January 31, 2022

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Dear Sirs/Mesdames:

Re: Request for Comment on the Independent Evaluation of the Ombudsman for Banking Services and Investments with respect to Investment-Related Companies ("Request for Comment")

The Private Capital Markets Association of Canada ("**PCMA"**) is pleased to provide our comments in connection with the Request for Comment as set out below.

About the PCMA

The PCMA is a not-for-profit association founded in 2002 as the national voice of the exempt market dealers ("**EMDs**"), issuers and industry professionals in the private capital markets across Canada.

The PCMA plays a critical role in the private capital markets by:

- assisting hundreds of dealers and issuer member firms and individual dealing representatives to understand and implement their regulatory responsibilities;
- providing high-quality and in-depth educational opportunities to the private capital markets professionals;
- encouraging the highest standards of business conduct amongst its membership across Canada.
- increasing public and industry awareness of private capital markets in Canada;
- being the voice of the private capital markets to securities regulators, government agencies and other industry associations and public capital markets;
- providing valuable services and cost-saving opportunities to its member firms and individual dealing representatives; and
- connecting its members across Canada for business and professional networking.

Additional information about the PCMA is available on our website at www.pcmacanada.com.

Response to Request for Comment

This letter presents the PCMA's position only with respect to certain inquiries set out in the Request For Comment. Our comments are those of the PCMA only and are not representative of any specific member of the PCMA. To avoid duplicative presentation of information, we have consolidated our responses to multiple questions under single headings where appropriate.

Background on Retail EMD Firms and the Private Capital Markets

In order to adequately respond to the Request for Comment, we have to contextualize the type of EMD firm whose interests are being represented in our commentary. The exempt market (or "private capital market") is a broad, diverse and innovative part of the Canadian capital markets. From the perspective of being defined by regulation, the "exempt market" merely refers to the mechanism of acquisition of securities by investors; but this alone does not adequately define the space and the stakeholders whose concerns are often not heard. For the purpose of this response letter, our intent is to speak on behalf of registered EMD firms that interact with retail and non-institutional high net worth investors by facilitating the distribution of private, non-reporting issuer and fund securities under the offering memorandum or accredited investor exemptions found in National Instrument 45-106 *Prospectus Exemptions* (**NI 45-106**) (**retail EMDs**).

Retail EMDs include (i) "independent dealers" that primarily distribute the securities of third-party issuers, and (ii) "captive dealers" that primarily distribute the securities of connected and related issuers such as mortgage investment entities, private equity funds and private REITs. The Canadian Securities Administrators (CSA) National Registration Database suggest that there are over 800 registered EMDs in Canada, compared to 88 MFDA member firms[1] and 174 IIROC member firms[2]. From the perspective of Ombudsman for Banking Services and Investments (**OBSI**) participation as of 2020, these numbers are 248, 170 and 98, respectively.[3]

Unless they are also part of a large financial institution umbrella organization, retail EMDs are almost universally smaller than their IIROC and MFDA counterparts in terms of their number of registered representatives, revenues and profits. Unlike IIROC and MFDA member firms, the retail EMD market is made up of a large number of small and operationally diverse participants. This reality is in contradiction to the myth that all investment dealers are large, wealthy and powerful corporations. Instead, the majority of EMDs are run by entrepreneurs and small business-owners that are not dissimilar to the client investors they serve. Recognizing this difference is fundamental to understanding how OBSI processes and rules impact these organizations differently than they do IIROC firms, MFDA firms and banks that perhaps better represent the stereotypical financial services corporation.

OBSI Governance, Independence and the Standard of Fairness

It is impossible to separate our comments regarding OBSI governance from our comments on its independence and observance of a standard of fairness. This is largely due to our belief that the characteristics that make retail EMDs unique are poorly understood at the highest levels within OBSI and this trickles down to every facet of their engagement with participating retail EMDs and complainants.

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[1] https://mfda.ca/mfda-2021-annual-report/pdfs/MFDA_AR_2021_online.pdf
[2] https://annualreport.iiroc.ca/2021/industry-profiles.html#dealers
[3] https://www.obsi.ca/en/news-and-publications/resources/AnnualReports-English/Annual-Report-2020---EN.pdf

According to the OBSI's 2020 annual report, there are more than 1,400 financial institutions and firms participating in the OBSI dispute resolution process. However, only 381 (IIROC at 170; MFDA at 98; and CBA at 113) are represented at the OBSI's top governance level through the 3 nominee-appointed Industry Board members. Perplexingly, the two largest categories of participating firms (Portfolio Managers at 692; and EMDs at over 248) are entirely without representation.[4] In addition, EMDs are the only category that has increased in participant representation every year since 2016.

