OMBUDSMAN
for Banking Services and Investments | des Services Bancaires et d'Investissement

May 10, 2012

Summary of Public Comments Relating to OBSI's Suitability and Loss Assessment Process, and Request for Comments on Proposed Changes

In the majority of investment complaints we receive each year about advice-based accounts, investors complain that they received poor advice, their investments or investment strategies were unsuitable and/or that their investments did not perform as they expected. In such 'suitability' complaints, investors ask to be compensated for the investment losses they incurred.

On May 26, 2011, OBSI issued for public comment a consultation paper detailing our suitability and loss assessment process. Twenty-one comment letters were submitted from investors, participating firms, industry associations, and other interested stakeholders. All comment letters have been posted on OBSI's website.

This document summarizes a number of enhancements to our suitability and loss assessment process that OBSI's Board of Directors proposes to implement. It also discusses key issues raised during the comment period.

OBSI has found the consultation process to be very helpful and we thank all stakeholders who participated for their feedback. Not only have we been able to identify opportunities for improvement, it has also given us the opportunity to clarify our approach. For example, we have been able to clarify that collecting and considering other information relative to the documented KYC information is only necessary when the KYC information is in dispute or is in question because it is misaligned with the investor's personal and financial circumstances. When there is no dispute or misalignment, we accept the documented KYC information and use it as a basis for the suitability assessment.

The objective of OBSI's methodology is to reasonably estimate an investor's compensable losses, if any, in a way that is as accurate and fair as possible and that minimizes '20/20' hindsight. For example, we specifically focus our calculations on unsuitable investments to minimize interference with the advisor's suitable recommendations. We always use historical data for the relevant time frame for our suitability assessments and suitable performance comparisons (also referred to as 'notional portfolios') so our assessments are made on the information that pertained at the time. Our methodology also contemplates a range of options, some of which involve using suitable performance comparisons and some of which do not.

As we noted in the consultation paper, there are many different possible approaches to calculating financial harm where an investor was unsuitably invested. Among firms, there is also a wide variety of alternative approaches in use. We have given them all careful consideration.

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Based on the comments received and a review of approaches used by Ombudsmen in other jurisdictions, we are proposing to make some improvements to our calculation methodology. For example, we propose to use indices for most suitable performance comparison calculations to reduce subjectivity and increase predictability and efficiency in these calculations.

Further discussion of this and other issues raised can be found in this document. A complete summary of stakeholder feedback is provided on our website.

PROPOSED CHANGES FOR PUBLIC COMMENT

OBSI proposes the following changes to our suitability and loss assessment process:

1. Use common indices as performance benchmarks in most suitable performance comparisons.
2. Take fees and trading costs into account in all cases when making suitable performance 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.
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.
5. Provide firms with working versions of our loss calculation spreadsheets during our investigation.

While we already provide frequent staff training, several commenters noted the importance of proper interview techniques when conducting investigations. A special in-depth training session on interview techniques was conducted for staff in December 2011. Such training in advanced techniques will be repeated on a regular basis including a session in June 2012.

BACKGROUND

OBSI's Role

As an ombudsman office, our role is to investigate complaints with a view to resolving them in a manner that is fair and reasonable in all the circumstances. In accordance with our *Terms of Reference*, when determining what is fair, we must consider general principles of good financial services and business practices, the law, regulatory policies and guidance, and any applicable professional body standards, codes of practice or conduct.

OBSI is not a court or a regulator. Therefore, while we use the law and industry regulations as guides to determining fair outcomes, we are not bound by specific case law. Also, it is not our

role to determine if there has been a regulatory breach before deciding whether compensation is warranted.

Our process is intended to be informal so we can resolve complaints as quickly as possible. At the same time, we apply the appropriate amount of rigour to each of our investigations to ensure the results are fair to the parties.

Independent Review

As part of its *Framework for Collaboration* with financial market regulators, OBSI must submit itself to knowledgeable, independent third party evaluations on a regular basis. The Navigator Company of Australia, which conducted the last review in 2007, was engaged by OBSI's Board of Directors – with the concurrence of the regulators – to review OBSI once again. The Navigator Company has extensive experience in this field, having reviewed eight different financial dispute resolution schemes around the world – several of them multiple times – as well as having conducted similar reviews of several non-financial dispute resolution schemes.

