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Ombudsman for Banking Services and Investments
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Dear Sirs/Mesdames:

Re: OBSI consultation on loss calculation for complaints involving unsuitably sold illiquid exempt market securities – PCMA response

The Private Capital Markets Association of Canada ("**PCMA"**) appreciates the opportunity to provide its comments in connection with the Ombudsman for Banking Services and Investments' ("**OBSI**") consultation on loss calculation for complaints involving unsuitably sold illiquid exempt market securities (the "**Consultation Paper**").

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.

The PCMA has also established our **Fair and Balanced Regulation Advocacy Website** which is available at: https://fairandbalancedregs.com. This Advocacy Website is a platform for commentary and analysis on regulatory proposals, consultations, and requests impacting capital raising, securities registration and compliance in Canada's private capital markets, examining their implications for issuers, exempt market dealers and dealing representatives. The PCMA is committed to supporting fair and balanced regulations in the financial sector and this is our resource to the public to share our views and for education and training purposes.

PCMA's responses to the Consultation Paper and general comments are set out below for your review and consideration.

GENERAL COMMENTS

PCMA Comment Letter in Response to CSA Proposal to Give OBSI Binding Decision-Making Powers of up to $350,000

The PCMA believes in fair and balanced regulation. The Canadian Securities Administrators ("**CSA"**) have previously published a request for comment on whether a CSA-recognized, not-for-profit, independent dispute resolution service provider (*i.e.,* OBSI), should be given binding decision-making powers of up to $350,000 (the "**Proposed Amendments**").[1] The PCMA believes such a proposal is unfair by design and our comment letter is available at:

- https://www.osc.ca/sites/default/files/2024-02/com_20240228_31-103_hansonr.pdf

The PCMA looks forward to the CSA's further publication for comment in the second half of 2025 regarding such matters that we understand will include the CSA's proposed approach to oversight.[2]

The PCMA maintains its concern in giving OBSI binding decision-making powers and its comments on OBSI's loss calculation methodology should not be construed as deviating from the PCMA's views outlined in our comment letter.

Need for CSA Oversight of OBSI's Loss Calculation Methodology

The PCMA believes that OBSI's loss calculation methodology should be reviewed and approved by the CSA members since OBSI has a conflict of interest in such matters. The PCMA believes the Consultation Proposal should have been made by the CSA for the following reasons:

- *Structural Conflict of Interest* - OBSI's mandate creates an inherent structural conflict that distinguishes it from traditional judicial damage assessments. Unlike courts, which operate within an adversarial system with established procedural safeguards, OBSI simultaneously acts as both settlement facilitator and loss calculator without comparable institutional protections. This dual role creates two specific concerns:

[1] See CSA's Proposed Amendments at: https://www.securities-administrators.ca/wp-content/uploads/2024/01/OBSI-CSA-Notice-and-Request-for-Comment-November-30-2023.pdf
[2] See CSA news release at: https://www.securities-administrators.ca/news/csa-provides-update-on-binding-dispute-resolution/

a. OBSI may be institutionally incentivized to calculate losses in ways that promote settlement rather than maximize accuracy, as its efficiency metrics and mandate to resolve disputes could influence its calculation methodology; and

b. unlike judicial proceedings, OBSI's process lacks formal evidentiary rules, systematic presentation of competing expert evidence, and comprehensive appeals processes. These structural issues may challenge the integrity of loss calculations.

- *Increased Stakes and Risk Exposure* - The CSA's proposal to have OBSI's damages award be binding amplifies these structural concerns. This substantial increase in potential liability, combined with limited procedural safeguards, creates an unacceptable level of risk for industry stakeholders. The current methodology framework, developed under a lower-stakes paradigm, requires substantial enhancement to address these heightened exposures.

To address these structural conflicts, the PCMA believes that the CSA should be more involved in reviewing and approving OBSI's loss calculation methodology, which requires ongoing review and oversight that includes stakeholder feedback. Otherwise, the PCMA has concerns over OBSI's accountability to the industry in a system where registrants have limited rights and could effectively become guarantors of positive investment outcomes.

<u>OBSI's Disagreement with Industry's Views on its Calculation Methodology</u>

The Consultation Paper notes that OBSI disagrees with the industry as to the fairness of its loss calculation methodology, particularly those involving illiquid exempt market securities. The industry's issues with OBSI's recommendations are due, in part, to the lack of a direct connection to applicable Canadian securities law, which regulates how registrants operate their businesses. PCMA members note that insurers generally will not pay the amount recommended by OBSI since they have concerns with OBSI's processes, calculations and other matters. In fact, if the CSA proposals are enacted to give OBSI binding decision-making powers, as outlined in the Proposed Amendments, the PCMA understands insurers will exclude any coverage for OBSI claims. The PCMA refers OBSI to an attachment in the PCMA's comment letter (see link above) which discusses such matters from an insurance broker, Purves Redmond Limited, which engaged in discussions with various insurance carriers.

The PCMA believes that if OBSI is to be given binding decision-making powers of up to $350,000, then the industry must have confidence in its loss calculation methodology.

The PCMA acknowledges that OBSI has published its methodology on its website called "*Comprehensive Investment Loss Calculation*" at: https://www.obsi.ca/en/how-we-work/our-approaches/comprehensive-investment-loss-calculation/.

The PCMA comments regarding OBSI's investment loss calculation process are discussed below.

SPECIFIC COMMENTS

<u>Consultation Question #1</u>   ***For loss calculations involving unsuitable illiquid exempt market securities for which no ending value can be determined, is OBSI's approach of assigning a value of zero and requiring the investor***

to return the unsuitable illiquid exempt market securities to the firm fair and reasonable? If no, are there any alternative approaches that we should consider?

The PCMA is against assigning a zero value to illiquid exempt market securities. For the reasons discussed below, the PCMA does not believe OBSI's approach is fair and balanced to all parties involved. Professional valuators, such as those holding a Chartered Business Valuator designation, regularly review assets that are difficult to value for many reasons, including illiquid securities. Being illiquid does not mean a valuation can be done, it just requires additional consideration and work. If OBSI seeks to obtain binding decision-making powers of up to $350,000, then it is in the public interest that OBSI has a loss calculation methodology that is fair and equitable. Additional commentary by the PCMA is set out below.

1. Need to Apply Market-Adjusted Damage Calculations to an Investor's Entire Portfolio

(a) *Fundamental Concerns with Zero-Value Assignment*

The PCMA believes that assigning a zero value to illiquid exempt market securities can affect the integrity of damage calculations in investment disputes. By defaulting to a zero-value assumption, this approach ignores the inherent value that may exist in these investments despite their illiquid nature. Moreover, it ignores that investors agreed to and paid for these securities based on disclosures provided at the time of investment.

(b) *PCMA's Support for Market Adjusted Damages Methodology*

The PCMA believes OBSI's MAD methodology is a reasonable approach to calculating investment losses in exempt market securities. This methodology, recognized by regulatory bodies and courts, provides a structured framework that compares actual investment performance against suitable benchmark alternatives while accounting for prevailing market conditions, risk factors, and investment objectives. MAD enables a more sophisticated assessment of investor harm by evaluating what returns would have been achieved through other alternative investments under similar market conditions.

