CITATION: Frayce v. BMO Investor Line Inc. et al, 2023 ONSC 16
COURT FILE NO.: CV-20-638868-CP
DATE: 20230120

ONTARIO
SUPERIOR COURT OF JUSTICE

B E T W E E N :

DENIS FRAYCE and MAXWELL WALLACE

Plaintiffs

- and -

BMO INVESTORLINE INC., CIBC INVESTOR SERVICES INC., CREDENTIAL QTRADE SECURITIES INC., DESJARDINS SECURITIES INC., HSBC SECURITIES (CANADA) INC., SCOTIA CAPITAL INC., and TD WATERHOUSE CANADA INC.

Defendants

Proceeding under the *Class Proceedings Act, 1992*

BEFORE: Justice Edward P. Belobaba

COUNSEL: *Paul Bates, James Sayce, John Archibald, Aryan Ziaie and Eli Waitzer* for the Plaintiffs

James D.G. Douglas, Ian C. Matthews and Adrian Pel for the Defendant BMO Investorline Inc.

Linda Plumpton, Gillian Dingle, Ryan Lax and Stacey Reisman for the Defendant CIBC Investor Services Inc.

Rahool P. Agarwal and Crystal Li for the Defendant Credential QTrade Securities Inc.

Linda Fuerst, Randy Sutton and Tyler Morrison for the Defendant Desjardins Securities Inc.

Mark Evans, Emma Irving and Ara Basmadjian for the Defendant HSBC Securities (Canada) Inc.

J. Thomas Curry, Paul-Erik Veel and Caroline Humphrey for the Defendant Scotia Capital Inc.

David Hausman, Vera Toppings and Mahdi Hussein for the Defendant TD Waterhouse Canada Inc.

HEARD: February 10, September 26 and 27, 2022 via Zoom video

Motion for Certification

[1] After more than 20 years of debate and discussion, the payment of mutual fund trailing commissions to discount brokers was prohibited in 2022. Canadian securities administrators concluded that it was one thing for mutual fund managers to pay such commissions to compensate full-service brokers for their time and effort providing actual advice about an investment's suitability. It was quite another to compensate on-line discount brokers who were already precluded from providing any such advice. The unjustified payment of trailing commissions to discount brokers (expensed to the mutual fund) arguably harmed mutual fund investors by reducing the value of their investment.

[2] These alleged losses have now generated two waves of class actions by unhappy investors: the first targeting the mutual fund managers for paying these trailing commissions to discount brokers[1] and the second, including this proposed class action, targeting the discount brokers for receiving such commissions.[2]

Background

[3] The prohibition against paying trailing commissions to discount brokers, also known as OEO ("Order-Execution-Only") or DYI ("do it yourself") brokers, was enacted in 2020 and took effect on June 1, 2022.

[4] Be that as it may, say the plaintiffs, the receipt of trailing commissions by discount brokers was illegal and exposed the discount brokers to damage claims long before the formal prohibition. In other words, the proposed class action against the seven defendant discount

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[1] *Stenzler v. TD Asset Management Inc*., 2020 ONSC 111.

[2] *Gilani v. BMO Investments Inc*., 2021 ONSC 3589.

brokers herein,[3] must be certified because even during the 20-plus years of discussion and debate, say the plaintiffs, the impugned practice was contrary to "applicable Canadian securities law."

[5] The defendants reject this characterization of the "applicable Canadian securities" regime and submit that over the 20-plus years of discussion and debate it was never suggested, and there is no evidence, that the receipt of trailing commissions by discount brokers was illegal or unlawful. It was not until December 19, 2019 that the Canadian Securities Administrators ("CSA") made clear in Staff Notice 81-332 that "the amendments to [NI] 81-105 Mutual Fund Sales Practices … would prohibit … trailing commission payments by fund organizations to dealers who do not make a suitability determination, such as order-execution-only (OEO) dealers" and further that this prohibition would take effect on June 1, 2022. Therefore, conclude the defendants, there is no basis in fact for the core allegation of illegality and for any of the proposed common issues. The motion for certification should be dismissed.

