

May 12, 2012

Tyler Fleming Director, Stakeholder Relations and Communications
401 Bay St. Suite 1505,
P.O. Box 5 Toronto ON M5H 2Y4
Fax: 1-888-422-2865
Email: publicaffairs@obsi.ca

Proposed changes to suitability assessment and loss calculation

http://www.obsi.ca/images/document/up-Consultation_Paper_May_2012_FINAL.pdf

We are pleased to respond to OBSI's Consultation request.

We believe the term " Unsuitable investment " should be well defined. Specifically, is the investment to be assessed as a stand-alone investment or as part of the integrated design of a portfolio tailored to an investor's risk-return profile and KYC? As we understand it, the general approach is that each investment recommended must be suitable on a stand-alone basis, a transaction-based framework. OBSI should be absolutely clear on what framework they consider the definition of a unsuitable (or suitable) investment to be.

Our first comment relates to the use of the term "advisor". We believe only the actual registration title should be used in the document. In the vast majority of cases this is " Dealer Representative" (before NI31-103 , it was "salesperson") .

In our experience, problems often arise because some Representatives have not informed themselves as fully as they should have about their clients' personal situations (KYC), the features, costs and T&C's of the investments they have recommended (KYP) and how those two investigations should be applied to the client's situation (suitability).

A recent Guest Column(IE , May 2012 *Whose responsibility is suitability?*) by lawyer Harold Geller observed: " *Clearly, the advisor and the dealer jointly bear the responsibility to recommend an appropriate match between the product and the client. Despite widespread investment industry misunderstanding to the contrary, suitability analysis is never the responsibility of the client. IIROC Rule 1300.1(q) requires that both dealer and advisor, "when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer." MFDA Rule 2.2.1 is similar. Nowhere is this obligation for ensuring suitability imposed on the client - even in the case of unsolicited orders.*" The article continues:

Kenmar Associates
Investor protection and education

*"This debate effectively ended in Canada when the **Alberta Securities Commission** declared (in *Re Lamoureux*, 2002) that the responsibility for ensuring suitability rests solely on advisors and dealers: "The obligation to ensure that recommendations are suitable or appropriate for the client rests solely with the registrant. This responsibility cannot be substituted, avoided or transferred to the client, even by obtaining from the client an acknowledgment that they are aware of the negative material factors or risks associated with the particular investment." This decision has been adopted extensively, including in the decision of the Ontario Securities Commission in *Re Daubney*, 2008, and that of IIROC in *Re Gareau*, 2011.*

Advisors and their firms have every right to protect themselves from a liability finding by clearly establishing that they have met the suitability standard. The best way to do that is to be thorough in carrying out the suitability obligation and by fully documenting that process. It is this process, not the result, that advisors must answer for. Indeed, it can be argued that the intentional denial of a regulatory obligation, such as the suitability obligation, is itself a breach of both the regulation and the civil duty of care owed to the client."

OBSI proposes the following changes to their suitability and loss assessment process (our comments are in parentheses) :

- 1. Use common indices as performance benchmarks in most suitable performance comparisons.** [We agree with using common benchmarks or if a financial plan has been prepared, the percent return target of the plan. Note that performance benchmarks are quite distinct from risk benchmarks. This process implicitly implies that notional portfolio modeling has a place in OBSI's loss calculation toolkit. We concur with that approach.]
- 2. Take fees and trading costs into account in all cases when making suitable performance comparisons.** [High fees, sales loads and trading costs should be taken into account when making comparisons.]
- 3. As a general rule, add interest on compensable losses only if an Investigation Report (a final report where we recommend compensation) is issued, but not add interest on facilitated settlements. Generally, interest on recommended compensation would be calculated from the date the investor complained to their firm and is intended to compensate the investor for not having access to the compensation during lengthy delays in resolving the complaint.** [We agree with this.]
- 4. Implement a self-imposed limitation period of six years from the time when we believe the investor knew or ought to have known there was a problem with their investments.** [We agree with this.]
- 5. Provide firms with working versions of our loss calculation spreadsheets during our investigation. Disclosure should not be limited to dealers.** [Whatever

Kenmar Associates
Investor protection and education

information is provided to dealers must be provided simultaneously to the complainant.]

We have some additional comments on topics directly related to suitability assessment and loss calculation:

NAAF/KYC : Dealers and dealer Representatives follow widely different KYC information collection processes ranging from minimal with little discussion to extremely detailed and formally communicated. Sometimes, the Rep inaccurately documents the client's KYC information on the KYC form. By gathering other information and documents OBSI is able to form the most fair and reasonable view about the accuracy and reliability of the documented KYC information. Considering information and evidence in addition to the KYC form to determine an investor's KYC information is consistent with the approach taken by regulators and the courts . It should be noted that the investment industry does not have a standard NAAF form and terminology is all over the map.

