



OBSI consultation on loss calculation for complaints involving unsuitably sold illiquid exempt market securities – request for public comment

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Part 1 – Executive summary

The Ombudsman for Banking Services and Investments (OBSI) is seeking input from stakeholders and the public in relation to our approach to calculating investor losses in cases involving unsuitable¹ sales of illiquid exempt market securities. We seek input from our stakeholders and other interested parties on the processes we currently use to help us determine whether there are better alternative approaches we should adopt in such cases.

In this document, we describe the development of our current approach to loss calculations involving illiquid exempt market securities, feedback we have received to date on our approach, and relevant considerations for an appropriate loss calculation methodology. We pose two questions for stakeholder feedback in this consultation document:

1. 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?
2. 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 public comment period for this consultation closes on **November 21**. Stakeholders are encouraged to participate in this consultation through a variety of communication channels. For information on how to share your views on this consultation, please see Part 4 – How to Provide Comments below.

¹ Throughout this document, the term “unsuitable” includes circumstances where a security's risk characteristics are unsuitable for an investor as defined in securities regulation, as well as where such securities are improperly sold, for example where an exempt market product has been sold to an investor who did not qualify under any available exemption.

Part 2 – Background and development of OBSI’s loss calculation methodologies

OBSI’s mandate and process

As a financial services ombudsman, our role includes investigating investor complaints about investment firms with a view to resolving them in a manner that is fair and reasonable in all the circumstances.

In accordance with our [Terms of Reference](#) and our [Code of Practice](#), when determining what is fair, we must consider the legal rights and obligations of the parties, regulatory policies and guidance, general principles of good financial services and business practices, and any applicable professional body standards, codes of practice or conduct.

We are not a court or a regulator. We use the law and industry regulations as guides to determining fair outcomes, but we are not bound by precedent or specific case law. Also, it is not our role to definitively determine if there has been a regulatory breach before deciding whether compensation is warranted.

The disputes we investigate and work to resolve often relate to the civil liability of the firm to the consumer, including:

- allegations of negligence in the performance of the firm or its agents’ obligations to the consumer, such as the obligation to recommend suitable investments
- the firm’s vicarious liability for the actions of an employee or agent
- whether the consumer shares liability for any losses that have occurred

As an alternative to the court system, our process is intended to be accessible to investors and firms without legal representation in order to preserve access to justice and promote the efficient resolution of complaints. Within this accessible framework, our process respects the principles of natural justice and procedural fairness, as described in our [Code of Practice](#), to ensure that our process and the outcome of each investigation is fair to the parties.

If we conclude that an investor complaint does not warrant compensation, we will explain our reasons to the investor and firm and close the case. If we conclude that compensation is appropriate, we will calculate the amount we believe the firm should compensate the investor, explain our reasons and calculations to the investor and firm, and recommend that the firm pay that compensation.

Development of OBSI’s current loss calculation methodologies

When OBSI received the mandate to investigate investment cases in 2002, we initially developed an approach to investment suitability cases on the basis of our internal expertise, consultation with regulators and industry stakeholders, and the advice of our legal counsel.

In 2007, we established our Analyst Team to provide accurate, consistent, professional loss calculations for all investment complaints handled by OBSI. Our Analyst Team is made up of financial analysts who are CFA charter holders or analysts in the process of obtaining that designation.

In 2011, we began an extensive two-year consultation on our process for assessing investment suitability and calculating losses. During the 2011 consultation, we received extensive feedback from industry and investors, and following the consultation, our Board approved enhancements to our fundamental loss calculation methodology. Since that time, we have engaged in a process of continuous improvement and

standardization of this approach, adapting it as necessary to new products and practices, with continued input from our stakeholders.

External feedback on loss calculation methodology

As part of our commitment to accountability, OBSI undertakes independent expert external reviews every five years. The first of these reviews took place in 2007, and subsequent reviews took place in 2011, 2016 and 2021. The results of these reviews can be found on [our website](#).