[6] I agree with the defendants.

[7] In my view, this motion for certification turns on the "some evidence" requirement as it relates to the proposed common issues or PCIs. I have attached a copy of the PCIs in the Appendix. The core issue is PCI-2 that asks whether the receipt of trailing commissions by the defendants (pre-2022) contravened any applicable securities law. The plaintiffs agree that if the answer to PCI-2 is "no" then there is no basis for the pleaded causes of action — breach of contract, negligence, unjust enrichment, knowing receipt and knowing assistance — and, I would add, no basis for any of the other common issues or damage claims. If the answer to the PCI-2 is "no", the proposed class action collapses and must be dismissed.

[8] The question for the court is whether the plaintiffs have adduced some evidence that the defendants' receipt of trailing commissions contravened Canadian securities law and was illegal even before the 2022 prohibition.

Analysis

[9] In my view, the plaintiffs can satisfy the 'some evidence of illegality' requirement in one of three ways.

[10] First, they can try to find a pre-2022 securities provision that clearly prohibited the impugned trailing commission practice and deemed it illegal or unlawful even absent the 2022 prohibition. Here, no such provision can be found.

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[3] The original claim issued in January, 2020 named 12 discount brokers as defendants but after an adjournment under s. 5(4) of the *Class Proceedings Act*, 1992, S.O. 1992, c. 6 ("CPA") and discussions between counsel, the named defendants were reduced to the seven herein.

[11] Absent such a provision, the plaintiffs decided to refer to several general standards of practice set out in the OSC and IIROC Rules[4] (such as "fair dealing" or "avoiding conflicts of interest") and argue that these provisions themselves amounted to a *de facto* prohibition of the impugned trailing commission practice. [5]

[12] The plaintiffs' primary focus was the conflict-of-interest provision. They pointed to numerous excerpts in the 20-plus years of studies and reports that commented critically on the "conflicts of interest" that can materialize when trailing commissions are paid in particular to full-service "advisory" firms. For example, the 1997 Stromberg Report noted that in the full-service advisory channel "some" people describe [trailing commissions] as simply "bribes to distributors" — basically, kick-backs paid to the distributor to promote and recommend the mutual funds that pay the most generous trailing commissions.

[13] Some of the commentaries also referred to the "conflicts of interest" that can arise in the OEO or discount broker channel. Here, however, the reasoning is less clear: if, as the plaintiffs agree, discount brokers cannot and do not provide "advice" or make recommendations about an investment's overall suitability (the on-line trading experience is computerized and there is no interaction with any actual human advisor) how and where does the suggested conflict of interest materialize in the OEO channel? An explanation from one of the plaintiffs' experts would have been helpful here but none was presented.

[14] The generalized admonition to avoid conflicts of interest, as argued by the plaintiffs, is also diluted by the plaintiffs' own evidence that simple disclosure was being advanced during the same time period by many of the same commentators as a sufficient antidote for the conflict-of-interest issue. The 1997 Stromberg Report, for example, noted and approved the call for "enhanced disclosure measures." Indeed, as the defendants correctly point out, it appears that many of the defendants' account agreements expressly disclosed the receipt and retention of trailing commissions.[6]

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[4] The Investment Industry Regulatory Organization of Canada ("IIROC") is a self-regulatory organization that oversees all investment dealers in Canada.

[5] Plaintiffs' counsel also referred to NI 85-105 s. 3.2(1)(a) which permitted the payment of trailing commissions if, among other things, "the obligation to make the payment arises after the time of the trade". That trailing commissions were paid "after the time of the trade" is not in dispute — indeed this point was confirmed by one of the plaintiffs' experts. However, argue the plaintiffs, these commissions were paid ostensibly to compensate for the "advisory" services provided by the recipient. No such advisory services were permitted in the OEO channel and thus no "obligation" ever arose to pay trailing commissions to discount brokers – ergo, any such payment was illegal. Respectfully, this interpretation of s. 3.2(1)(a) was not only resoundingly rebutted by the defendants, it rests on a circular reasoning that in essence begs the very question of "illegality" and the satisfaction of the "some evidence" requirement, both of which are discussed in detail below.

