a specific waiver by the client of his right to demand for margin and notice of sale. In the absence of these, an investment dealer who liquidates without notice is liable for breach of contract and/or conversion.⁹⁴

Where securities are not explicitly pledged to the investment dealer⁹⁵, the firm has no right of sale, and has at best a right of lien enabling it to retain possession until payment is made by the client.⁹⁶ In Canada, it is common that the margin agreements of investment dealers have clauses which grant a general lien to the firm.⁹⁷ This is a contractual legal lien which only entitles the firm to retain the client's securities until all debts of that client are fully settled.⁹⁸ It is a possessory lien only. The right to sell without notice must be covered by separate agreement between the parties because this is not an inherent right of the possessor of a legal general lien.⁹⁹

Securities in excess of this reasonable amount must be segregated from securities which the dealer owns or may deal with.

94 Gilman, *supra*, note 31 at 201:

Every unauthorized taking of personal property, and all intermeddling with it, beyond the extent of the authority conferred, in case a limited authority is given, with intent so to apply and dispose of it as to alter its condition or interfere with the owner's dominion, is a conversion.

This definition is broad enough to cover both the case where, in the absence of authority to do so, an investment dealer rehypothecates a client's securities beyond the extent of the client's indebtedness, or where the client's securities are sold without demand for margin or notice of sale. For Canadian discussions see:

A.E. Ames & Co. v. Sutherland supra, note 27 at 635 (H.C.) *per Street J.*, at 419 (C.A.) *per Meredith J.* In this case the client, through his subsequent actions, was deemed to have ratified the wrongful sale. *Clarke v. Baille supra*, note 17; *Conmee v. The Securities Holding Corp. supra*, note 23; *Buchan v. Newell* (1913), 15 D.L.R. 437 (Ont. C.A.); *McLaughlin v. Solloway and Mills, supra*, note 26; *Hoefle v. Bongard & Co., supra*, note 37 at 372-373 [S.C.R.], *per Rand J.* (dissenting); *Dominion Securities Ltd. v. Glazerman, supra*, note 29. In action for wrongful conversion, the onus is on the party making the allegation. See *Solloway v. Blumberger, supra*, note 27. Also, where an investment dealer is sued for illegally converting a client's stock through sale, the firm is not precluded from counterclaiming for the deficiency on such a sale. See *A.E. Ames v. Sutherland, supra*.

For interest the reader may also want to see *Canarim Investment Corp. v. Jordan*, [1987] B.C.J. No. 1335 (C.A.), where the CLIENT was guilty of conversion!

95 An example of this would be where a client has deposited securities which he owns outright with the investment dealer as margin security.

96 *Buchan v. Newell* (1913), 15 D.L.R. 437 (Ont. C.A.).

97 See for example *Picavet v. Bache*, [1973] 1 O.R. 8 (C.A.) and the example cited at note 84 above.

98 *Halsbury's, supra*, note 75, (4th ed.) vol 28, at para. 516.

99 We have seen at note 20 that such a clause will exist in the margin agreements of Canadian investment dealers.

Apart from clauses in the margin agreement, the existence of a stockbrokers' lien is recognized in common law. In addition, the right to sell is recognized because it is a custom of the securities industry that there is a "superadded power of sale" with respect to client's shares in the investment dealer's possession.¹⁰⁰ Therefore, at common law, it is said that an investment dealer has a lien and the right to sell his client's securities when there is a default in payment. There has been some question as to whether the right of sale which attaches to an investment dealer's lien is also a statutory right, by virtue of the provisions of the Toronto Stock Exchange Act.¹⁰¹

Final resolution of these issues is important, as the answers determine whether margin clients have any rights under provincial Personal Property Security Acts (P.P.S.A.). The P.P.S.A.s generally apply only to consensual liens¹⁰², and statutory liens and those arising by rule of law (e.g., custom) are specifically excluded.¹⁰³ One notable Canadian case, *Jones v. Davidson and Partners Ltd.*,¹⁰⁴ suggests, on the grounds that the stockbrokers' right to sell is based on common law and custom (but not statute!), that the Ontario P.P.S.A. does not apply. However, this case deals with a cash account transaction (not a margin account), and it is a decision of an inferior court. The pertinent comments are contained in the obiter dicta of the judgment.