Given the vocal criticism of OBSI's suitability and loss assessment process from a minority of industry stakeholders, OBSI's Board of Directors specifically tasked the independent reviewer with conducting a detailed examination of the methodology as part of the larger report. The review concluded:

1. *OBSI's overall methodology is competent and highly consistent with that used in the other comparable jurisdictions.*
2. *There are some differences at a level of detail and in implementation of the methodology:*
    i. *Some reflect the different consumer demographic, financial market and regulatory framework in Canada – in our view appropriately;*
    ii. *The approach to loss calculation (for some cases only) – where OBSI uses a notional portfolio approach and other schemes have tended to use a variety of simpler methods of calculation. The OBSI approach is in our view superior, providing a fairer and more accurate approach to calculating investment loss; and*
    iii. *OBSI's use of trained in-house investment analysts is unique amongst the schemes we researched, however we found this provided a level of expertise and consistency that we thought was clearly superior.*
3. *These differences have diminished in the time we have been conducting this review. The Australian FOS has, after consultation and support from industry, recently adopted a new methodology which is virtually the same as OBSI, including the use of notional portfolios where appropriate.*
4. *OBSI's decision-making in investment complaints is competent and highly consistent with comparable EDR schemes in other countries, if anything producing a slightly lower proportion of decisions in favour of consumers.*

The findings of the independent reviewer were considered as part of the Board's deliberations on proposed changes to the methodology, as were discussions that took place with financial regulators.

STAKEHOLDER FEEDBACK

Step 1: KYC Determination

Review of Documents

Stakeholder Comments:
One stakeholder noted that OBSI's KYC review goes beyond documents generated during the dealer's KYC process, and that we should limit our review to those documents. Others commented that KYC forms might not accurately reflect the investor's profile and that it is reasonable that OBSI investigate this itself without limiting the sort of information we can review.

OBSI Response:
Firms and advisors follow widely different KYC information collection processes ranging from minimal with little discussion to extremely detailed and formally communicated. Sometimes, the advisor inaccurately documents the client's KYC information on the KYC form. By gathering other information and documents we are 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 courts and regulators.

Collecting and considering other information relative to the documented KYC information is only necessary when the KYC information is in dispute or is in question because it is misaligned with the investor's personal and financial circumstances. When there is no dispute or misalignment, we accept the KYC information and use it as a basis for the suitability assessment.

Interviews

Stakeholder Comments:
Without asserting that OBSI investigators lack sufficient interviewing skills, several stakeholders noted the importance of proper training in this area. The need to avoid asking leading questions and to be sensitive about delicate topics were among the reasons identified. One participating firm also noted that the OBSI process involves a credibility determination on the part of the investigator based on unsworn testimony.

OBSI Response:
OBSI interviews are designed to gather relevant information and give the parties a chance to tell us about their experience and recollections. We evaluate the information each party

provides along with documentation and other evidence, being mindful to identify and consider discrepancies or inconsistencies by or between the parties. Firms and investors have the opportunity to comment on the information we've considered, including information gathered during interviews, and/or to provide further information or arguments they believe we should take into account.

OBSI investigators receive regular and ongoing training. However, as noted earlier, in response to stakeholder feedback a special in-depth training session on interview techniques was conducted for staff in December 2011. Such training in advanced techniques will be repeated on a regular basis including a session in June 2012.

Other Evidence

Stakeholder Comments:
One stakeholder commented that examining other evidence, such as advisor or client notes, tax return information, account statements and correspondence, may be appropriate.

OBSI Response:
We agree that information of this nature is relevant to an independent assessment of the reasonableness and accuracy of documented KYC information when it is in dispute.

Reaching a Conclusion

Stakeholder Comments:
The comments received on this aspect of our process fell into two themes. Most participating firms or industry associations suggested that OBSI should either rely entirely on the signed KYC form or only conclude that an investor's KYC information was different from that found on the form in extremely limited circumstances. One industry association commented that a firm's KYC and suitability obligations are not unlimited, and that the suitability of advice should be assessed on the basis of what the firm knew or should have known about the investor.

On the other side, investors and investor advocates were in agreement that OBSI should form its own view of the KYC information, given that the KYC process and the information obtained are at the heart of most disputes. An investor rights organization noted that the KYC form is but one tool the advisor will use to fulfill their KYC obligations.

OBSI Response:
OBSI considers the KYC form a key piece of evidence. In some cases the KYC information is not in question or in dispute and we can accept the KYC form as documented without further assessment. However, when the KYC information is in question or in dispute, we gather and/or attempt to verify the information that advisors knew or should have known about their client at the time they completed the KYC document. We also consider what the investor knew or should have known or understood about the KYC form when they signed it. If the evidence shows that the documented KYC information is inconsistent with the investor's personal and

financial circumstances or their needs or goals, we will form a view about the investor's objectives and risk tolerance considering all the relevant information. We will also consider comments from each party about the information we considered to come to our views.