The 2011 and 2016 reviews included careful reviews of OBSI's loss calculation methodologies and concluded that our loss calculation tools gave the organization an ability to determine fair compensation that was "world leading" in sophistication and efficiency, and consistent with underlying international best practices. The 2016 reviewers noted specifically that:

"We agree with the 2011 independent review findings that OBSI's loss adjustment methodology leads the ombudsman world. Approaches are also consistent with underlying international policies (e.g. the use of indices, opportunity cost)."

The 2016 review commented specifically that the OBSI methodology was neutral, producing results that do not systematically favour either side in a dispute and commended OBSI for ongoing refinements and improvements to the process.

The 2016 reviewers also noted that they had heard concerns expressed by some firms and industry groups about a range of issues, such as whether losses were offset by gains on other holdings within a portfolio; off-book transactions; apportioning losses when the investment portfolio transfers from one firm to another; vicarious liability; and apportionment of losses to customers. The reviewers expressed some surprise that these issues remained of concern, noting that these were all issues that had been the subject of extensive consultation in 2011-2012 and should have been well settled. The reviewers found that some of these misgivings were historic – i.e. they arose on cases closed some time ago, while others arose from misinformation or misunderstandings. However, the reviewers also noted that some of these misgivings were more fundamental and recommended that OBSI should provide additional guidance on its loss calculation approaches available on its website. We accepted this recommendation and subsequently published a new, updated and clarified description of our approach to suitability and loss calculations on our website. We also began an outreach campaign involving direct presentations by our analyst team to regulators, firms and consumer advocates to provide detailed context on our approaches and tools and to respond directly to any stakeholder questions.

Our 2021 external review again examined and commented on our loss calculation methodology and approach to suitability complaints. The reviewers noted that while consumer commentators viewed OBSI's methodology as being a leading, world-class approach to estimating losses:

Unfortunately, the methodology continues to be a significant point of contention for stakeholders. As described in greater detail below, we heard many of the same criticisms that industry stakeholders raised in 2011 and 2016. We found these criticisms to be largely unsubstantiated, and likely the result of the continued application of what the 2016 reviewers described as a "mythology" surrounding OBSI's loss calculation methodology on the industry side.

The 2021 reviewers concluded that "we agree with the findings of the previous reviewers that OBSI's loss calculation methodology is first-rate, enabling all parties to agree on underlying assumptions and ensuring

that prices from the relevant time are used, bringing a high level of efficiency, consistency and fairness to the process.”

The 2021 reviewers went on to examine a number of key areas of criticism in detail, including:

- our approach to opportunity costs, comparative portfolios and indices, which they agreed with
- allegations that our decisions were made with hindsight, which they found unsubstantiated
- views expressed by some industry participants that we should not examine the accuracy of documented KYC information and risk assessments when considering an investment suitability complaint, which the reviewers disagreed with
- our approach to considering the suitability of a portfolio when the client received portfolio advice from a firm, and the suitability of a specific security when the investor received individual security recommendations from a firm, which they found to be reasonable
- our approach to compensation for non-financial losses, which they found reasonable, though they recommended that we publish guidance on our approach to non-financial losses and fix amounts for specific levels of non-financial harm. We accepted this recommendation.

Of specific relevance to this consultation, the 2021 reviewers also considered criticism relating to our approach to calculating losses in cases where we have found that an illiquid exempt market security has been unsuitably sold to an investor. The reviewers found our approach reasonable, however, they noted the objections of some exempt market dealers and portfolio managers to our methodology and recommended that OBSI conduct a public consultation on its loss calculation methodology for exempt market product cases. We have accepted this recommendation, which is the subject of this consultation.

OBSI loss calculation for unsuitable, illiquid exempt market securities

Our fundamental approach to financial harm calculation

OBSI’s fundamental approach to redress for investors who have incurred harm as a result of an error or wrongdoing by a financial services firm, is to identify an amount of compensation that would put the investor in the position they would have been had the error or wrongdoing not occurred. This amount may be reduced where it is fair in the circumstances to do so, for example, where a consumer ratified an error, failed to reasonably mitigate their losses, or contributed to their own harms in an unreasonable or negligent way.

Our approach to loss calculation is consistent with the approach that would be taken by courts of law in assessing financial harm in similar cases and is similar to the approach taken by large ombudservices in other countries such as the UK Financial Ombudsman Service and the Australian Financial Complaints Authority. As an alternative to the legal system, it is fair and appropriate that our approach to compensation and consumer responsibility should reflect the legal approach to compensation and consumer responsibility.