The benefit of MAD lies in its ability to provide objective, market-based comparisons that reflect real investment alternatives available at the time of the original investment. These comparisons consider factors such as market volatility, economic conditions (including interest rates and inflation/deflation), and sector-specific trends that may have influenced investment performance during the relevant period. This approach acknowledges that investment performance must be evaluated within the context of broader market conditions. While the PCMA supports the MAD methodology, the selection of appropriate indices for calculating the damages is a critical consideration that warrants separate and detailed discussion. See Section 3(g)(i) - *Benchmark Considerations and Investment Characteristics - OBSI's Current Use of Benchmarks* below.

(c) *Market Adjusted Damages Should Be Applied to an Investor's Entire Portfolio*

The current application of MAD creates a disconnect between regulatory requirements and damage assessment practices. The application of MAD to individual investments, rather than at the portfolio level, contradicts the portfolio-based approach mandated by the CSA through the CFRs. This misalignment creates concern for the damage calculation methodology.

Below is a simplified example of using a MAD calculation where part of an illiquid exempt market portfolio is assigned a zero value when determining the loss.

Hypothetical Calculation Using OBSI Current Approach

Facts

An investor held a portfolio valued in Canadian dollars at $2,200,000, consisting of 35% exempt securities ($770,000), 45% public securities ($990,000), and 20% fixed-income securities ($440,000).[3] Within the exempt securities, 10% ($220,000) were deemed unsuitable, and 25% ($550,000) were deemed suitable. The investment period was 3 years and 7 months (~3.583 years). The benchmark for comparison was the TSX 60 Index, with an assumed annual return of 5% for public securities and 8% for suitable exempt investments.

The unsuitable investments were assumed to have zero value at the end of the investment period, resulting in a total loss of the original subscription price. If the funds allocated to the unsuitable investments had instead been invested in the TSX 60 Index, they would have generated additional gains. The following calculations isolate the financial impact of these unsuitable investments.

The facts above are set out in **Table 1** below.

Table 1

Category	% Asset Allocation	Details	Description
Total Portfolio Value	100%	$2,200,000	
Exempt Securities	35%	$770,000 (original subscription price)	
Public Securities	45%	$990,000	
Fixed Income Securities	20%	$440,000	
Unsuitable Investments	10% of Exempt Securities	$220,000 (original subscription price)	Portion of the exempt securities deemed unsuitable.
Investment Period		3 years, 7 months	Approx. 3.583 years assumed for the analysis.
Benchmark: TSX 60 Index for Comparison (Annualized)		8%	Annual return assumption for suitable exempt securities.

[3] For ease of illustration, it is assumed that the weight of the holdings within the portfolio stayed the same throughout the investment period.

<u>Assumptions made for illustrative purposes only</u>[4]

- *The opportunity cost of unsuitable investments is calculated based on the TSX 60 benchmark performance, which is assumed to be an appropriate benchmark for comparison.*
- *Unsuitable investments are assumed to have zero value at the end of the investment period.*[5]
- *No adjustments were made for distributions, tax benefits, fees, expenses, or commissions.*
- *All values are presented in nominal CAD without adjusting for inflation.*
- *The analysis assumes no portfolio rebalancing or corrective actions during the investment period.*

Based on the facts above, the financial impact of the unsuitable investments is determined as follows:

1. **Loss of the Original Subscription Price:** The unsuitable investment, totalling $220,000, was assigned a value of zero ($0.00) at the end of the loss calculation period, representing a total loss of the initial subscription price.

2. **Opportunity Cost:** Had the investor's funds allocated to unsuitable investments been invested in the TSX 60 Index, at an assumed annual return of 8%, their future value would have been $289,862 after 3 years and 7 months.
    - Gain from TSX 60 Benchmark: TSX 60 Gain = $69,862

This represents the missed opportunity to grow the funds within a suitable, liquid investment.

3. **Total Financial Impact:** The combined financial impact of the unsuitable investments is:
    - *Loss of Original Subscription Price*: $220,000
    - *Missed Gain from TSX 60 Benchmark*: $69,862
    - *Total Opportunity Cost: Total Loss* = $220,000 + $69,862 = $289,862

Based on the above, the allocation of 10% of the exempt securities portfolio ($220,000) to unsuitable investments resulted in a complete loss of value for those securities and an additional missed opportunity of $69,862 in potential gains had the funds been invested in the TSX 60 Index. The total opportunity cost incurred was $289,862. This calculation highlights the financial impact of unsuitable investments within a portfolio.

(d) *<u>Regulatory Framework for Portfolio-Based Approach</u>*

The regulatory requirements for a portfolio-based assessment is set out in Companion Policy to NI 31-103, which explicitly mandates that "***suitability cannot be determined only on a trade by trade basis, but must be determined on the basis of the client's overall circumstances***." This requirement extends beyond initial investment decisions, as registrants must evaluate whether recommendations for one account would "***materially affect the concentration and liquidity of the client's investments across all their accounts***." These regulatory directives create a comprehensive framework that should extend to how damages are calculated when unsuitable recommendations occur.

[4] These are all important factors that need to be included when calculating damages.

[5] It would be expected that not all exempt securities have a zero value and that various methods would be considered to determine a reasonable fair market value.

(e) *Current MAD Application Ignores Portfolio Context*

The PCMA notes that the practice of isolating MAD calculations to individual unsuitable investments is not in alignment with a portfolio approach. When evaluating the performance of an unsuitable investment against external benchmarks, the current approach assumes investments exist in isolation, ignoring their role within a broader portfolio strategy. This narrow focus fails to capture how specific investments contribute to diversification, risk mitigation, or the achievement of long-term objectives within the overall portfolio context.

(f) *Private Market Investments and Portfolio Strategy*

The role of private market investments in modern portfolio construction demands particular attention when considering damage calculation methodologies. These investments serve distinct and valuable functions within diversified portfolio strategies, offering unique benefits that cannot be properly evaluated in isolation. Simply stated, suitability is not assessed in isolation of the overall client holdings so damages should not be either.

i. *Role of Private Investments in Portfolio Diversification*

Private market investments provide essential diversification benefits that alter the risk-return characteristics of investment portfolios. These investments may deliver returns uncorrelated with public markets, offering the potential of portfolio protection through market cycles. An illiquid exempt market security, while potentially appearing risky in isolation, may serve as an important component in achieving an investor's long-term financial goals through its portfolio diversification benefits. The current practice of applying MAD to individual unsuitable investments fails to capture these portfolio-level advantages, resulting in a distorted assessment of investor harm.