The ability for OBSI to have a fair and meaningful governance structure is negatively biased by its preferential treatment of a small group of powerful investment industry participants. Particularly, among retail EMDs where business sizes, models and asset classes can be markedly different from those found in the traditional IIROC or MFDA space, adequate representation at the OBSI Board level is needed to ensure that the retail EMD industry is understood and that OBSI remains accountable to these stakeholders.

The Memorandum of Understanding (**MOU**) between certain members of the CSA and OBSI states that OBSI should "provide impartial and objective dispute resolution services that are *independent from the investment industry*, and that are based on a standard that is fair to both Registered Firms and investors *in the circumstances of each individual complaint"* [*emphasis added*]. Further, the MOU states that "when determining what is fair, OBSI should take into account *general principles of good financial services and business practice*" [*emphasis added*].

The PCMA is concerned that a proper understanding of fairness in the circumstances of an EMD-based complaint, together with an understanding of general principles of good financial services and business practices within the retail EMD space, cannot be achieved without a governance structure that gives fair representation to small business EMDs at the board level - independent from bias that favours large IIROC, MFDA or bank business models.

Since 2017, OBSI's annual reports show that a total of 41 EMD cases have been closed by OBSI, of which only 3 were resolved in favour of the complainant (and an additional 2 that resulted in refusal of OBSI's recommendation); and yet EMDs overwhelmingly express dissatisfaction with the OBSI process despite this relatively low success rate by complainants. Understanding why this is should be a priority for OBSI. Anecdotally, the PCMA has been advised of protracted disputes between EMD firms and OBSI representatives during the complaint resolution process due to perceived misunderstandings of their industry and offerings as well as the comparatively "high stakes" nature of the complaints when taken within the context of their size of operations. Unlike with many IIROC and MFDA member firms, retail EMDs may live or die by an OBSI award recommendation.

It should be alarming to OBSI and the CSA that in 2020 only two refusals to compensate were published and both were from EMD firms. So, while the 8 EMD case closures amounted to less than 2% of the total case closures for investment firms of all types, these EMD cases made up 100% of the refusals to compensate. Some might try to construe this as an indictment of the EMD industry at large, except that this is contradicted by the fact that a mere 8 of more than 248 participating EMD firms (3.2%) were subject to an OBSI complaint in 2020 compared to 72 of the combined 268 IIROC and MFDA member firms (26.9%). Instead, the PCMA implores the OBSI to see this data for what it is: statistical evidence that the OBSI process is not working for retail EMD market participants.

[4] https://www.obsi.ca/en/news-and-publications/resources/AnnualReports-English/Annual-Report-2020---EN.pdf

The one-size-fits all approach taken by OBSI with respect to its operational processes does not reconcile with the typical EMD business model and is representative of unconscious board-level bias toward "traditional" financial services. While we acknowledge that traditional litigation processes can be costly, we would fundamentally disagree that OBSI complaint resolution processes are superior in fairness and rule of law to court-based litigation where rules, evidentiary standards and legal doctrines are upheld equally as against all parties. Admittedly, this can break down when there is a significant financial mismatch and power differential between the complainant and the responding firm. While this may be the case with large multi-billion dollar organizations (like those whose representatives sit as industry nominee members on the OBSI board), it is not the case with the majority of retail EMD firms. It's worth noting that both of the retail EMD firms that refused OBSI recommendations in 2020 ceased operations within the same year.

For most retail EMDs, the power differential between clients and firms is minimal, and in some cases may even favour high-net worth complainants whose financial resources outstrip those of the EMD firms with whom they engage. In order to oversee EMDs fairly, with independence from the financial services industry and with an understanding of business practices applicable to the retail private capital markets, OBSI's governance model must give fair representation to small businesses and consider the impacts of OBSI policy on these firms' ability to compete in the financial markets.

a) To what extent does OBSI's governance structure allow OBSI to provide fair and meaningful representation on its board of directors and board committees of different stakeholders?

OBSI's board of directors structure favours IIROC, MFDA and banking participant firms by granting them Industry Director nominee rights. This biases OBSI governance toward traditional and large financial services providers creating a competitive disadvantage for small firms, innovative structures and specifically retail EMDs and portfolio managers.

b) To what extent does OBSI's governance structure promote accountability of the Ombudsman?