[6] The TD Waterhouse Canada Inc. Account and Services Agreement and Disclosure Statement in 2013 advised unitholders that "TD Waterhouse may receive various forms of compensation, including trailing commissions from

[15] The defendants also note that neither the "fair dealing" nor the conflict-of-interest provisions were ever used in any enforcement proceeding against any discount broker relating in any way to the receipt of trailing commissions.

[16] The "some evidence" problem facing the plaintiffs in their reliance on "applicable Canadian securities law" in the pre-prohibition era is therefore two-fold: (i) none of the "applicable" securities provisions on their face, or even reasonably interpreted, provide a logical connection to the conclusion that the discount brokers' receipt of trailing commissions was unlawful and is automatically voided for "illegality" — an expert's opinion, arguably connecting the fair dealing or conflict of interest provisions to a finding of overall "illegality", would obviously have assisted; but (ii) no such opinion was presented.

[17] The first two ways to satisfy the "some evidence of illegality" requirement — finding plain language in the pre-2022 securities law or filing an expert opinion logically connecting the referenced securities provisions about fair dealing or conflicts of interest to a finding of overall illegality in discount brokers' receiving trailing commissions — do not succeed for the reasons set out above.

[18] The third way to satisfy the "some evidence of illegality" requirement is via credible third-party studies or reports or even stakeholder correspondence that express the view that even before 2022 the receipt of trailing commissions by discount brokers genuinely contravened Canadian securities law. Here, as already noted, the plaintiffs tried to do this. They filed a lengthy lawyer's affidavit describing the 20-plus years of studies and reports and attaching relevant excerpts. It is important to note that the defendants filed no evidence.

[19] The only item in the plaintiffs' evidence that arguably comes close to satisfying the "some evidence" requirement about overall illegality is a November 9, 2016 letter to IIROC from Kenmar Associates, an investor-advocacy organization. In its four-page letter, Kenmar generally applauds the work of the discount brokers and the valuable service they provide. The letter then goes on to say this:

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issuers or other parties, which may include affiliates of TD Waterhouse. Such compensation may vary depending on the product, service or issuer, including where the issuer is an affiliate or a connected issuer to TD Waterhouse or the product or service is provided by an affiliate." The same agreement in 2022 stated that "TDWI earns commissions, including trailing commission, on certain investment funds you purchase (paid by investment fund managers)".

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> There is however one point that should be addressed by IIROC. These OEO providers do not provide personalized investment advice but are receiving trailer commissions, effectively not honouring the terms of the A class mutual fund Simplified Prospectus. This overcharging of clients is not consistent with dealing fairly honestly and in good faith with clients. Accordingly, we ask IIROC to enforce the law and sanction these firms, put an immediate end to the practice and provide for full restitution to investors who have been exploited.

[20] By asking IIROC to "enforce the law and sanction these firms", this letter provides some evidence that at least one stakeholder was of the view that applicable securities laws were being contravened well before the imposition of the 2022 prohibition.

[21] The problem, however, is this. The entirety of the 20-plus-year narrative, including the excerpts and submissions from the numerous stakeholders and commentators, was presented via affidavits filed by the plaintiffs. The defendants, as already noted, filed no evidence.

[22] In deciding whether the "some evidence" requirement is satisfied, the court is obliged to consider the entirety of the plaintiffs' evidence. It cannot pick one item that appears to favour the plaintiffs' submission and ignore the many other items (also in the plaintiffs' evidence) that undermine this submission. Where the plaintiffs file "some evidence" that is arguably germane (for example, the Kenmore letter) but this evidence is contradicted and negated by other evidence also filed by the plaintiff, the "some evidence" requirement is not satisfied.[7]

[23] Here, the plaintiffs filed a significant amount of evidence that contradicted and negated the submission contained in the Kenmore letter. I refer to the following:

- The evidence shows that the 20-plus years of discussion and debate was not about legality *per se* but whether, as a matter of policy, trailing commissions should be abolished entirely (i.e. in both the advisory *and* OEO channels). Ultimately, the CSA settled on a compromise — they continued to permit trailing commissions in the advisory channels but ended these payments in the OEO channel as of June 2022.

