

November 22, 2024

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Ombudsman for Banking Services and Investments
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Dear Mr. Wright:

Re: OBSI Consultation on Loss Calculation for Complaints Involving Unsuitably Sold Illiquid Exempt Market Securities – Request for Public Comment

The Investment Industry Association of Canada (“IIAC”) is the national association representing investment firms that provide products and services to Canadian retail investors. Our members manufacture and distribute a variety of securities including closed-end funds and other exempt products.

We write with respect to the OBSI’s request for comments (the OBSI’s “**Request for Comments**”) on its approach to calculating investor loss in cases involving unsuitable investments in illiquid exempt market securities. We appreciate the opportunity to comment on this important issue.

Summary of Position:

We support the OBSI’s efforts to seek comments on its approach to calculating investor loss in cases involving illiquid exempt market securities. However, from the information that the OBSI has made available, we are concerned about the fairness of the OBSI’s approach and its alignment with the OBSI’s Terms of Reference. We recommend that the OBSI defer to participating firms and align its valuation process with, for example, National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (“**NI 31-103**”). If the OBSI maintains its approach, there are circumstances in which the OBSI ought to deviate from that approach and additional considerations that should apply.

Response to Question No. 1:

The Request for Comments poses the following question:

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?

As discussed below, the OBSI's approach for loss calculations involving unsuitable illiquid exempt market securities raises fairness concerns. The OBSI's approach is inconsistent with its Terms of Reference and the OBSI has produced insufficient information on its valuation methodology.

Inconsistent with Terms of Reference

The OBSI's approach to assigning an ending value of zero to illiquid exempt market securities and recommending that participating firms repurchase those securities at book value raises fairness concerns.

According to the OBSI's approach, where there is insufficient evidence on the value of a security, the OBSI will not only assume that the claimant has suffered damages, but will assume that the claimant is entitled to compensation based on an ending value of zero, which maximizes claimants' recovery at the expense of practicing firms. We are concerned that OBSI's blanket approach to assigning an ending value of zero to illiquid exempt market securities is inconsistent with the OBSI's own Terms of Reference. For example:

1. Section 4.1 of the OBSI's Terms of Reference states that the OBSI will at all times serve as an independent and impartial arbiter of Complaints. The OBSI's approach to calculating investor loss in cases involving illiquid exempt market securities is not impartial given that it systemically redistributes risk and assumes loss in favour of claimants. This approach places greater burden on participating firms that deal in exempt market products and could have a chilling effect on what has been identified as an important market for investors.¹
2. Section 13.1 of the OBSI's Terms of Reference provide that "[a]fter investigating a Complaint, the OBSI will make a recommendation for payment of compensation or other action if, in the OBSI's opinion, the Complainant has suffered a loss, damage or harm [...]." According to the OBSI's stated approach, where there is insufficient information on the ending value of a security, the OBSI will nonetheless *assume* that the Complainant has suffered a loss. However, if the OBSI does not have sufficient information on the value of a security, it should not be able to "form an opinion that the Complainant has suffered a loss, damage or harm". In those situations, the OBSI should be confident in concluding that there is insufficient evidence of damages and, therefore, no basis to make a compensation recommendation. That conclusion is consistent with the loss calculation methodology courts undertake in assessing financial harm in similar cases.
3. Section 13.5(a) of the OBSI's Terms of Reference provide that any payment that the OBSI recommends will not exceed the amount that the OBSI "considers appropriate to compensate the Complainant for loss, damage and harm suffered by the Complainant due to the acts or omissions of the Participating Firm or its Representative in the Provision of Financial Services." The OBSI's stated approach requires that, in cases where there is insufficient information or evidence to establish that the Complainant has suffered *any* loss, the OBSI will nonetheless deem it appropriate to recommend that the Participating Firm compensate the Complainant as if the entire value of the subject securities has been lost.

More generally, we are concerned that the OBSI may default to its "general approach" of assigning an ending value of zero to a security in all cases involving exempt market products or where the value of a

¹ Ontario Securities Commission, [Consultation Paper 81-737, Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures](#), October 10, 2024.

security is not easily derived from a public market. The OBSI must avoid sacrificing fairness in favour of expediency under a uniform approach to determining loss. The OBSI should instead maintain a nuanced approach to accurately assess any loss relating to exempt market securities, based on the unique circumstances of each case.

Insufficient Information on Valuation Methodology

The Request for Comments does not provide sufficient detail on the type of evidence that the OBSI considers and the assumptions upon which its methodology is based. The Request for Comments notes that the OBSI will work closely with respondent firms to understand the current value of exempt market securities and will consider “relevant” evidence produced by the firm or gathered independently by the OBSI. However, it is not clear if the OBSI’s approach is focused on evidence of market value such as price quotations for the same or similar class of securities, or if the OBSI considers broader evidence on the value of the underlying company with reference to, for example, reported earnings and assets.