OBSI accountability appears limited to a small group of powerful stakeholders, including regulators, investor advocates, IIROC firms, MFDA firms and banks. Since other stakeholders, such as EMDs, are unrepresented, there is no accountability to them.

c) What, if any, changes would you recommend to OBSI's governance structure and why?

OBSI's governance structure should be equally weighted between industry (theoretically pro-industry), regulatory (theoretically neutral) and investor advocate (theoretically pro-investor) members. Industry members should be representative of the greatest possible breadth of financial service provider in Canada, including retail EMDs and portfolio managers.

d) To what extent is OBSI's dispute resolution service impartial and objective? Are the standards used by OBSI fair to both parties?

OBSI services are generally pro-investor, including a general belief that OBSI personnel are advocating on behalf of complainants absent concrete evidence to the contrary. Absent concrete evidence to dismiss a complaint, it is believed that OBSI processes are not impartial and objective, essentially creating a reverse-onus dispute resolution service. Legal academics have consistently raised concern over reverse-onus laws.

e) In determining fairness, to what extent does OBSI take into account good business practice and relevant laws, regulatory policies, guidelines, professional standards and codes of practice or conduct?

Due to its representative structure, OBSI's approach to good business practice, relevant laws, policies and guidelines appears structured around the business models of those stakeholders that have board nominee representation. The concept of fairness requires context that cannot be found without enhanced dialogue with other industry members.

Processes to Perform Functions on a Timely and Fair Basis, and Core Methodologies

The OBSI process is described as being difficult by many retail EMDs as a result of two distinct, but related characteristics of nearly all private capital investments: they are relatively illiquid and are therefore extremely hard to value until they have "exited" and paid out. While mutual funds have a stated and reliable interim net asset value, and publicly traded securities have daily ascertainable market prices (by virtue of the simple fact that a "market" exists), many private capital investments have unknown values and cannot be liquidated by complainants to create concrete and knowable damages as a foundation to their complaint. This may seem innocuous, but is very problematic to the OBSI process.

In the case of suitability or product due diligence complaints, this illiquidity-driven inability to value the investments results in binary outcomes for retail EMD firms. The EMD will either be successful in their defense of the complaint, or OBSI will presume a 100% loss of capital from the subject matter investment in order to quantify losses. This is why OBSI proceedings relating to suitability complaints are extremely high stakes for most retail EMD firms. If unsuccessful in their defence of the complaint, the retail EMD firm will be responsible to recompense the complainant on the basis of a presumed (yet unproven) 100% loss. We note that this can be approached through recommended acquisitions of subject securities by the EMD firm, however the total cost to the firm is unchanged.

The dramatic impact of this approach to awards in the retail EMD space can be seen in OBSI data. The median investment compensation award in 2020 for all investment industry participants was $2425 and the average was $9250.[5] By comparison, the two EMD firms that refused compensation had recommended award amounts of $50,810 and $33,055, respectively, while the only other recommendation for an award in the EMD space (which was paid to the complainant) was $85,804.[6] This means that the median award amount for EMD firms was $50,810 (2000% higher than the investment industry median) and the average award was $56,566 (600% higher than the investment industry average). To contextualize the impact of these recommendations, an EMD's required excess working capital under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) is $50,000: less than each of the median and average awards amounts. Failure to maintain adequate working capital can result in suspension or termination of registration, so a firm choosing to accept the recommendation may be choosing to put itself offside of NI 31-103 working capital requirements.

We find ourselves in a situation where retail EMDs are being systematically subjected to the highest payout risk from an OBSI complaint, while simultaneously being the most operationally vulnerable to high

[5] https://www.obsi.ca/en/news-and-publications/resources/AnnualReports-English/Annual-Report-2020---EN.pdf
[6] https://www.obsi.ca/en/news/highrisk-exempt-market-securities-unsuitable-for-older-investor-with-limited-assets.aspx

awards by virtue of their small size. Retail EMDs do not have capital reserves to voluntarily pay large settlement amounts where they disagree with the recommendation. In fact, what OBSI may not recognize is that during the dispute resolution process, they may not even be negotiating with the EMD firm itself, but rather indirectly with the EMD's insurers - many of which will not make payouts without first exhausting their rights to due process through a court of competent jurisdiction. While investor advocacy groups may erroneously believe that this could be remedied by granting binding recommendation powers to OBSI, we believe that binding authority would instead result in the majority of retail EMDs becoming uninsurable and 2020's already unenviable record of award recommendations resulting in disappearances of firm being repeated, if not exceeded. Special consideration must be given to the fact that other investor clients of the defunct firm would no longer have the ability to pursue OBSI (or other) dispute resolution services and this would not be in the public interest.