Interviews : Complainant Interviews are a crucial part of the evidence collection process. given the many known deficiencies of the NAAF/KYC process. Such interviews often provide additional important information that needs to be considered to accurately assess personal circumstances. The topics we've found the most valuable include but are not limited to:

1. the dealer's marketing materials provided and the Title /professional qualifications used by the Rep
2. the recorded KYC information and the process used to collect and discuss it (and whether the complainant was provided a signed copy);
3. any documents or information that appear to support or conflict with documented NAAF/ KYC information for each account;
4. the investor's personal and financial circumstances, including age, employment status family circumstances, income, net worth, and how these circumstances may have changed over time;
5. the investor's investment experience , analytical skills,and knowledge; some dealer Account Agreements state that an investor has *medium* experience if they've previously invested in mutual funds!
6. the investor's financial goals and requirement, income needs , liquidity requirements , tax status and time horizon for each account in question; as OBSI reports a disproportionate number of complaints from seniors , we recommend that the loss calculations take into account the complainants age.
7. the investor's informed willingness and demonstrated financial capability to take risks and absorb losses;
8. the Rep's recommendations and the reasons for them and the representations the Rep made about the recommended investments; and

Kenmar Associates
Investor protection and education

9. the information the Rep provided to the investor, the manner in which it was provided and the investor's understanding of it

For some seniors , internet-challenged and the infirm/disabled ,OBSI should be prepared to make a home visit. If OBSI records the interview, the complainant should be notified in advance.

Risk Ratings : We do not agree with OBSI continuing to analyze mutual funds using the risk ratings in the simplified prospectus because we believe it is not fair to do so given that (a) the prospectus provides a listing of risks that is not captured by the standard deviation based 5 element risk rating. Risk and uncertainty in stock markets : *Standard deviation does not equal Risk !* <http://www.moneysense.ca/2012/05/03/risk-and-uncertainty-in-stock-markets/?link> "Risk is what you have when you're playing poker .There are a known number of outcomes with 52 cards, and the probabilities can be mathematically calculated. You can't do that with markets. There is an infinite set of possibilities, so it is a completely different animal. Risk has the connotation that there is some kind of control there. But even with indexing, there isn't that control. You get whatever the market gives you." The takeaway message is that standard deviation can't model uncertainty".We've been saying this for over two years re Fund Facts PLUS a lot more and (b) neither the Prospectus or Fund facts is available to the investor at the time of purchase. The OSC has recognized that changes are required in the FF risk disclosure and are taking remedial measures.

Disclosure : Disclosure on the part of the Rep does not make an otherwise unsuitable investment, suitable. If a recommendation is unsuitable for an investor, it remains unsuitable even if the Rep provided the client with full disclosure of the risks and characteristics of the investment. In most cases the investment knowledge and experience of most retail investors is inadequate to make an informed decision. That's precisely why they seek advice. National Instrument NI 31-103 states that the "*registered representative is responsible for the advice given. In providing this advice, the registered representative must meet an **appropriate standard of care**, provide **suitable investment recommendations** and provide **unbiased investment advice**".*

Document availability : Any dealer documents used by OBSI to negate a claim should be made available to the complainant for review.

Mitigation : We agree that once an investor is fully aware that his or her investments are unsuitable , they have the obligation to take steps to minimize their losses. However, if the Rep maintains the investment is suitable, does not recommend sale or worse , recommends retention, the obligation should be dismissed. This is because the typical financial consumer does not have the knowledge, skill , information or tools to perform a suitability assessment. In many cases there are costs for liquidation such as early redemption fees in mutual funds or brokerage commissions .In these cases, OBSI should make these costs part of the loss calculation. Dealers that do not prepare Investment Policy Statements and/or provide personal rates of return for accounts make it very

Kenmar Associates Investor protection and education

difficult for retail investors to determine whether or not an investment is unsuitable

Related Suitability Issues : Loss Capacity, income tax issues and liquidity are particularly important suitability issues especially for seniors. Loss Capacity is the ability to with-stand and recover from a bear market. It is primarily determined by age,health, income/expenses, time horizon and level of savings/net worth. It is not the same as Risk tolerance. Leveraging adds significant risk to a portfolio and undue risk , if such loans are unnecessary or excessive ; it should also be a factor in OBSI's suitability determination(s) independent of the financial products purchased.

What's compensatable , what's not:

OBSI should publicly clarify for investors which elements of financial loss are subject to compensation and which are not- for example :

- Actual investment losses due to unsuitable investments or other causes
- Excessive or unnecessary fees paid
- Early redemption penalties or broker fees to exit unsuitable investments
- Interest charges for *unnecessary* margin or loans to make unsuitable investments
- Excessive* sales commissions (buying the expensive series of a fund rather than a cheaper version)
- Undue income tax liabilities/penalties as a result of churning or unsuitable investments
- The costs associated with preparing the claim/complaint
- Opportunity costs /losses
- Consequential damages resulting from unsuitable investments or undue leveraging

Limitation Period Time Clock: OBSI should clarify more precisely, at what point(s) in the complaint process the statute of limitations time clock is stopped and restarted.

We add parenthetically that if commercially available suitability software were made mandatory by regulators , the number of complaints would dramatically fall.

Overall, we find, with the exceptions noted, the proposed changes to the suitability process to be fine. In fact , OBSI's process is far more robust and detailed than the vast majority of investment dealers. The changes , with the exception noted, to the loss calculation methodology are acceptable. Here too , the transparency , rigor and fairness are significantly better than the methodology used by the industry and other Ombus services, especially the use of notional portfolios.

Kenmar Associates
Investor protection and education

We would welcome an opportunity to meet with you and discuss this critical issue.

Should you wish to disclose or post this letter on your website, permission is granted.

Sincerely,

Ken Kivenko P.Eng.
President, Kenmar Associates
kenkiv@sympatico.ca
(416)-244-5803

cc

Mr. Doug Melville
Ombudsman and CEO, Ombudsman for Banking Services and Investments
401 Bay Street, Suite 1505, P.O. Box 5
Toronto, ON M5H 2Y4
dmelville@obsi.ca