The fundamental incompatibility between portfolio management principles and individual security assessment becomes clear in this context. The PCMA believes that investment portfolios should be managed holistically under the CSA framework and MAD needs to evaluate damages on a portfolio basis. These approaches should be consistent to maintain confidence in OBSI's loss calculation assessments.

ii. *Risk Assessment and Portfolio Management*

Under the CSA's portfolio-based suitability guidelines, risk assessment must consider the entire portfolio's composition to ensure alignment with investor risk tolerance, objectives, financial circumstances, and time horizon. Individual high-risk investments may be entirely suitable when balanced appropriately within a broader portfolio strategy. The PCMA believes that EMDs and their dealing representatives ("**DRs**") should be accountable for individual securities but in the overall portfolio construction. EMDs' know-your-client questionnaires typically gather information about an investor's entire investment portfolio. The PCMA believes this portfolio-level information is sufficient for OBSI to take a portfolio-based approach in their analysis, even without a formal financial plan. While DRs are not required to be financial planners, suitability assessments are generally conducted at the portfolio level. Therefore, OBSI's loss calculations should similarly follow a portfolio-based approach.

(g) *Benchmark Considerations*

OBSI discloses its most frequently used indices for its suitable performance comparisons as set out in its *Comprehensive Investment Loss Calculation* which has been reproduced below for ease of reference.

Asset Type/Objective	Risk level	Index
Equity/Growth	Medium	Canada – S&P TSX Composite U.S. – S&P 500 Global – MSCI World International – MSCI EAFE
Equity/Growth & Income	Medium	S&P TSX 60
Bonds/Income	Low to Low-medium	DEX Universe Bond
Cash/Safety, Liquidity	Low	Cashable GICs

The PCMA would like clarity on the rationale on how these indices were selected for use as a comparison for illiquid exempt market securities. The PCMA would also like OBSI to provide hypothetical scenarios of which index would apply in a given fact pattern involving illiquid exempt market securities.

The PCMA notes that the industry has historically had concerns with OBSI's use of indices and how they relate to illiquid exempt market securities. For example, in a comment letter dated July 25, 2011, by RBC Dominion Securities Inc., it stated the following:

> *"Using market indices as benchmarks for portfolio performance is fundamentally flawed. The problem begins with a basic mismatch: investments that are suitable for a client may not be present in the index, while the securities within the index may not be appropriate for that client's needs. This disconnect extends throughout the investment period. Market indices also fail to account for crucial individual factors. They don't reflect proper asset allocation for specific clients, ignore the impact of client fees (especially over multiple years), and assume an unrealistic consistency in investment behavior. Furthermore, using indices as benchmarks introduces selection bias, incorrectly equates investment suitability with performance, and overlooks the realities of actual investing patterns. This practice ultimately provides a misleading basis for evaluating portfolio performance."*

Private market investments inherently include characteristics such as illiquidity premiums and extended investment horizons that are not included in the typical benchmarks currently identified and used by OBSI. Short-term performance comparisons against public market indices misrepresent these investments' nature and intended function. The time horizon mismatch becomes particularly problematic as these investments often require significant periods to realize their full value potential, making short-term performance metrics largely irrelevant to their strategic purpose. For example, a real estate development took five years to complete. At the completion of the project, the return on investment was 100%, however, the actual annual return during years one to four was nil.

The PCMA believes these benchmarks may fail to reflect the unique attributes of private investments and their use is not appropriate in all circumstances. As a result, this potential misalignment may create an evaluation framework that unfairly penalizes EMDs.

The PCMA requests that OBSI provide a detailed explanation of how it determines that a particular index or benchmark of public market securities is a fair and balanced approach. This detailed explanation, analysis and rationale for its inclusion of various indices in various scenarios since it would help the industry understand this longstanding issue and concern.

(h) *Portfolio-Level Assessment Aligns with CSA Portfolio Approach*

The PCMA believes that a MAD methodology that evaluates damages at the portfolio level would create an alignment between regulatory requirements and practical implementation. This approach would calculate damages by comparing the actual portfolio performance against the deemed loss. The portfolio-based methodology aligns with CSA's guidance on portfolio-based suitability determinations.

As noted above, the implementation of portfolio-based MAD would recognize that while individual investments may underperform relative to benchmarks, they often provide crucial portfolio benefits through diversification, volatility reduction, or strategic alignment with investment objectives. This approach ensures MAD calculations reflect modern portfolio theory principles while providing a fair framework for assessing EMD recommendations within their proper context.

(i) *Addressing Moral Hazard*

The PCMA believes a portfolio-based MAD would resolve any issues of focusing solely on single investments for purposes of a loss calculation. There is a concern that the existing approach creates an environment where investors can claim underperforming investments are unsuitable while retaining the benefits of their agreed-upon portfolio strategy. This asymmetric allocation of responsibility to EMDs can occur when investors have the benefit from overall portfolio performance and accepted the risks associated with private investments.

The PCMA notes that the current situation, where the CSA requires portfolio-based advice under the CFRs, while OBSI pursues damages for individual investments, creates an unfair contradiction.

(j) *Illustrative Example - Demonstrating the Application of Portfolio-Based MAD Calculation*

To illustrate the importance of a portfolio-based approach, consider the example in **Table 2** below. The analysis illustrates three scenarios and the impact of the loss using a MAD calculation based on a total portfolio approach.

One looks at an investor's overall portfolio return (actual return) during the applicable period and determines whether the portfolio's overall actual performance:

1. ***fully absorbs*** the investment loss, resulting in no financial harm and no compensation payable by a registrant. This means the actual total portfolio performance exceeds the investment loss;

2. ***partially absorbs*** the investment loss, leaving a residual financial impact that must be compensated by the registrant. This means the actual total portfolio performance partially absorbs the investment loss; or
3. ***fails to absorb*** the investment loss entirely, which must then be fully compensated by a registrant. This means the actual total portfolio performance is lower than the investment loss.

This methodology shifts the focus from isolated investment performance to the overall financial outcome for the investor, ensuring a fairer assessment of damages for the reasons discussed above.

The three scenarios above are set out in **Table 2** below.

Table 2 is based on the hypothetical example from **Table 1** above, including its notes.

Table 2

Scenario During Applicable Period	Actual Portfolio Value	Actual Total Portfolio Gain/Loss During Applicable Period	Actual Loss (Illiquid Exempt Market Security)	Net Result	Outcome
#1 Actual Total Portfolio Performance Exceeds Investment Loss	$3,000,000	$800,000	$289,862	$510,138	Gain Exceeds Loss
#2 Actual Total Portfolio Performance Partially Absorbs Investment Loss	$2,400,000	$200,000	$289,862	-$89,862	Gain Partially Absorbs Loss
#3 Actual Total Portfolio Performance Less Than Investment Loss	$1,900,000	-$300,000	$289,862	-$289,862	Loss Exceeds Loss

The PCMA's proposed loss calculation methodology:

- aligns with CSA's portfolio-based suitability framework;
- reflects investor outcomes, ensuring fairness for EMDs; and

- avoids overstating investor harm by focusing on the total financial experience rather than isolated investments viewed on a transactional basis.

(k) *Portfolio Impact Damages Calculation*

The framework discussed above is what the PCMA references as a Portfolio Impact Damages Calculation ("**PIDC**") framework that provides a sophisticated, fair, and principled approach to evaluating financial loss caused by unsuitable investments involving illiquid exempt market securities. To clarify, this assumes that not all exempt market securities are unsuitable and that a portion may be deemed suitable or any losses are negated by a portfolio's overall performance during the applicable review period.