OBSI should consider whether or not its one-size fits all approach is appropriate. Retail EMDs are not like IIROC firms, MFDA firms, portfolio managers or banks. Certain complex complaint types (including suitability and product due diligence complaints) should not fall within the purview of OBSI for retail EMDS and the award cap of $350,000 should be lowered for small firms of any type. Investment dealer firms know that they cannot treat all clients the same, and yet OBSI processes treat all firms the same - from the smallest EMD to the largest bank.

a) Putting aside OBSI's decisions themselves, do you think OBSI has established processes that are demonstrably fair to both parties? Why or why not? Do both parties have an opportunity to be heard? Are there consistent and clear communications from staff?

With respect to retail EMD complaints, the nature of the private investment products do not lend themselves to the OBSI approach. Where extremely complex valuation and suitability cases are raised as core to the complaint, OBSI's processes (which lack evidentiary standards and mutual rules) are not fair to industry members. In addition, the compensation amounts are significant to small firms and retail EMDs, so depriving them of formal legal process shifts the balance of power too far in favour of complainants.

b) Why do you think some firms refuse to compensate consumers in the amount recommended by OBSI or at all when a positive recommendation is given by OBSI?

With respect to retail EMD's and small business firms, we suspect that the reasons for refusal are unique. Our belief is that refusals to compensate fall within one or more of the below categories:

(i) The firm disagrees with the OBSI recommendation and wishes to exercise their legal rights to a litigation hearing through the use of established rules, evidentiary standards and legal doctrines (a key example of this is limitation laws, which are incongruous between provincial statute and OBSI policy);
(ii) the firm disagrees with OBSI's loss valuation due to the illiquid nature of the subject matter investments;
(iii) the firm's insurers will not pay out for a recommendation that includes asset acquisition by the firm, and the firm lacks the resources to self-fund the entire settlement amount without breaching regulated working capital requirements;
(iv) the firm's insurers will not pay out until they have had the full ability to defend a claim in accordance with the policy of insurance;

(v) the firm cannot afford the recommendation can only offer settlement amounts below the recommended amount however the complainant has now anchored their expectations to the OBSI recommendation.

c) Should the $350,000 limit on OBSI's compensation recommendations be increased?

We do not believe the $350,000 limit should be increased for retail EMDs, but will not comment on whether or not it is appropriate for other investor firms and/or financial institutions. Conversely, we believe this amount should actually be lowered for certain firms to either align with small claims court limits or be set to a sliding scale that is representative of the differences in financial assets between firms of various size.

We note that the median and average award recommendations by OBSI have remained below 3% of the current $350,000 limit for the last 4 years and only once in that time period has the $350,000 limit been utilized. Based on this data, it is extremely unclear why OBSI needs to be able to assess complaints in excess of these amounts unless it is being done to favour large organizations for which the increase would be immaterial and thereby grant them greater protection from small, scaling or new-market entrants.

d) What powers do you think OBSI should have and, specifically, do you think OBSI should have the authority to issue binding decisions?

The PCMA generally believes that OBSI should not have the authority to issue binding decisions because doing so takes away the legal rights and due process afforded under common legal doctrines. At minimum, any binding authority should be significantly limited in scope to simple matters that do not require the consideration and evaluation of significant amounts of evidence, determinations of credibility, or other matters of complexity. Essentially, OBSI binding authority should never extend beyond the standards applicable to a summary judgment application under traditional litigation.

Conclusion

Through dialogue with our constituent members, the PCMA has identified serious concerns about current OBSI processes being appropriate for retail EMD firms. These concerns are supported by OBSI's own data, and we are grievously worried about the impact of the current push to expand OBSI's powers and scope. Political discussion, even from within the CSA, indicates a desire to increase competitiveness within the Canadian financial marketplace, but we fear that OBSI and its processes are being used as a tool to inhibit competition and preserve the advantage held by large corporate participants. An anti-competitive environment is anathema to innovation and does not benefit Canadian investing public. Small business firms and retail EMDs must at minimum be represented at the OBSI board level to help steer policy, and OBSI processes should be altered to accommodate the differences between firms and industries rather than leveraged as a tool to preserve the monopolies of large financial services firms.

We thank you for the opportunity to provide you with our submissions and would be please to discuss this with you further at your convenience.

Yours truly,

PCMA
Private Capital Markets Association of Canada