AUGUST 26, 2024 • 5 MIN READ

Limits to gatekeeper obligations

AUTHORS

 Colette Koopman

 John A. Fabello

 Gillian B. Dingle

Securities registrants are required to act as "gatekeepers" of the capital markets[1]. This obligation, which transfers some market regulation responsibilities from regulators to registrants, carries risk for registrants. Unlike regulators who enjoy immunity from civil claims associated with the impacts of their enforcement efforts, registrants do not enjoy immunity; they can be subject to civil claims for complying with their gatekeeper obligations or enforcement action for allegedly failing to do so. As a result of this exposure, fairness dictates that there should be limits on a registrant's gatekeeping obligations.

On the civil front, courts have placed limits on when and how securities dealers may be liable to clients for damages associated with account freezes as a result of concerns that account activity may be in contravention of securities laws[2]. However, on the regulatory front, the recent trend has been to expand rather than limit regulatory expectations on registrants with respect to gatekeeping obligations. The decision in *Re Englesby and Nishimura* clarifies and places limits on a registrant's obligation to make inquiries as the first step in discharging gatekeeper obligations[3].

What you need to know

- **Registrants only need to inquire if there are "red flags":** Registrants with gatekeeper obligations only need to inquire if a situation raises what would be considered a red flag to a registrant acting as a duly diligent person. Registrants generally do not need to inquire if there are possible reasonable explanations for the conduct in question.
- **Three-step approach to determine compliance:** The regulatory test for assessing whether a registrant has complied with their gatekeeper obligations is comprised of these three questions:
    1. Could the activities at issue reasonably be considered a red flag requiring a registrant to make inquiries?
    2. Did the registrant make the necessary inquiries?
    3. Did the registrant act reasonably based on the information revealed from the inquiries?

The decision

Background

The Canadian Investment Regulatory Organization (CIRO) alleged that two registrants failed to fulfill their gatekeeper obligations because they did not make inquiries into conduct that should have raised red flags, namely:

- the deposit and sale of shares and withdrawal of large amounts of cash in short intervals;

- “uneconomic” trading (e.g., selling at a loss);
- trading out of line with recorded KYC objectives; and
- trading out of line with historical account activity[4].

In light of these alleged red flags, CIRO staff argued that the registrants should have made inquiries to satisfy themselves that this trading was not indicative of illegal activities: the registrants should have asked questions regarding how the clients obtained the shares, what the acquisition price was and whether the clients had a relationship with the issuer[5].

The registrants argued that one of the clients at issue was a consultant, and it was common for consultants to be paid in shares and subsequently sell them[6]. The trading at issue was done at a loss, but that alone did not give rise to a red flag on the basis that it should be considered trading for no legitimate purpose (i.e., uneconomic trading). Further, any trading that was inconsistent with Know Your Client (KYC) objectives might represent a failure to update objectives, but a change in net worth alone should not be seen as a red flag requiring inquiry[7].

Issue

The CIRO panel outlined that when faced with alleged breaches of gatekeeper obligations, three steps must be considered. First, a panel must consider whether a person who is active in the investment industry, serves a gatekeeper role, and is duly diligent might reasonably consider the event at issue to require inquiries[8]. If the panel concludes that inquiries are required, it will then consider whether the registrant made the necessary inquiries from all reasonably available sources of information[9]. Finally, if reasonable inquiries were made, the panel will consider whether the registrant acted reasonably based on the information uncovered[10].

Outcome

The panel found that each of the alleged red flags had a reasonable possible explanation and therefore would not have triggered a duly diligent registrant to make further inquiries[11]. For example, the fact that shares were sold at a loss could be explained by the client seeing that the price of the shares was falling and wanting to sell the shares before their price fell further[12]. It was also normal for consultants to be paid in shares and subsequently sell them, and a change in profession could result in changes to KYC information. Overall, the panel agreed with the registrants that an investment advisor active in the investment industry and reasonably diligent would not have considered any of these to be red flags requiring further inquiry.

FOOTNOTES

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

For permission to republish this or any other publication, contact Janelle Weed.

© 2025 by Torys LLP.

All rights reserved.