It is the PCMA's view that PIDC provides a fair and balanced approach to calculating losses involving illiquid exempt market securities for the following reasons:

- **Protects Against Unwarranted Penalties** - The PIDC framework ensures that registrants are held accountable for actual harm caused by unsuitable investments, but only when demonstrable financial harm occurs. By evaluating the impact of unsuitable investments within the context of the investor's overall portfolio performance, PIDC can avoid penalizing registrants for outcomes unrelated to their actions.

- **Consistent with the CFRs** - PIDC aligns with the CFRs, which mandate a portfolio-based suitability framework. The CFRs emphasize that suitability assessments must consider the client's overall financial circumstances, not just individual transactions. PIDC operationalizes this principle by calculating damages at the portfolio level, ensuring that harm is assessed holistically rather than in isolation.

- **A Sophisticated Approach to Damage Assessment** - The PIDC framework incorporates objective benchmarks to calculate the opportunity cost of unsuitable investments. This ensures that compensation is based on real-world alternatives available to the investor at the time of their investment decision.

- **Provides Fair Compensation for Demonstrated Harm –**The PIDC framework provides proportional accountability by addressing three potential scenarios:

  - *Scenario 1: Portfolio Absorbs the Loss*: If the overall portfolio performance exceeds the loss from unsuitable investments, no compensation is required, as no measurable harm has occurred;

  - *Scenario 2: Partial Absorption*: If the portfolio partially absorbs the loss, the registrant compensates for the remaining shortfall; and

  - *Scenario 3: Full Harm*: If the portfolio fails to absorb the loss, the registrant is fully accountable for the financial loss of the unsuitable investment.

  This tiered approach ensures fairness for investors while avoiding undue penalties for registrants.

- **Recognizing the Role of Diversification and Risk** - Exempt market securities often provide diversification benefits and risk-adjusted returns that cannot be measured in isolation. The PIDC framework respects the role of these investments within a portfolio, ensuring that damages are calculated with an understanding of their broader strategic function.

- **Addressing Criticisms of PIDC -** Some critics may argue that PIDC could lead to situations where no compensation is provided by a registrant, even when unsuitable investments are identified. However, this critique overlooks the inherent fairness of the framework:

  - *Accountability Without Overreach*: PIDC maintains that registrants are accountable for genuine harm, not hypothetical losses. If the portfolio absorbs the impact of unsuitable investments, the investor has suffered no financial harm, and compensation is unnecessary.

  - *Alignment with Portfolio-Based Principles*: Evaluating harm at the portfolio level reflects the realities of the modern portfolio approach and aligns with the CFRs and current regulatory standards.

  - *Avoiding Arbitrary Valuations*: By focusing on opportunity costs rather than assigning arbitrary values to illiquid securities, PIDC provides a potentially more accurate and defensible assessment of harm.

The PCMA believes that the PIDC framework can provide a principled and balanced approach to assessing investor harm in the exempt market. By aligning with regulatory standards, focusing on portfolio-level outcomes, and ensuring proportional accountability, PIDC should strike the right balance between protecting investors and avoiding unwarranted penalties for registrants.

The goal of a PIDC framework is to ensure that compensation is grounded in demonstrable financial harm while respecting the differences of illiquid exempt market investments compared to public securities. It provides the fairness and sophistication necessary for maintaining trust in the exempt market, fostering an environment where investors and registrants alike can thrive. By evolving to include portfolio-level assessments and refining benchmarks for illiquid exempt market securities, PIDC offers a comprehensive solution that aims for fair outcomes for all stakeholders.

2. Suitability Determination and OBSI's 'All or Nothing' Approach

(a) *What is 'All or Nothing' Suitability Determination*

The PCMA has concerns that OBSI is making an 'all or nothing' suitability determination when it evaluates the suitability of an illiquid exempt market investment. The 'all or nothing' concept refers to an approach where an entire investment is deemed either wholly suitable or entirely unsuitable for an investor. If unsuitable, the registrant is held fully responsible for any resulting losses.

The PCMA believes such a binary approach oversimplifies the complexity involved in assessing investment suitability for exempt market securities and does not align with the requirements under applicable securities law. The PCMA is concerned that such an approach is administratively convenient and unfair, especially when OBSI may be granted binding decision -making powers of up to $350,000.

(b) *Partial Suitability Determinations*

Suitability determinations demand a nuanced understanding of all of its constituent elements, or indicia of suitability (*i.e.,* risk profile (tolerance and capacity), time horizon, diversification, investment knowledge), that is part of the analysis. An 'all or nothing' assessment fails to recognize scenarios where part of a single investment may be suitable while another portion may not be. If the possibility of partial suitability is ignored, this approach risks producing compensation recommendations that are disconnected from the actual investor harm experienced. This can lead to unjust compensation outcomes that are disproportionate to the loss borne by the investor.

An 'all or nothing' approach significantly differs from the customary suitability assessments that EMDs conduct. These assessments involve a review of an investor's entire financial situation, considering all relevant and available factors to determine suitability. Therefore, the PCMA believes that OBSI needs to align its methodology in calculating damages with the practical realities faced by registrants, who must weigh multiple factors to determine suitability in a manner that puts the investor's interests first.

The PCMA believes OBSI should incorporate partial suitability determination as part of its evaluations, recognizing that an investment may be suitable in part but not in its entirety. Such an approach would not only reflect the complex nature of investment decisions but would also provide fairer compensation outcomes that reflect the harm incurred by investors. The PCMA requests that OBSI publish such guidelines and methodologies. As OBSI is guided by a fairness standards and not applicable securities law, all stakeholders deserve full transparency and accountability by OBSI.

(c) *Example of Partial Suitability Determination Involving Investment Concentration*

The CSA notes that diversification is a factor when assessing the suitability of investments. For example, a lack of diversification may lead to heightened exposure to a single issuer's performance or sector-specific downturns, which can severely impact an investor's overall portfolio value. When selling exempt market securities, registrants must evaluate whether an investor's portfolio is overly concentrated as one indicator of suitability. Specifically, this evaluation should consider whether the investor's portfolio is excessively concentrated on:

- securities of a single issuer or related group of issuers;
- exempt market securities; or
- a single industry or asset class (*e.g.,* real estate) without sufficient diversification across other sectors or asset classes.

The CSA generally questions investments in securities of a single issuer or related issuers exceeding 10% of an investor's net financial assets. The CSA indicates that such concentration may be suitable depending on the facts and requires a registrant to undertake an enhanced suitability review. Therefore, concentration risk should be assessed on a case-by-case basis to ensure it aligns with the client's overall financial and risk profile. The PCMA would expect OBSI to undertake the same type of analysis in its reviews.

Consider a scenario where an EMD determines that a 12% investment in a single issuer of exempt market securities is suitable for an investor's portfolio, however, OBSI determines that only 9% is appropriate. The deemed excess concentration is 3%. In such situations, the loss calculation should focus on the 3% excess rather than deeming the entire investment unsuitable. This enables a fairer assessment of damages and avoids penalizing the portion of investments that are suitable.