We recommend that the OBSI defer to the valuation methodologies adopted by participating firms, consistent with s. 14.11.1 of NI 31-103 and/or rule 1201(2) of the *Investment Dealer and Partially Consolidated Rules*, copies of which are appended to this letter as **Appendix “A”** and **Appendix “B”**. This will allow the OBSI to maintain a fair and transparent approach that aligns with the practices of participating firms.

Response to Question No. 2:

The Request for Comment poses the following question:

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?*

As discussed below, if the OBSI maintains its “general approach” to loss calculations in cases involving unsuitable illiquid exempt market securities, there will be circumstances that result in unintended consequences including the unwarranted payment of windfall gains to claimants. As such, there are circumstances that warrant deviating from the “general approach” and other factors that the OBSI should consider with making settlement recommendations.

Circumstances Warranting Deviation from General Approach

If the OBSI elects to proceed with its general approach to calculating investor loss in cases involving illiquid exempt market securities, there will be circumstances that warrant deviating from that approach. For example, the OBSI’s general approach should not be followed when:

1. A participating firm is not operationally able to accept an OBSI recommendation to repurchase the complainant's illiquid securities because, for example, the firm does not have a trading desk and cannot maintain an inventory to hold securities. This is significant given the size and model of many firms that deal in exempt market products.
2. A claimant's KYC information, subscription agreement, and/or pattern of investments contemplated investing in exempt market securities, but the OBSI determines that the complainant's investments were unsuitable for other reasons such as, for example, an overconcentration of investments in a particular industry. A participating firm should not be expected to repurchase and hold those exempt market securities.
3. The claimant's investment horizon has not elapsed, and the securities are not defunct. If, for example, a complainant's KYC information includes an investment time horizon of ten years at the time of making a recommendation but presents a complaint within 3 years of the recommendation, the OBSI should conclude that the loss claim is premature. Put differently, the "relevant time period" for determining profit/loss should reflect the investor's time horizon and, if that time period has not elapsed, it is unfair for OBSI to arbitrarily assign an ending value of zero for the sake of expediency in resolving the claim.
4. The illiquidity of the subject securities is caused by systemic market forces or other intervening events. If, for example, a security becomes illiquid because of market shocks created by geopolitical events or prevailing economic conditions, a participating firm should not be expected to repurchase and hold those securities.
5. In addition to the foregoing, there may be instances in which the securities at issue contain resale restrictions that effectively prohibit a participating firm from repurchasing illiquid securities from a complainant despite the OBSI's recommendations.

Moreover, there may be other circumstances in which the OBSI's approach to valuing illiquid exempt market securities is not appropriate. If the OBSI elects to maintain its standard approach, we recommend that the OBSI allow for reasonable exceptions to that approach.

Additional Considerations

If the OBSI maintains its general approach, the OBSI should consider the following in order to improve the fairness of outcomes for consumers and participating firms:

1. The Request for Comments suggests that a security will be deemed illiquid where the security is not listed on a public market or there have been "too few" arm's length transactions to establish a market price. This approach captures too wide an array of securities ranging from, for example, securities in defunct publicly listed companies to thinly traded private real estate funds. A standard approach to this broad spectrum of securities is not achievable.
2. Before determining that a security is "illiquid", consideration should be given to whether the participating firm has been afforded a reasonable opportunity, in the context of the market, to find a buyer for the security and thereby mitigate the amount of the investor's loss.

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3. Not all illiquid and/or exempt market securities are high risk in nature. The risks, benefits, and attributes of exempt market securities vary and should be considered as part of the OBSI's recommendation process.
 4. There are important benefits to investing in exempt market securities, particularly for investors with extended investment horizons. Exempt market securities can play a crucial role in an investor's strategy by, for example, offering illiquidity premiums and providing a means of diversification to reduce portfolio risk. The OBSI must avoid negatively impacting the market for exempt products through a punitive approach to calculating loss.²
 5. When determining whether an investor has mitigated their losses, the OBSI ought to consider whether the investor has been provided with notice in accordance with s. 14.11.1(2) of NI 31-103 ("There is no active market for this security so we have estimated its market value.") or (3) (The value of this security is "not determinable") without investor objection. Risk Disclosures in signed Subscription Agreements are also relevant.
 6. The investment level approach in the OBSI's simplified example raises concern and should be substituted for a 'portfolio approach' to evaluating suitability in all circumstances.

We would be pleased to discuss at your convenience.

Sincerely,

Investment Industry Association of Canada

² *Ibid.*

Appendix "A"