Loss calculation in suitability complaints generally

In the majority of investment complaints we receive each year about advice-based accounts, investors are seeking compensation for the financial harm they incurred as a result of what they believe to be poor advice, or unsuitable investment strategies and/or because their investments did not perform as they expected.

Advisors and firms are not responsible for the performance of investments, because, with some very limited exceptions, all investments involve the risk of loss. However, advisors and firms may be responsible for their client's harms if they make unsuitable investment recommendations or misrepresent the risks and potential benefits of the investments they recommend.

Our website provides stakeholders and the public with a full overview and description of our [Process for Assessing Investment Suitability and Compensable Losses](#).

OBSI's overall objective in any suitability case is first to determine whether unsuitable advice was given to the consumer, and if so, to recommend an amount of compensation that would place the investor in the approximate financial position they would have been in if the unsuitable investment advice had not been given and acted upon. Resulting recommended compensation amounts can range from small to very large, in some cases reaching OBSI's compensation limit of \$350,000.

Our goal is to estimate an investor's compensable losses, if any, in a way that is as accurate and fair as possible, which means basing our decisions on the information that would reasonably have been available to the advisor and firm at the time the advice was given and that does not rely on hindsight. For example, 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.

In order to determine an amount that will place the investor in the approximate financial position they would have been had the unsuitable investment advice had not been given and acted upon, our methodology contemplates a range of possible calculation approaches. The approach taken in a given case will depend on the specific facts of the case, most importantly what the evidence indicates would have happened had the unsuitable advice not been given.

Where the evidence in a suitability case indicates that the investor would have invested in suitable investments, we will compare the consumer's actual unsuitable investment performance with the performance of a hypothetical comparative portfolio of suitable investments. In most instances, we will use the performance of common indices to approximate the performance of a suitable portfolio. However, we may use different comparative portfolio assets if the circumstances of the case warrant it. If the investor's actual unsuitable investments performed worse than suitable investments would have, taking reasonable fees and commissions into account, the difference is the investor's financial harm as a result of the unsuitable advice.

Following our comparative portfolio calculation, if we determine that the investor did not incur financial harm, we will conclude our investigation by explaining to the investor and the firm why we believe no compensation is warranted. If we determine that the investor did incur financial harm, we will consider whether the investor should bear responsibility for some of the loss before determining the amount we believe the firm should compensate the investor.

We note that this comparative portfolio approach is neither inherently positive nor negative for consumers or firms. In rising markets, this approach generally leads to higher compensation recommendations (because suitable investments would usually have done better). However, in declining markets, the opposite is true, and the approach generally results in lower recommendations for compensation (because the consumer would have lost money on suitable investments).

Calculating financial harm for unsuitable illiquid exempt market securities

In cases involving illiquid exempt market securities, we will generally follow our standard loss calculation methodology, with modifications necessary to facilitate the calculations.

When calculating financial harm, our first step is to calculate actual gains or losses over the relevant time frame on the investor's unsuitable investments. We consider the amount invested, less withdrawals, amounts paid to the investor (such as cash dividends or distributions) and applicable transaction or carrying costs (such as fees), compared to the value of the investments or portfolio at the end of the relevant period (the ending value).

To perform this calculation, the ending value of each unsuitable investment must be determined. This is difficult or impossible for certain illiquid exempt market securities because either no market exists, or because so few arms-length transactions occur that no market price can be determined.

Where no market price exists, we will work closely with the firm to understand the ending value of any exempt market security/securities at issue and will consider any relevant evidence they provide or that we can determine through our own research. At times there is reasonable evidence that allows us to at least estimate an ending value. In some cases, it is clear that there is no remaining value. When an ending value can be reasonably determined, we will follow our general loss calculation methodology using that ending value. However, there are instances when inadequate information for valuation exists.

For cases involving unsuitably sold securities that may have value but where there is insufficient evidence available about the value of the security, it is not possible to conduct a loss calculation that takes into account the investor's actual losses (since this depends on the ending value of their investments).