To provide a numerical example, if an investor's total portfolio at the time of the investment is valued at $833,333, and they invest $100,000 (or 12%) in a single issuer of exempt market securities, OBSI might determine that only $75,000 (or 9%) is suitable for the investor. This means $75,000 is suitable, while the remaining $25,000 is not due to an excess concentration. Instead of calculating damages on the entire $100,000 investment, any compensation calculation should be based on the $25,000 overconcentration. This approach helps to ensure compensation is proportional to the unsuitable portion which is fair to both the investor and the EMD.

The PCMA expects OBSI to include this type of analysis in its reports. In the PCMA's view, it would be an exceptional circumstance if not $1 of an exempt market security is suitable as part of an investor's entire portfolio.

(d) *Concerns with Reclassification of Risk Profiles*

The PCMA has concerns that OBSI may be reclassifying risk profiles to make it easier to determine that an entire investment in an exempt market security is unsuitable.

For example, to be over-simplistic, the PCMA has concerns when OBSI reevaluates a registrant's determination of an investor's risk profile (*i.e.,* risk capacity and risk tolerance) from high risk to medium or low risk to conclude that an entire investment is unsuitable. The PCMA believes such a reclassification is a red herring since high-risk securities may be entirely suitable for investors having a low risk or medium risk profile based on a portfolio approach. The ease of reclassification without dealing with, for example, concentration issues, is too simple and unfair to registrants.

If OBSI evaluates an investor's risk profile and reaches a different conclusion than the registrant, the PCMA expects OBSI to clearly explain its reasoning based on the information that was available at the time of the EMD's assessment. Additionally, PCMA expects OBSI to determine the concentration level of the investment that would be appropriate in an investor's portfolio, based on OBSI's reassessment of the investor's risk profile. Zero would be a rare occurrence based on a total portfolio approach. This analysis is within OBSI's capabilities and its staff of financial analysts.

The PCMA notes assessing what portion of an investor's portfolio is suitable for investing in an exempt market security is what EMDs do when reviewing a trade, and would expect OBSI to do the same, especially if it seeks to become an adjudicator with binding decision-making authority with no rights of appeal and limited procedural rights fo registrants.

(e) *Concerns with Time Horizon*

The PCMA is unclear regarding OBSI's views on time horizon and exempt market securities. In particular, for those securities offered under the Offering Memorandum exemption (**OM Offered Securities**) in section 2.9 of National Instrument 45-106 – *Prospectus Exemptions* (the **OM Exemption**).

It is unclear whether OBSI's approach sufficiently considers the practical realities of redemption rights and issuer practices involving OM Offered Securities. Many issuers selling OM Offered Securities pay more than their stated redemption limits, which demonstrates greater liquidity than their offering memorandum (**OM**) suggests. Without clear criteria for evaluating appropriate time horizons, whether based on actual redemption patterns, fee structures, or other metrics, OBSI's analysis risks being disconnected from market reality. A concern is that OBSI might conclude an investor's time horizon is incorrect and deem the entire investment unsuitable. This potential conclusion underscores the need for transparency in OBSI's views, particularly since these views may not align with members of the CSA. Unlike the CSA, OBSI states that it is not bound by law but by what it determines to be fair, therefore, there is a likelihood that OBSI's views may not be the same as the CSA. Industry needs transparency regarding such matters since it may impact how EMDs operate their businesses.

For example, certain OM Offered Securities provide for a redemption right that is set out in an issuer's OM. In particular, the OM form requirements under the OM Exemption requires disclosure for redemptions processed by an issuer during a period of time. It is not uncommon for issuers to fully satisfy all redemption requests with cash redemption payments despite an issuer having lower redemption limits or caps in their OM. For example, an issuer's constating documents may only require redemptions of $100,000 paid in cash per quarter, but in practice, an issuer satisfies redemption requests well over that amount.

Therefore, if issuers are fully redeeming investments for cash, in excess of their redemption limits, the PCMA would like to know what OBSI would determine to be the appropriate time horizon for an investment in such an issuer. Is it related to the ability of an issuer to satisfy redemption requests, the time when an investor can seek the return of their principal without any early redemption fee, or are there other criteria? Clear and well-defined criteria are essential to ensure fairness and transparency and reduce uncertainty for both EMDs and investors and provide a source of confidence in OBSI's assessments.

(f) <u>*Final Comments on Suitability*</u>

Considering the above, the PCMA urges OBSI to provide details on its current approach to suitability determinations for illiquid exempt market securities. The PCMA hopes OBSI aligns its methodology with industry standards and securities law requirements by:

- *Adopting Partial Suitability Determinations*: OBSI should evaluate each constituent element of suitability, such as risk profile, time horizon, and concentration, on a case-by-case basis to determine the extent to which an investment is suitable.

- *Considering Industry Practices and Legal Requirements*: OBSI should take into account the practices of issuers, especially regarding redemption behaviors that exceed formal limits, and align its assessments with the regulatory frameworks established by the CSA.

The PCMA believes that OBSI can enhance the fairness of suitability determinations by providing transparent, detailed analysis to EMDs and investors. This fairness is achieved through publishing clear guidelines and methodologies, ensuring appropriate investor redress without unfairly penalizing EMDs. Such an approach would foster greater confidence in OBSI's role and contribute to the integrity and efficiency of the exempt market.

3. Allocation of Responsibility Between Investor and EMD

The PCMA notes that Section E (Investor Responsibility) of OBSI's "*Comprehensive Investment Loss Calculation*" published on its website, discusses the concept of shared responsibility in an investment loss. Specifically, it states that OBSI will consider whether or to what extent an investor should be held responsible for any financial harm incurred, including whether an investor should have mitigated their loss.

Investments inherently involve risk, and while registrants are responsible for ensuring the suitability of an investment, investors also bear a level of responsibility for their investment decisions. An approach that places all liability on a registrant without considering the investor's own decisions or actions creates an unfair burden on registrants.

In reviewing firm refusals posted on OBSI's website[6,7], certain OBSI decisions show instances where responsibility for financial harm is shared between the investor and the EMD. Below are some examples:

- ***Becksley Capital Inc.***: Mr. J was found to be 40% responsible for his losses due to his awareness of and willingness to accept the risks associated with leverage. Despite the referral agent falsifying documentation, Mr. J also signed documents falsely confirming assets he did not possess. While Becksley improperly delegated it's know-your-client obligations and is held responsible for the unsuitable investment, Mr. J's actions contributed to his losses, leading to shared responsibility.

- ***Monarch Wealth***: Mr. H and Ms. W were found to be responsible for the investment losses they incurred after transferring their accounts away from Monarch in March 2010. Although Monarch was found responsible for 50% of their losses up to that point, the clients had the option to sell the unsuitable investments after the transfer. Choosing not to act on this option made them responsible for subsequent losses.