In the absence of a clear body of authority, it is an enlightening exercise to speculate how future decisions will deal with the stockbroker-margin client relationship with respect to the Personal Property Security Acts.

Because liens which have their foundation in statute or rule of law are not covered by the P.P.S.A.'s, there will be an inclination to presume that the custom-based stockbrokers' lien is excluded. However, we saw earlier that the stockbroker-margin client relationship is also based on a margin agreement. The presence of this contractual dimension may be sufficient to bring the client's pledge of securities within the realm of a

100 *Jones v. Davidson & Partners Ltd. supra*, note 72 at 257 per Parker A.C.J.H.C.:

Thus while common law liens are generally said to be possessory only, usage may justify recognition of certain liens with a superadded right of sale.

101 R.S.O. 1970, c. 465, s. 10, dealing with the powers of the Board of Directors of the Exchange, and more specifically *Toronto Stock Exchange By-Laws, supra*, note 10 at para. 803-319, By-Law 16.13, "Members' Rights to Customers' Securities re Customers' Indebtedness".

102 R.H. McLaren, *Secured Transactions in Personal Property in Canada*, (Toronto: Carswell, 1979) at I-25, I-51.

103 E.g. *Personal Property Security Act*, R.S.O. 1980, c. 375, as am. R.S.O. 1981, c. 2 and 58 (Bill 151, 1st sess. 34th Leg. 1989), [hereinafter OPSPA] and *Personal Property Security Act*, R.S.M. 1987, c.P35, s. 3(1)(a), [hereinafter PPSA].

104 *Supra*, note 72.

consensual lien. The margin contract expands the rights of the investment dealer beyond what they would have been at common law, therefore the potential exists for defining the relationship between the parties as consensual, and subject to the provisions of the provincial P.P.S.A.'s.

If this is accepted, we would say that we are dealing originally with a common law lien (which is excluded from the P.P.S.A.'s) that has been modified/overridden by a contract, thereby creating a consensual lien (which is within the scope of the P.P.S.A.'s). The determinative issue may be whether or not the stockbrokers' lien is also statutory, but this has not yet been resolved by our courts.

Presume that we have a consensual lien that at face value falls under the P.P.S.A. umbrella. The margin contract would be a "security agreement" as defined in the Acts, that is, it creates or provides for a security interest.¹⁰⁵ As stocks purchased on margin are always retained by the investment dealer until full payment is received, the security interest would be perfected by possession.¹⁰⁶

Falling within the provisions of the provincial P.P.S.A.'s would result in at least two consequences of potential concern for the investment dealer.

First, the security interest on margin account collateral would be subject to the general priority provisions of the Acts.¹⁰⁷ A margin client, instead of depositing cash, can settle his account with respect to a new purchase by delivering other stock certificates to the investment dealer. If the dealer accepts encumbered securities which are already the subject of a registered security interest, its possessory security interest will be subordinate.

The only possibility for avoiding this would be if the investment dealer is considered to have a "purchase-money security interest."¹⁰⁸ This is a security interest which is taken or reserved by the seller of the collateral to secure payment of all or part of its price, and it has priority over any other security interest.¹⁰⁹ Technically though, the investment dealer is not the "seller" of securities in the client's margin account; it has merely acted as an agent facilitating the transaction and is never the owner.

The second P.P.S.A. provision of concern relates to the rights and duties of the secure party upon default by the debtor. The settlement date for a margin account is the next business day, so default under the

105 *Supra*, note 103 s.1.

106 *Supra*, note 103 OPISA s. 22, PPSA s. 24.

107 *Supra*, note 103 OPISA s.30(1), PPSA s.35(1).

108 *Supra*, note 103 OPISA s.1, PPSA s.1.

