

Harvey Naglie

October 15, 2024

Mark Wright

Director, Communications and Stakeholder Relations

Ombudsman for Banking Services and Investments (OBSI)

20 Queen Street West, Suite 2400

P.O. Box 8

Toronto, ON M5H 3R3

Dear Mr. Wright,

Re: Comment on OBSI Consultation on Loss Calculation for Complaints Involving Illiquid Exempt Market Securities

I appreciate the opportunity to provide feedback on the consultation concerning OBSI's approach to calculating losses for illiquid exempt market securities. As a significant touchpoint for investor protection in Canada, OBSI's role in ensuring fairness for investors and firms is critical. In that spirit I would like to address certain aspects of the proposed methodology that I believe require adjustment to meet the evolving complexities of illiquid securities and at the same time provide appropriate redress for harmed investors.

General Comments on OBSI's Current Methodology

OBSI's current practice of assigning a value of zero to illiquid exempt market securities in the absence of reliable market data is a logical starting point but, in my view, needs refinement. The rigid application of a zero-value without considering any potential for recovery, even partial, ignores the possibility that some securities may retain residual value. This blanket approach risks either overcompensating investors or unfairly disadvantaging firms, depending on eventual outcomes. I suggest adopting a more nuanced method for assigning value, one that allows flexibility while maintaining investor protection as the core priority.

This more nuanced approach will be subject to firms actively producing relevant valuation evidence in a timely manner. Where firms fail to provide prompt and sufficient information, the zero-value approach would apply. I believe that this would incentivize firms to engage more transparently, while still offering fairness in situations where valuations are genuinely unclear.

Response to Consultation Questions

1. Is assigning a value of zero to illiquid exempt market securities and requiring investors to transfer the securities to the firm fair and reasonable?

While assigning a value of zero in cases where no market data exists may seem appropriate, requiring the investor to transfer the securities to the firm as part of the settlement does not sufficiently address the complexities involved. This practice may appear reasonable on the surface—ensuring no “double recovery”—but it introduces additional complications that undermine the fairness of the resolution process.

First, requiring the investor to relinquish the security shifts the burden of realizing any potential residual value entirely onto the firm. This not only complicates settlements but may also lead to delays in compensation and further disputes, particularly if the firm does not have mechanisms in place to manage illiquid securities. A better solution would be to give firms an option: either accept the security and any residual value, or pay a nominal residual value (e.g., a percentage of the original investment) to the investor as part of the settlement, without transferring the asset. This would allow flexibility based on the nature of the security, without forcing an all-or-nothing approach that could create additional friction.

Furthermore, in cases where an investor is required to transfer the security, OBSI should provide clear guidelines on the timeframe within which firms must realize any residual value. If the firm fails to liquidate or realize value within a defined period, the security’s ownership should revert to the investor, ensuring that no party is disproportionately disadvantaged by prolonged uncertainty.

2. Are there exceptional situations where assigning a zero value should not be used, and are there additional steps to improve fairness?

There are indeed scenarios where assigning a zero value to an illiquid security is inappropriate. For instance, where there is credible evidence—such as recent valuations, third-party estimates, or upcoming corporate events—that suggests the security may recover some value soon, OBSI should adopt a more flexible approach. In such cases, it would be more equitable to assign a nominal or estimated value to reflect the potential for recovery, with provisions for revisiting the settlement should the security’s value change substantially within a defined period.

Additionally, the fairness of outcomes could be improved by requiring more robust disclosure from firms during the OBSI investigation process. Firms should be obligated to provide comprehensive documentation, including any valuations, forecasts, or corporate updates related to the illiquid security. If the firm is unable to substantiate its claims about

potential value, the zero-value approach would remain appropriate. On the other hand, when a firm can demonstrate reasonable potential for future value, that should factor into the settlement, even if the security remains illiquid at the time of the complaint.

Recommendations for Improvement

1. Tiered Valuation Approach

Rather than defaulting to a zero value for illiquid securities, OBSI should introduce a tiered approach that reflects varying levels of evidence. Where no valuation data exists, the zero-value approach can be applied. However, when firms provide evidence of potential value, even if speculative, this should influence the settlement process. A nominal or discounted value could be assigned in such cases, ensuring both sides are treated fairly.

2. Incentivizing Firm Transparency

OBSI should penalize firms that fail to cooperate fully in providing valuation data or other relevant information. This could be achieved by using the zero-value approach as a punitive measure when firms are uncooperative, while more flexible arrangements can be applied when transparency is maintained.

3. Limit Timeframes for Security Transfer

When investors are required to transfer illiquid securities to firms, clear timeframes should be established for firms to realize any value. If no value is realized within a specified period (e.g., two years), the ownership should revert to the investor, or the security should be deemed fully worthless with no further obligations on either side.

Conclusion

OBSI's methodology for loss calculation in cases involving illiquid exempt market securities is a reasonable foundation, but it requires more flexibility and clarity to ensure fair outcomes for all parties. By introducing a tiered valuation system, incentivizing firm transparency, and refining the process for security transfers, OBSI can enhance its already strong framework and provide better protection for investors while maintaining fairness for firms.

The views expressed in this letter are my own and do not necessarily reflect the views of FAIR Canada. Thank you for considering my comments. For further discussion or clarification on any points raised in this submission, please feel free to contact me directly.

Sincerely,

Harvey S. Naglie