As mentioned earlier, OBSI's process of considering evidence in addition to the KYC form to confirm an investor's KYC information is not unique. This is the same type of process that branch managers, compliance officers, regulators and the courts go through when handling suitability cases.

Step 2: Suitability Analysis

Determining Investment Characteristics and Risks

Stakeholder Comments:
A couple of stakeholders commented that determining the risk profile of investments is a highly subjective exercise. It was also noted that IIROC and the MFDA use different scales for classifying risk ratings. One association was of the view that OBSI should never override the risk ratings published in a mutual fund prospectus. One investor organization argued OBSI should review all relevant evidence, not rely solely on the simplified prospectus, and in the future not rely solely on the Fund Facts document.

OBSI Response:
The MFDA uses a five-point risk rating scale and IFIC has issued guidance that mutual funds should be rated on a five-point system. IIROC has published a three-point risk rating scale, though not all IIROC firms use a three-point scale.

To have a consistent approach across files, we initially rate all securities on a five-point scale. If the firm uses a three-point scale, or other scale, we then re-evaluate the securities to determine where they fit in the firm's scale based on our original analysis. For example, consider a firm that uses a three-point risk rating scale consisting of high, medium, and low risk categories. If our original analysis indicates that we would rate a security medium-high, we would then re-evaluate the security to determine if it would be high or medium on a three-point scale.

Only in very rare circumstances have we applied a mutual fund risk rating that differed from the published rating. We will continue to analyze mutual funds using the risk ratings in the simplified prospectus because we believe it is fair to do so given that the prospectus is the document made available by the mutual fund company and is available to both the advisor and investor at the time of purchase.

Disclosure Doesn't Validate an Unsuitable Recommendation

Stakeholder Comments:
There was general agreement that disclosure does not make an unsuitable investment suitable for an investor. One investor organization noted that investors should not be expected to second-guess the suitability of recommendations. However, an industry association said that if full disclosure is followed by client consent and direction to make an investment, the investor must bear responsibility for any losses.

OBSI Response:
There is a material difference between an advisor advising against an unsuitable, unsolicited trade and an advisor recommending an unsuitable investment. If the investor proceeds with an unsolicited trade contrary to an advisor's clear warning, the investor assumes responsibility for the trade. However, since an advisor is responsible for making suitable recommendations, we believe the investor should be able to rely on the advice given and be confident their investments are suitable without further verification.

It is clear that disclosure on the part of the advisor does not make an otherwise unsuitable investment, suitable. If a recommendation is unsuitable for an investor, it remains unsuitable even if the advisor provided the client with full disclosure of the risks and characteristics of the investment. However, upon considering the investment knowledge and experience of the client, and other evidence, we may decide that the investor should accept responsibility for some or all of any loss incurred.

Making a Suitability Determination

Stakeholder Comments:
Where an investor's KYC information is not consistent with the investments made, most commenters were in general agreement with OBSI's process. Several commenters also suggested additional criteria for determining the suitability of investments, such as commissions, loss capacity, and order execution. An industry association suggested OBSI should acknowledge that balancing risks is an accepted part of investment advice.

OBSI Response:
Suitability determinations are made taking into account many factors as they existed at the relevant time. Specifically, we use historical data provided by reliable third-party sources, such as Bloomberg and Moody's, and any research or information the advisor or firm used at the relevant time in our suitability assessments. We note that investors and firms have the opportunity to comment on our views and to present additional information or arguments for our consideration.

There are cases where we may find it appropriate for a medium-risk investor to hold higher-risk investments in combination with lower-risk investments. In these instances, we consider the investor's investments in the context of their whole portfolio. We will ask the advisor why he or

she believed the higher-risk investments were suitable for the client and ask whether the advisor explained to the client that a portion of their portfolio would be invested in higher-risk investments. If the advisor had a reasonable plan and explained that plan to the client, we may not find it unsuitable that a medium-risk client held some high-risk investments.

Step 3: Determining Financial Harm and Compensation

Calculating Actual Investment Performance

Stakeholder Comments:
No comments were received.

OBSI Response:
N/A.