National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*

Determining market value

- 14.11.1 (1)** For the purposes of this Division, the market value of a security
- (a) that is issued by an investment fund which is not listed on an exchange must be determined by reference to the net asset value provided by the investment fund manager of the fund on the relevant date,
 - (b) in any other case, is the amount that the registered firm reasonably believes to be the market value of the security
 - (i) after referring to a price quotation on a marketplace, if one is published for the security, using the last bid price in the case of a long security and the last ask price in the case of a short security, as shown on a consolidated pricing list or exchange quotation sheet as of the close of business on the relevant date or the last trading day before the relevant date, and after making any adjustments considered by the registered firm to be necessary to accurately reflect the market value,
 - (ii) if no reliable price for the security is quoted on a marketplace, after referring to a published market report or inter-dealer quotation sheet, on the relevant date or the last trading day before the relevant date, and after making any adjustments considered by the registered firm to be necessary to accurately reflect the market value,
 - (iii) if the market value for the security cannot be reasonably determined in accordance with subparagraph (i) or (ii), after applying the policy of the registered firm for determining market value, which must include procedures to assess the reliability of valuation inputs and assumptions and provide for
 - (A) the use of inputs that are observable, and
 - (B) the use of unobservable inputs and assumptions, if observable inputs are not reasonably available.
- (2) If a registered firm determines the market value of a security in accordance with subparagraph (1)(b)(iii), when it refers to the market value in a statement under section 14.14 [account statements], 14.14.1 [additional statements], 14.14.2 [security position cost information], 14.15 [security holder statements] or 14.16 [scholarship plan dealer statements], the registered firm must include the following notification or a notification that is substantially similar: "There is no active market for this security so we have estimated its market value."

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- (3) If a registered firm reasonably believes that it cannot determine the market value of a security in accordance with subsection (1), the market value of the security must be reported in a statement delivered under section 14.14 [account statements], 14.14.1 [additional statements], 14.14.2 [security position cost information], 14.15 [security holder statements] or 14.16 [scholarship plan dealer statements] as not determinable, and the market value of the security must be excluded from the total market value referred to in paragraphs 14.14(5)(e), 14.14.1(2)(e) and 14.14.2(5)(c).

Appendix “B”

Investment Dealer and Partially Consolidated Rules

1201. Definitions

(2) The following terms have the meanings set out when used in the Corporation requirements:

“market value”

- (i) For the purposes of the monthly, quarterly, and annual reporting for securities, derivatives and precious metals bullion:
 - (a) quoted on an active market, the published price quotation using:
 - (I) for listed securities, the last bid price of a long security and, correspondingly, the last ask price of a short security, as shown on a consolidated pricing list or marketplace quotation sheet as of the close of business on the relevant date or last trading date prior to the relevant date, as the case may be,
 - (II) for unlisted investment funds, the net asset value provided by the manager of the fund on the relevant date,
 - (III) for all other unlisted securities (including unlisted debt securities) and precious metals bullion, a value determined as reasonable from published market reports or inter-dealer quotation sheets on the relevant date or last trading day prior to the relevant date, or, in the case of debt securities, based on a reasonable yield rate,
 - (IV) for money market fixed date repurchases (no borrower call feature), the price determined by applying the current yield for the security to the term of maturity from the repurchase date. This will permit calculation of any profit or loss based on the market conditions at the reporting date,
 - (V) for money market open repurchases (no borrower call feature), the price determined as of the reporting date or the date the commitment first becomes open, whichever is the later. The value is to be determined as in paragraph (i)(a)(IV) of this definition and the commitment price is to be determined in the same manner using the yield stated in the repurchase commitment, and
 - (VI) for money market repurchases with borrower call features, the borrower call price, (VII) for listed derivatives, the market value or settlement price on the relevant date or last trading day prior to the relevant date,

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- (VIII) for over-the-counter derivatives, a value determined as reasonable by considering:
 - (A) the market value or settlement price of the equivalent listed derivative, if available; and
 - (B) values from published market reports or inter-dealer quotation sheets on the relevant date or last trading day prior to the relevant date, and after making any adjustments considered by the Dealer Member to be necessary to accurately reflect the market value,
 - (b) where a reliable price cannot be determined:
 - (I) the value determined by using a valuation technique that includes inputs other than published price quotations that are observable for the security, derivative or precious metals bullion, either directly or indirectly, or
 - (II) where no observable market data-related inputs are available, the value determined by using unobservable inputs and assumptions, or
 - (III) where insufficient recent information is available or there is a wide range of possible values and cost (defined in subsection 3802(1)) represents the best value estimate within that range:
 - (A) cost, and
 - (B) where the market value information is being included in a client report or account statement, the Dealer Member must include the following notification or a notification that is substantially similar: “There is no active market for this [security/derivative/precious metals bullion] so we have estimated its market value.”
 - (c) where a value cannot be reliably determined under subclauses (i)(a) and (i)(b) of this definition:
 - (I) no value shall be reported, and
 - (II) where the market value information is being included in a client report or account statement, the Dealer Member must include the following notification or a notification that is substantially similar: “Market value not determinable.”

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- (ii) For the purposes of the daily and intra-day reporting for securities, derivatives and precious metals bullion:
 - (a) that are quoted on an active market, the value determined according to subclause (i)(a) of this definition,
 - (b) where a reliable price cannot be determined and:
 - (I) the position has been recently valued in accordance with the Dealer Member's valuation policies and procedures, the last value calculated for the position, or
 - (II) the position has not been recently valued, the value and, if applicable, disclosure determined according to subclause (i)(b) of this definition,
 - (c) where a value cannot be reliably determined under subclauses (ii)(a) and (ii)(b) above, the value and, if applicable, disclosure determined according to subclause (i)(c) of this definition.