- The evidence also shows that the CSA afforded OEO dealers a transition period of approximately two years to adopt new compensation models for mutual funds sold

[7] I agree with the analysis in Kain, *Developments in Class Actions Law: The 2013-14 Term – The Supreme Court of Canada and the Still-Curious Requirement of 'Some Basis in Fact'*, (2015) 68 S.C.L.R. (2d) 77 that is set out at 132. Kain suggests that the "some evidence" determination permits a limited weighing of the evidence when "the cogency of the plaintiff's evidence in its own right … is contradicted by the plaintiff's other evidence …" This makes sense. If all the plaintiff can do is adduce some evidence (that the proposed common issue exists and can be decided on a class-wide basis) but this evidence is contradicted or undermined by the other evidence that is also presented by the plaintiff, then it cannot be said that the "some evidence" requirement has been satisfied.

through their platforms, which is not an accommodation that would have been made if the existing practice had been determined to be unlawful.

- The evidence shows that IIROC had embarked on its own process of putting rules in place governing the receipt of trailing commissions by discount brokers but this initiative was abandoned given the pending CSA amendments. The IIROC approach would not have prohibited the practice but would have limited trailing commissions to 25 basis points annually. This evidence, again provided by the plaintiffs, is inconsistent with the allegation that the defendants' receipt of trailing commissions was always illegal.

- The plaintiffs' securities regulation expert, Frank Allen, gave evidence that he was not aware of any "enforcement or compliance proceedings" by CSA members or IIROC against any discount brokers "in connection with their receipt of trailing commissions in respect of mutual fund securities held by their clients". Mr. Allen also confirmed that the amendments that took effect on June 1, 2022 are "forward looking and do not require discount brokerages to reimburse the funds that have been or will be received via trailing commissions."

- Doug Steiner, another of the plaintiffs' experts and a former CEO at E*Trade, a discount broker, agreed on cross-examination that the receipt of trailing commissions by discount brokers was not contrary to any law:

> Q. And while you were affiliated with the E*TRADE Canada business, you didn't consider that the receipt of trailing commissions by it was contrary to any law?
>
> A. That's correct.

[24] The defendants go on to note that from at least the year 2000, investment fund managers were required to disclose particulars of dealer compensation in simplified prospectuses qualifying the sale of mutual fund units. Under s. 53(1) of the *Securities Act*,[8] no mutual fund units can be sold to the public unless and until the manager has obtained a final receipt for the prospectus from the "Director" (in case of an Ontario mutual fund issuer, the head of the investment fund branch of the OSC or its delegate). After 2011, mutual fund managers were also required to prepare "Fund Fact" documents describing the essential features of mutual fund units in a simple-to-read format, including particulars of dealer compensation. The OSC Director was also required to issue a receipt for the Fund Facts document before mutual fund units could be sold.[9]

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[8] *Securities Act*, RSO 1990, c S.5.

[9] *Ibid.*, s. 61(1).

[25] Under paragraph 61(2)(b) of the *Securities Act* (and equivalent provisions of the securities laws of other Canadian jurisdictions), the Director must decline to issue a receipt for any prospectus (including a mutual fund prospectus) if it appears that "an unconscionable consideration is intended to be paid [in these cases, by the mutual fund manager] for any services or promotional purposes".[10] Yet, all of the mutual fund preliminary prospectuses and Fund Facts at issue in this action received receipts.