Suitable Performance Comparison

Stakeholder Comments:
There was varied feedback on the methods used to make suitable performance comparisons. A few industry stakeholders commented that suitable performance comparisons result in arbitrary outcomes or serve as performance guarantees. An industry association believes that they should only be used where a fiduciary duty exists. Other stakeholders generally agreed with using suitable performance comparisons, though some added it should be modified to include portfolio rebalancing and, when comparing against indices, average fees for index funds or ETFs. One stakeholder commented that OBSI should never use indices as performance benchmarks. Other comments support the use of indices or other investments as suitable performance benchmarks and request guidance on OBSI's benchmark selection criteria.

OBSI Response:
Since advisors are responsible for making suitable recommendations, we typically need not consider whether the relationship between the investor, advisor and firm is fiduciary in nature. Whether the relationship is fiduciary or otherwise, a duty of care exists and if we find unsuitable investments or strategies were recommended, it is fair and appropriate to compare the performance of the unsuitable investment(s) or portfolio to suitable performance benchmarks based on what the investor was likely to have held. OBSI's goal is to compare the investor's position to the position the investor would have been in if suitable advice had been provided.

There is no attempt or intention for OBSI's approach to guarantee a certain performance for investors. In fact, sometimes the suitable performance benchmark performs worse than the investor's actual unsuitable investments. In these cases, we do not recommend compensation even though the client was unsuitably invested.

We appreciate that there is no way to know exactly what investments a client would have purchased had the advisor made suitable recommendations to the client. However, we disagree that suitable performance comparisons result in arbitrary outcomes. We believe that suitable performance comparisons provide the most reasonable representations of how an investor's portfolio would have performed had they been suitably invested. We also note our suitable comparison approach is consistent with Ombudsman schemes in other comparable jurisdictions and with the practices we have observed at many Canadian investment firms.

OBSI and our stakeholders agree that OBSI's loss calculations should be as objective, consistent and predictable as possible, but also flexible to address exceptional cases in a fair and reasonable manner. Finally, OBSI's loss calculation process must be as efficient as possible to allow for timely resolution of complaints.

For many years we have calculated suitable investment performance by using either previous or actual suitable investments the investor held, or by using indices. Our first preference was to use the investor's suitable investments as a benchmark. This approach provides a fair representation of how the investor would have likely invested and how their investments would have performed if they had been suitably invested. By using actual investments, the effect of commissions and fees was also captured in our notional performance calculations, whereas index-based calculations did not capture the cost of commissions and fees. However, we have received professional advice suggesting that indices are typically used as benchmarks to calculate and compare investment performance for compensation purposes in privately-settled investment disputes as well as in the courts, and it has been recommended that OBSI use indices rather than other performance benchmarks in our calculations.

Using indices will increase the consistency and predictability of our loss calculation process. It will also increase the efficiency of our process. First, it will minimize debate over benchmark selection by making the choice of benchmarks clearer and narrower. Second, it takes less time for OBSI's Investment Analysts to complete index-based loss calculations. Indices will still allow us to address exceptional cases and we will still have the flexibility to use an investor's suitable investments or other performance benchmarks in the limited circumstances where it would be appropriate.

Therefore, in view of stakeholder comments, the professional advice we have received, and in the interest of having an objective process that is consistent, predictable and efficient, yet flexible, we propose to change our process to use index benchmarks in most cases.

At the same time, while we have not typically adjusted index performance for fees or trading costs in the past, we propose doing so going forward. This will provide a more accurate representation of how an investor's investments or portfolio would have performed had they been suitably invested.

Interest

Stakeholder Comments:
One commenter requested that OBSI provide additional details on how and when we calculate interest.

OBSI Response:
We may calculate interest for two reasons: (1) to calculate financial harm to an investor and/or (2) to compensate the investor for not having use of the compensation we believe is owed to them.

(1) Financial harm:
If financial harm should be calculated using a suitable performance comparison, and an interest-based investment such as cash or a GIC was likely the suitable investment, we use treasury bill or GIC rates to calculate interest on the amount invested, in the same manner as an index or other benchmark. We may also calculate compound interest on the amount invested and add it to actual losses in the rare instances when we cannot determine a suitable performance benchmark.

(2) Loss of use:
In the past, we have calculated interest on an investor's compensable loss in cases where we have issued an Investigation Report recommending compensation (Investigation Reports are generally only issued after an attempt to facilitate a settlement has failed) and in some cases where we have facilitated a settlement. To provide clarity to firms and investors alike, going forward OBSI proposes to generally add interest on compensable losses only when we issue an Investigation Report. Interest on a compensable loss is calculated using the average three-month Canadian Treasury Bill yield (as calculated by the Bank of Canada) compounded annually from the date the client complained to the firm to the date OBSI's report is final.