- ***Keybase Financial Group***: Mrs. O was found to be 25% responsible for the loss on her first of two mortgage investment. While Keybase was held responsible for facilitating the investment through its advisor, Mrs. O did not thoroughly review the mortgage documents and relied on her friend's inaccurate description of the investment. Her lack of due diligence contributed to the losses. For instance, if an investor receives comprehensive disclosure about the risks involved in

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6 *Source*: https://www.obsi.ca/en/news-publications/firm-refusals/.

7 *PCMA Question on firm refusals on OBSI website* - OBSI publishes firm refusals on its website which is part of its ability to "*name and shame*" registrants as a means of enforcing its compensation recommendations. The PCMA notes that certain independent reports evaluating OBSI stated that "*name and shame*" is not working including OBSI's report published in June 2022. The PCMA is not aware that any of these independent reports mention that OBSI has not published firm refusals for almost four years. See the table below. The last firm refusal published on OBSI's website is dated December 1, 2020. There have only been 22 firm refusals disclosed on OBSI's website since 2007 and no firm refusals in 2017, 2018 and 2019. The PCMA suggests that OBSI update its website or explain why it has not been updated.

Year	2007	2012	2013	2014	2015	2016	2020
Number of Firm Refusals	1	3	5	6	4	1	2

an investment but chooses to proceed regardless, any subsequent losses should be evaluated with consideration of the investor's informed decision.

The PCMA notes that the industry would benefit from OBSI providing additional detailed examples, hypothetical or actual cases, that clearly discuss the application of various factors explaining how shared responsibility is determined by OBSI. The PCMA believes this educational component is an important part of OBSI working with industry. The PCMA is concerned that if OBSI is taking a different view than those of the CSA or accepted industry practice, PCMA members need to know and take them into account when operating their business to reduce any risk of damages awarded by OBSI.

<u>Consultation Question #2</u>

If we maintain our general approach of assigning a value of zero to unsuitable illiquid exempt market securities when a value cannot be determined and requiring investors to return these securities to firms as part of any settlement:

a) are there exceptional situations or specific circumstances where such an approach should not be used?

b) are there any other considerations or steps that we should take in the recommendation and settlement process that would improve the fairness of outcomes for consumers and/or firms in cases where illiquid exempt market securities have been unsuitably sold?

The PCMA's response for 2(a) is set out immediately below. The PCMA's response involving 2(b) is discussed under "***Other Considerations***" below.

The PCMA does not believe that OBSI should assign a value of zero to unsuitable illiquid exempt market securities in all circumstances. For example, it should not be done in circumstances when an issuer is in bankruptcy proceedings. In such circumstances, the approach of assigning a value of zero fails to account for potential value preservation or creation through court-supervised restructuring or liquidation processes and may prejudice security holder interests.

When an issuer seeks bankruptcy protection, court-appointed monitors or trustees assume control with a statutory mandate to maximize value for all stakeholders. These officers possess unique advantages in determining security values, including complete access to confidential financial information, restructuring plans, and potential buyer interest. They operate under court supervision with fiduciary obligations to all security holders.

The PCMA proposes that in such circumstances, OBSI develop an "***Exigent Circumstances Protocol***" (the "**Protocol**") whereby OBSI would suspend its valuation determination when an issuer enters bankruptcy proceedings. Under this Protocol, OBSI would continue its complaint review process but defer its final loss calculations until the monitor or trustee completes their valuation assessment.

The potential for divergent valuations between OBSI and the monitor/trustee creates market concerns. If OBSI determines a lower value based on incomplete information while a monitor/trustee subsequently establishes a higher value through comprehensive analysis, it could undermine confidence in OBSI's loss calculation methodology and create unnecessary market confusion.

While this may extend some complaint resolution timelines, the PCMA believes accuracy in valuing illiquid exempt market securities takes precedence over expedience. The risk of incorrect valuations increases significantly when OBSI lacks access to the comprehensive information available to bankruptcy court officers.

A Protocol would enhance market integrity by ensuring consistent treatment across proceedings, support the objectives of bankruptcy law, and protect investor interests by preserving potential recovery value as a portion of the investment may have been suitable. Maintaining alignment between OBSI's valuations and court-supervised proceedings strengthens market confidence and ensures fair treatment for all stakeholders.

By deferring to the monitor/trustee's valuation, OBSI can avoid duplicating efforts and conserve resources that would otherwise be spent attempting to value complex securities with limited information. This approach leverages existing court-supervised processes.

A Protocol would also provide clear communication channels between OBSI and court-appointed officers, ensuring that all stakeholders receive consistent information about security valuations. This transparency would enhance market confidence and reduce confusion among affected parties.

A Protocol should provide flexibility for handling complex restructuring cases where value determination requires detailed analysis of business operations, market conditions, and potential recovery scenarios. This adaptability ensures more accurate outcomes while respecting the expertise of court-appointed professionals.

OTHER CONSIDERATIONS

The following section provides the PCMA's comments involving other considerations or steps that OBSI should take in its loss calculation process that would improve the fairness of outcomes for all parties.

4. Include Tax Benefits in Loss Calculation

Assessing unsuitable investments requires understanding an investor's complete financial picture. To do this effectively, it is important to consider all elements, including tax benefits, which can significantly affect the calculation of investment losses. Ignoring tax benefits can lead to incorrect calculations of investment losses, resulting in unfair compensation. To ensure fairness and uphold legal principles, the PCMA believes that tax benefits must be factored into the calculation of investment losses by OBSI. In reviewing OBSI's ""*Comprehensive Investment Loss Calculation*", the PCMA could not find any mention that OBSI includes the tax benefits received by an investor in OBSI's loss calculation.

The PCMA finds this concerning as a fundamental legal principle of compensation is to restore an investor to the financial position they would have been in had the unsuitable investment not occurred. This principle is well-established in Canadian law and requires calculating the net economic loss, which includes both the losses incurred and any benefits received, such as tax advantages.

If OBSI does not deduct tax benefits from investment losses, then it can lead to overcompensation, where the investor receives more than their actual economic loss. Compensation should not place the investor in a better position than they would have been if the misconduct had not occurred. The types of tax benefits available to investor is discussed below.

(a) *Tax Benefits Available to Investors*

When evaluating investment losses, OBSI must consider several key tax benefits that investors typically receive. These benefits directly impact the actual economic loss and should be carefully assessed in any compensation calculation to avoid incorrect loss calculations and ensure fair compensation. Consider the following examples of tax benefits that may be received by an investor:

- *Flow-Through Share Tax Benefits*: Flow-through shares are investments that allow resource companies to "flow through" their exploration and development expenses to investors, who can then deduct these expenses from their personal income. The primary benefits include Canadian Exploration Expenses (**CEE**) and Canadian Development Expenses (**CDE**) deductions. Investors can typically deduct up to 100% of CEE and 30% of CDE annually against any income source, substantially reducing their taxable income in the year of investment.

- *Capital Loss Treatment*: When investments decline in value, investors receive tax benefits through capital loss provisions. These losses can be used to offset capital gains in the current year, carried back three years to recover previously paid taxes, or carried forward indefinitely. This flexibility in applying capital losses represents a significant tax advantage that must be considered when calculating net economic loss. For example, if an investor can use their losses to offset gains taxed at a 40% marginal rate, the actual economic impact of the loss is reduced by this tax benefit.