[26] Moreover, for a significant part of the proposed class period, investment fund managers distributed D-series mutual fund units, which generally paid reduced trailing fees and were designed specifically for sale through discount brokers. The distribution of D-series mutual funds suggests that the regulators concluded that this form of compensation payable to discount brokers was not illegal.

[27] In sum, a significant amount of the evidence filed by the plaintiff strongly supports the defendants' position that the practice of paying trailing commissions to discount brokers, although controversial and needing reform, was not illegal or unlawful until the law was changed effective June 1, 2022.

Conclusion

[28] The plaintiffs have not satisfied the "some evidence of illegality" requirement. The evidence filed by the plaintiffs — that suggests that the receipt of trailing commissions by discount brokers contravened applicable securities provisions and was illegal even before the June 1, 2022 prohibition — was rebutted by the bulk of the evidence, also filed by the plaintiffs, that suggested otherwise.

[29] Given the plaintiffs' failure to satisfy the "some evidence of illegality" requirement, there is no basis (as the plaintiffs have conceded) for any of the pleaded causes of action. Absent a viable cause of action, there is no basis for PCI-2 or indeed any of the other PCIs. Absent any common issues, there is no basis for a class proceeding and no need to even consider ss. 5(1)(b), (d) or (e) of the CPA. Nor is there any need to consider the defendants' additional submissions about limitations periods or their motion to strike certain affidavits.

Disposition

[30] The motion for certification is dismissed with costs.

[31] If the issue of costs cannot be resolved by the parties within 30 days, they should advise the court accordingly and either request more time or suggest a schedule for written cost submissions.

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[10] *Ibid.*, s. 61(2)(b).

[32] I am obliged to counsel on both sides for their assistance.

Signed: *Justice Edward Belobaba*

Belobaba J.

Date: January 20, 2022

Appendix – Proposed Common Issues

Regulatory Obligations

1. What is the purpose and effect of the Applicable Canadian Securities Laws as they relate to the payment and receipt of Trailing Commissions?
2. By receiving and retaining Trailing Commissions from the Class Members, did the Defendants contravene any of those Applicable Canadian Securities Laws?

Knowing Receipt / Knowing Assistance

3. Did the Mutual Fund Managers owe Class Members trust and/or fiduciary duties in respect of their investments in mutual fund trusts?
4. If the answer to Question 3 is yes, did the Mutual Fund Managers breach trust and/or fiduciary duties by paying Trailing Commissions to the Defendants?
5. If the answer to Question 4 is yes, did the Defendants' receipt of Trailing Commissions constitute knowing receipt?
6. If the answer to Question 4 is yes, did the Defendants knowingly assist Mutual Fund Managers in breaching their trust and/or fiduciary duties by their receipt of Trailing Commissions?

Breach of Contract

7. Did the Defendants' contracts contain obligations to comply with the Applicable Canadian Securities Laws?
8. Did the Defendants' contracts contain obligations to place Class Members' best interests ahead of the Defendants' interests?
9. Did the Defendants' contracts contain obligations to act in good faith?
10. If the answers to any of Questions 7, 8 or 9 is yes, did the Defendants' receipt of Trailing Commissions breach those obligations?

Negligence

11. Did the Defendants owe a duty of care to the Class Members who were their clients?

12. If so, what was the standard of care applicable to the Defendants?
13. Did the Defendants breach that standard of care? If so, when and how?

Unjust Enrichment

14. Have the Defendants been enriched by their receipt and retention of Trailing Commissions?
15. If the answer to Question 14 is yes, have the Class Members suffered a corresponding deprivation?
16. If the answer to Question 15 is yes, is there a juristic reason for the enrichment of the Defendants?

Aggregate Damages

17. If the Defendants are liable to Class Members, can an award of aggregate damages be made to Class Members?

Disgorgement

18. If the Defendants are liable to Class Members, are Class Members entitled to disgorgement of the Defendants' profits gained by their receipt of Trailing Commissions?

Punitive, Exemplary or Aggravated Damages

19. Does the Defendants' conduct justify an award of punitive, exemplary or aggravated damages?

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