Just Actual Losses

Stakeholder Comments:
No comments were received.

OBSI Response:
N/A.

Investor Responsibility

Stakeholder Comments:
Several investors and investor advocates submitted that the notion of investor responsibility is problematic, as most investors are unaware that they should try to mitigate the loss or how they should go about doing this. One commenter said that if an advisor lacked necessary

professional credentials, the investor should not be held responsible for losses. Another put forward that it is incorrect to suggest an investor can "ratify" an unsuitable investment by continuing to hold it after they knew it was unsuitable. One participating firm indicated that where there are disputed facts, the complainant has not been interviewed under oath, and/or their credibility has not been clearly established, OBSI should never assign 100% of the responsibility to the advisor or firm.

OBSI Response:
We have obtained guidance in the past from legal counsel regarding mitigation and investor responsibility. Once an investor is aware that his or her investments are unsuitable for them, they have the obligation to take steps to minimize their losses. If the investor continues to hold the investment, we may determine that they are responsible for any losses incurred from that point forward. What steps we would expect an investor to take and when we would expect the investor to take them will depend on their investment knowledge and the degree to which they relied on their advisor.

While advisors are most often considerably more knowledgeable than their clients, and the investors we see often rely heavily on advisors (and are often encouraged by firms to do so), it is not always the case. We also see investors whose investment knowledge or experience would enable them to question the advice they receive and/or to take quick action to limit losses. Therefore, we evaluate investor responsibilities given the particular facts and circumstances in each case, considering the investor's level of investment knowledge and degree of reliance on the advisor along with other factors.

We do not agree that it is unfair to allocate 100% of the responsibility for losses to the advisor or firm when the circumstances warrant. In virtually all of the cases that we investigate, some facts are in dispute as between the parties. We also don't believe that an investor needs to be interviewed under oath before we can recommend that a firm be held 100% responsible, just as a firm employee or advisor doesn't need to be interviewed under oath for us to find that compensation is unwarranted.

Final Compensation Assessment

Stakeholder Comments:
An industry association and an investor organization noted that a consistent standard of fairness can only be achieved by employing different loss calculation methodologies based on the unique circumstances of the case. The investor organization also suggested OBSI expand the scope of its non-financial loss powers to include pain and suffering. An investor advocate suggested OBSI employ a simple GIC rate + 5% award for compensable losses. One firm requested that OBSI share working versions of loss calculations to ensure consistency and accuracy, and in the interest of transparency.

OBSI Response:
We agree that the appropriate methodology for calculating losses will depend on the particular facts and circumstances of a case. We do not believe we have the appropriate expertise at this time to evaluate pain and suffering.

GIC rates do not always reflect the type of investment the investor would have held. Since suitable investments will not always have positive returns or outperform unsuitable investments, we think it is fair to both firms and investors to consider what would have been suitable and likely to have been held, and to compare unsuitable to suitable performance over the relevant period.

We agree that sharing working versions of our calculations would be of benefit to firms. We propose to do so going forward.

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Supplementary

Many commenters submitted proposals on issues that fall outside of the consultation paper. Comments not directly related to this consultation have not been included in this summary but have been taken under advisement by management and OBSI's Board of Directors.

OBSI's independent reviewer noted the lack of a limitation period in considering investor complaints. We have also heard this issue raised by firms in the past. Because it is not a court proceeding, OBSI's process is not subject to statutory limitation periods. However, we propose establishing a self-imposed limitation period of six years from the time when the investor knew or ought to have known there was a problem with their investments.

REQUEST FOR COMMENTS

OBSI invites written comment on the five proposed changes to the suitability and loss assessment process outlined above. All stakeholders are invited to provide feedback.

During this comment period, OBSI will participate in information sessions organized by IIROC and the MFDA to discuss the methodology and obtain feedback. Additional information will be provided during these sessions, which will offer an opportunity for questions and discussion on how OBSI applies the specific methods to calculate investor losses in various fact situations. Look for details on these sessions to be provided to members directly by IIROC and the MFDA.

To assist stakeholders in understanding the revised methodology, examples of how it would be applied based on certain fact scenarios can also be found on our website.

After receipt and consideration of any further comments, OBSI's Board of Directors will finalize a new methodology which will be published on OBSI's website.

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Comments will be accepted until July 9, 2012, and will be posted on OBSI's website.