- *Dividend Tax Credits*: For investments in dividend-paying securities, investors receive dividend tax credits that reduce their overall tax burden. Eligible dividends receive enhanced tax credits, effectively lowering the tax rate on this income significantly below the investor's marginal rate. These credits offset investment losses and should be factored into compensation calculations.

- *Interest Deductibility*: When investors borrow to invest (leveraged investing), they can generally deduct the interest costs from their taxable income. This deduction applies to loans taken for the purpose of earning investment income and can significantly reduce the after-tax cost of the investment. In cases where unsuitable leveraged investments are made, these tax deductions should be considered as benefits that reduce the net investment loss.

- *Registered Account Tax Implications*: Investments held in registered accounts such as RRSPs and TFSAs provide tax advantages. RRSP contributions generate immediate tax deductions, while investment growth in both RRSPs and TFSAs is tax-sheltered. When calculating losses in these accounts, withholding tax implications for withdrawals, potential tax charges related to investment certificate removals and the initial tax benefits from contributions should be considered to accurately assess the net economic impact. Additional consideration should be given to how the Canadian Revenue Agency would treat monetary compensation paid by dealers for investments held within registered accounts.

(b) *Illustrative Example of a Tax Benefit Involving Flow-Through Shares*

To illustrate how tax benefits impact net economic loss, consider the following example involving flow-through shares. Investments like flow-through shares provide significant tax deductions and credits. These tax benefits reduce the investor's taxable income. Failing to account for these benefits inflates the loss and does not reflect the true financial impact on the investor. Consider the following illustrative example.

An investor purchases $50,000 worth of flow-through shares from an EMD under an applicable prospectus exemption.

Initial Investment

- Amount Invested: $50,000

Tax Benefits Received

- **CEE** Deduction
  - The full investment amount of $50,000 is deducted by the investor as CEE
  - Investor's Marginal Tax Rate: 40%
  - Tax Savings from CEE Deduction: $50,000 × 40% = $20,000
- Investment Tax Credits: For simplicity, assume no additional tax credits are claimed

Investment Performance

- Current Market Value: $10,000
- Market Value Loss: $50,000 (initial investment) - $10,000 (current value) = $40,000

Capital Gains Tax upon Sale

- Adjusted Cost Base ("**ACB"**): Reduced to $0 due to the full CEE deduction
- Capital Gain upon Sale: $10,000 (sale proceeds) - $0 (ACB) = $10,000
- Tax on Capital Gain:
  - Capital Gains Inclusion Rate: 66.7%
  - Tax on Capital Gain: $10,000 × 66.7% (inclusion rate) × 40% (tax rate) = $2,667

Net Tax Benefit

- Total Tax Benefits Received: $20,000 (tax savings from CEE deduction)
- Less Tax on Capital Gain: $2,667
- Net Tax Benefit: $20,000 - $2,667 = $17,333

Net Economic Loss Calculation

- Gross Loss: $40,000 (market value loss)
- Less Net Tax Benefit: $17,333
- Net Loss: $40,000 - $17,333 = $22,667

By incorporating the $17,333 in net tax benefits, the investor's net economic loss is reduced from the market value loss of $40,000 to $22,667. This adjusted figure reflects the financial impact on the investor after accounting for the tax advantages received due to the flow-through investment. The PCMA believes that such an analysis is critical for OBSI to undertake as part of its loss calculation.

(c) *Need for Investor Documentation*

The PCMA recommends that OBSI clearly set out its expectations regarding the documentation required from investors to calculate tax benefits. This should include detailed lists of acceptable forms of documentation, deadlines for submission, and any alternative evidence that may be accepted. OBSI should also specify what assumptions it will make if an investor fails to provide such documentation in a timely manner.

Additionally, OBSI should consider implementing a standardized form or checklist to simplify the process for investors, ensuring they understand exactly what is needed. Clear guidelines for investor documentation would ensure transparency in the process, helping both registrants and investors understand their responsibilities and minimize misunderstandings. This approach would ultimately improve the accuracy of tax benefit calculations and lead to fairer outcomes for all parties involved and improve the administration process.

5. EMD Cannot Always Buy Back Securities

As part of OBSI's review process, if it determines that exempt market securities are unsuitable, it typically recommends that EMDs repurchase these securities from investors (the "**EMD Buy Back"**). The PCMA has concerns with such an approach for the following reasons:

- *Capital Assumptions* - The recommendation assumes that an EMD has sufficient capital or reserves to make such a payment. However, many EMDs, especially smaller firms, may not have the financial resources to meet such obligations, placing an unrealistic burden on them.

  EMDs are required to maintain a minimum regulatory capital of $50,000 under NI 31-103. Additionally, EMDs must maintain positive working capital at *all* times. Diverting significant portions of their capital to buybacks could jeopardize their ability to meet regulatory obligations, threatening their solvency and financial health.

- *Insurance Coverage* - An EMD may not have insurance coverage to compensate investors for unsuitable securities in the event of a settlement. If the CSA grants OBSI binding decision-making powers of up to $350,000, the PCMA understands insurers will exclude coverage for OBSI's decisions. This exclusion would leave EMDs financially vulnerable, with no recourse to insurance in cases where OBSI's decision obliges them to buy back securities.

  The lack of adequate insurance coverage for these scenarios could create significant financial risks for EMDs, effectively forcing them to bear the entire burden of settlements without any support from insurers. This situation could lead to financial instability within the exempt market dealer community, potentially resulting in a reduced ability to serve investors.

- *Risk of EMD Insolvency* **-** Forcing an EMD to buy back illiquid securities without considering its financial capacity significantly increases the risk of insolvency. Many EMDs operate with limited capital, and a large buyback obligation could force them to surrender their registration, reducing market competition and investor choice. The exempt market plays a vital role in providing investment opportunities that are not available in the public markets, and the loss of EMDs due to insolvency could diminish the diversity and accessibility of investment options for Canadian investors. It may also strand investors that are not part of the complaint since other registrants may be unwilling to service an defunct EMD's investor base in the absence of any recurring revenue such as trailer fees.

- *Alternative Solutions* - The PCMA believes that OBSI needs to consider alternative approaches rather than recommending a blanket EMD Buyback. One potential alternative could involve partial settlements or a phased approach to mitigate the financial strain on EMDs while still providing some relief to investors.

  For instance, rather than requiring an immediate full buyback, OBSI could recommend a structured repayment plan over a period of 12 to 36 months, allowing EMDs to manage their cash flow more effectively. Conditions for such a plan could include periodic reviews to assess the financial health of the EMD and adjustments to the repayment schedule if necessary.

The PCMA believes these alternatives would help balance the need to protect investors with the need to maintain the financial stability of EMDs, ultimately serving the broader public interest by preserving market integrity and competition.