109 *Supra*, note 103 OPISA s. 32(2), PPSA s. 34(4).

security agreement (margin contract) can occur as soon as two days after the transaction is completed. However, the P.P.S.A's state that at least 15 days prior to a sale of collateral the secured party must provide the debtor with a detailed written notice of the intended disposition.¹¹⁰ An investment dealer simply cannot comply with this requirement.

The Acts provide for several exceptions, but it is questionable whether the investment dealer-margin client relationship would be included in any of these. For example, notice by the secured party is not required when it believes on reasonable grounds that the collateral will decline speedily in value.¹¹¹ Case authority exists confirming that stock warrants would fall within this exception¹¹², but warrants are wasting assets which are notorious for their volatility. If the margined position consisted of Royal Bank preferred shares, the classification would not be as clear. Only the Ontario P.P.S.A. contains an adequate exclusion to cover this situation. It waives the 15-day notice by the secured party where the collateral is of the type customarily sold on a recognized market.¹¹³ A Canadian stock exchange would certainly be such a market.

(III) CONCLUSION

THE CANADIAN INVESTMENT INDUSTRY does not fall perfectly within the principles and doctrines that have been nurtured in England and the United States. The size of our industry, the profile of our clients, and the roles of the provincial and federal governments are examples of idiosyncrasies which will require Canada's legal system to reject some of the corresponding tenets from these other jurisdictions. As the investment industry continues to grow in size and importance, Canadian courts will inevitably develop precedents which have foreign foundations, but accommodate our uniqueness.

Some of the proposals in this study concerning the Canadian stance on particular issues are necessarily speculative. Reported case authority in many areas is sparse. One possible reason for this is that much of the English and American investment law is viewed by our system as logical and appropriate, and challenges to such ingrained principles are therefore stifled in the lawyer's office. It is also probable that regardless of the legal principles involved, most investment dealers strive to settle problems privately. In such a competitive industry as the retail investment trade, a firm will be hesitant to damage its reputation in the

110 *Supra*, note 103, OPSA s. 63(4) and 63(5), PPSA s.60(5).

111 *Supra*, note 103 OPSA s.63(7), PPSA s.60(5).

112 *Jones v. Davidson and Partners Ltd.*, *supra*, note 72.

113 *Supra*, note 103 OPSA s.63(7).

eyes of the investing public. The average claim by a retail client is typically small compared to the capitalization of the firm, and to the cost of advertising and promotion necessary to build and maintain client loyalties. The potential for making a worthy contribution to legal precedent is obviously not considered!

For one reason or another, disputes between Canadian investment dealers and their clients rarely become reported case law.¹¹⁴ More importantly, we can take comfort in the fact that of the hundreds of thousands of trades that occur daily in our investment markets, very few involve any dispute whatsoever.

A further clarification is in order concerning Canadian case law that has arisen from the investment dealer-client relationship. Certain firms appear to be named in reported actions much more frequently than others. This cannot be taken as a general reflection of the integrity of the firm or the efficiency of its compliance officers. A probable reason for the conspicuous presence of some (and absence of others!) in litigation is that several Canadian firms have historically emphasized the retail aspect of their business. The appearance of their names in case law captions is merely a statistical consequence of larger sales forces, and a greater volume of trading transactions. As in any service industry, none of the firms operate problem-free.

The complexities of investment markets themselves are paralleled by the distinct, yet inseparable intricacies of the relationship between the investment dealer and the client. Combining the inconsistency of market theories and approaches with the youthful stage of Canadian precedent in this field, it is clear that there is no such thing as an investment strategy with a pre-determined level of risk.

114 Letter from F.B. Lamont, former Chairman of the Investment Dealers Association of Canada, to the author of (January 25, 1989) [unpublished]. Mr. Lamont offered the following comment:

My experience on the settlement of clients' complaints is that there is usually fault on both sides when problems arise and frequently it is best to make some realistic sawoff and drive on, even if as a matter of law, there is one side with total responsibility if one were able to judge matters to the nth degree.