6. Issues involving the Transfer of Securities to an EMD

(a) Questions Regarding the General Acceptance of Buy Backs by EMDs

OBSI is recommending transferring securities to EMDs as part of its settlement process involving unsuitable trades involving illiquid exempt market securiteis. In the Consultation Paper, OBSI states that "[*i]n most cases, firms have accepted our recommendations made using this methodology, but occasionally, firms have told us that receiving securities from investors as part of a settlement is not acceptable to them*."

This statement appears to suggest that registrants are broadly in agreement with buyback practices, implying a uniform acceptance of such settlements. However, the PCMA questions whether there is sufficient empirical evidence to support this characterization. The wording leaves the impression that refusals are rare and exceptional. The PCMA does not believe this is the case based on discussions with PCMA members.

As discussed below, EMD Buybacks often present significant operational, compliance, and regulatory hurdles for EMDs. The reluctance to accept buybacks is not simply a matter of inconvenience but relates to the inherent complexities of transferring the securities. The nuances of these challenges must be given greater weight in determining what constitutes a fair and reasonable outcome for both investors and EMDs.

In the Consultation Paper, OBSI states that it has "*worked with the firm and investor to find a mutually acceptable resolution, which for fairness reasons has generally involved the firm taking back at least some of the illiquid exempt market securities*." The PCMA is concerned about OBSI imposing a buyback obligation on registrants without considering their existing risk management protocols that may inadvertently penalize firms.

The presumption that investors should not bear the inconvenience of holding illiquid securities because they were "unsuitably sold" does not fully consider the operational realities for firms. Fairness should be applied equitably to all parties, recognizing that registrants should not be treated as a default repository for illiquid assets, especially where the proposed solution may undermine their ability to operate.

(b) *Absence of Authority to Transfer Securities*

The practice of transferring securities is problematic in situations involving distressed or insolvent issuers where the traditional corporate infrastructure has ceased to function. The absence of officers, directors, or transfer agents makes it practically impossible to execute OBSI's recommended transfers. This gap creates significant operational and legal uncertainty. The PCMA believes this is more the norm in failed offerings, which it believes contributes to an investor complaint since they lost money.

The PCMA requests that OBSI publish comprehensive guidance on how security transfer will be addressed, including providing for the standardization of documents as discussed below. The PCMA notes that it is not uncommon for articles of non-reporting issuers to have share transfer restrictions and protocols that must be addressed. Therefore, in the absence of clarification by OBSI, the PCMA does not understand how such transfers will be approved legally hence such guidance is needed. This matter should not be left to the investor and EMD to resolve as this is a process being imposed by OBSI and it needs to be legally compliant.

(c) *Zero-Value Assignment and Tax Implications*

OBSI’s practice of assigning zero value to illiquid exempt market securities for loss calculation purposes creates concerns regarding reporting to taxation authorities. This issue requires immediate attention as it could lead to unintended tax consequences for both investors and EMDs where OBSI recommends an EMD buy back shares. The current valuation methodology, while serving OBSI's dispute resolution purposes, may inadvertently influence how these securities are treated for tax purposes.

The PCMA is concerned that the assignment of zero value to illiquid exempt market securities could be misconstrued as a determination of the security's actual worth by taxation authorities, such as the Canadian Revenue Agency. This misinterpretation could have implications for tax loss claims, capital gains calculations, and other tax-related matters. Such a situation creates confusion between OBSI's administrative valuation and the actual market value of these securities, particularly in cases where the securities may retain some intrinsic value despite their illiquidity.

Accordingly, the PCMA believes OBSI should issue a public statement clarifying the limited scope and purpose of zero-value assignments. This statement should explicitly differentiate between administrative valuation for dispute resolution purposes and determinations of fair market value for tax or other purposes.

(d) Standardization of Security Transfer Documentation

The PCMA recommends that OBSI develop and publish standardized transfer documentation tailored for use in the exempt market when OBSI recommends that a firm buy back securities from an investor. These documents should address a wide variety of scenarios that arise during security transfers, such as changes in ownership structure, transfers involving restricted securities, and cross-border transactions. This standardization would help facilitate an efficient and consistent process while maintaining the necessary legal protections.

The standardized documentation should include provisions for special situations such as:

- transfers involving defunct issuers;
- cross-jurisdictional transfers; and
- cases where traditional transfer agents or officers and directors of an issuer are unavailable.

By providing clear and thorough securities transfer documentation, OBSI can help streamline the transfer process, minimize potential disputes, and reduce administrative delays for all market participants, including investors and EMDs.

It is particularly important that EMDs have the opportunity to comment on the representations, warranties, and covenants that OBSI expects to be included in such documents. Involving the PCMA and other stakeholders in the process ensures that the documentation reflects the practical realities they face, enhancing both the utility and fairness of the standardized forms.

The final version of the standardized securities transfer documentation should be made publicly available to all market participants. This transparency should promote consistency in how transfers are managed, reduce the risk of disputes, and enhance the overall efficiency and reliability of the settlement process. By creating a clear, standardized framework, OBSI can help bring greater order and predictability to security transfers in the exempt market.

7. OBSI's KYP Expertise

In a review of OBSI's "*Comprehensive Investment Loss Calculation*" OBSI has not indicated how it reviews and considers a registrant's due diligence of an investment product as part of its know-your-product ("**KYP**") obligations under applicable securities law.

In the Consultation Paper, OBSI states that "… *we base "know your client" and "know your product" analyses on information that was reasonably available at the time the advice was given, and we always use historical data for the relevant time frame for our risk assessments and suitable performance comparisons*."

PCMA members are aware of KYP documentation requests made by OBSI involving its suitability review involving a complaint. In such circumstances, it is unclear whether OBSI is assessing whether an EMD has fulfilled its KYP obligations or seeking additional information as part of its suitability review.

The types of information and documents an EMD would provide would depend on the intended purpose of such a request. Moreover, the PCMA is unclear what expertise OBSI would draw on to determine whether an EMD's KYP review was sufficient since the PCMA believes OBSI staff do not have the requisite transaction experience to make a proper determination.

The PCMA requests that OBSI provide clear guidance on what it requires in the context of a KYP review, and why. There are many actions and information that would need to be gathered by an EMD to provide such information. Moreover, the PCMA want to ensure OBSIs' KYP determinations and views are consistent with those of the CSA that regulate EMDs.

*   *   *

The PCMA appreciates the opportunity to provide you with its comments regarding the Consultation Paper.

The PCMA proposes that OBSI establish a working group consisting of industry participants to collaboratively discuss various matters as set out in its comment letter and otherwise, that may assist in a mutual understanding of this unique marketplace. The PCMA's exempt market expertise can help provide detailed insights on market-specific considerations that should inform these methodologies.

The PCMA remains committed to working collaboratively with OBSI and other stakeholders to promote practices that protect investors while ensuring a fair and balanced regulatory environment for all participants in the private capital markets.

Yours truly,

PCMA Advocacy Committee Members*

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PCMA Chair of Advocacy Committee &
Executive Committee Member

"*Nadine Milne*"
PCMA Executive Committee Member &
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**The views expressed herein are those of the above individuals in their role as members of the PCMA and not necessarily those of the organizations of which they are employed or affiliated.*

cc: PCMA Board of Directors
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Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
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