In these cases, we follow our standard loss calculation processes but assign an ending value of zero to the security and calculate the losses on that basis. It is important to note that this does not imply an assumption of total loss, but rather, zero is a value that we use for the purpose of determining a fair compensation recommendation. Since the amount of the recommendation calculated using this methodology could result in double recovery to the investor if there is any residual value in the security, in these cases we generally recommend that the investor transfer the security to the firm as part of the settlement. This ensures that any residual value in the security accrues to the firm, and that it is the firm, rather than the consumer, that incurs any inconvenience or delay in realizing the value of the security.

In 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. In these cases, we have 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. While we appreciate that receiving and holding illiquid exempt market securities may be unusual or difficult for some firms, we must also consider that holding the illiquid exempt market security may also be difficult for the investor for to whom it was unsuitably sold.

Simplified Example:

Ms. Smith invested \$100,000 with Firm ABC 3 years ago and has experienced significant investment losses. She complained to the firm that she has been unsuitably invested, was dissatisfied with their response, and escalated her complaint to OBSI.

Investigation process:

1. Following preliminary evidence gathering, OBSI's investigation first considers whether the documented KYC information and objectives are reasonable. In this case, the firm's documented KYC information stipulates that Ms. Smith's risk tolerance and objectives are:
 - Risk tolerance: 100% medium risk
 - Investment objective: 100% growth

Considering Ms. Smith's personal circumstances and the information available at the time of the investments, we determine that this KYC information is reasonable.

2. OBSI's analyst team then examines the securities in the account to assess their risk level in accordance with OBSI's [Process for Assessing Investment Suitability and Compensable Losses](#). OBSI's analysis of the portfolio indicates that during the relevant time period, Ms. Smith's investments holdings at ABC were invested in:
 - 40% publicly traded medium risk securities
 - 30% publicly traded high risk securities
 - 30% illiquid exempt market high risk securities

Therefore, our analysis indicates that 40% of Ms. Smith's portfolio has been suitably invested, and 60% has been unsuitably invested. Our investigation also shows that the firm recommended individual investments to Ms. Smith, rather than providing investment planning and advice on a portfolio basis.

3. Our next step is to calculate whether Ms. Smith has experienced any financial harm as a result of these unsuitable investments. Because Firm ABC had provided investment-level, rather than portfolio-level advice to Ms. Smith, our analysis from this stage forward focuses only on the 60% of the portfolio that was unsuitably invested - any gains or losses on the suitable investments are not considered.

OBSI's analyst team determines the actual performance of the unsuitably invested securities in Ms. Smith's account by calculating the amount invested in the high-risk securities, less any withdrawals, amounts paid to the investor (such as cash dividends or distributions) and applicable transaction or carrying costs (such as fees), compared to the value of the high risk securities at the end of the relevant period.

For the publicly traded high-risk securities, market price data is readily available, and the analyst team calculates that these investments lost \$10,000.

For the illiquid exempt market securities, however, no market data exists. OBSI's analysts work with firm ABC to identify any reliable evidence of the securities' value at the end of the relevant period, but none is available. Firm ABC states, however, that the securities continue to have value that will be realized on a future date.

Because no ending value can be determined, for the purposes of our loss calculation the high-risk exempt market securities are assigned a value of zero, which leads to a calculated loss of \$30,000 on these investments. Therefore, for the purpose of our loss assessment, Ms. Smith has experienced a \$40,000 loss on the unsuitable investments.

4. OBSI's analyst team then considers how a portfolio of suitable investments would have performed over the same time period and with the same withdrawals and fees. In accordance with our [published benchmarks](#), the S&P TSX Composite Index is used as a benchmark for a medium risk growth portfolio. Using the same amount invested, withdrawals, and costs, this analysis indicates that a suitable portfolio would have lost \$10,000 over the same period.
5. Therefore, we have calculated that Ms. Smith has incurred financial harm of \$30,000 as a result of being unsuitably invested. We consider whether Ms. Smith shares liability for these losses and determine that she does not.
6. We therefore recommend that Firm ABC pay Ms. Smith \$30,000 and that Ms. Smith transfer the illiquid exempt market securities to Firm ABC so that any residual value of the securities accrues to firm ABC and there is no double-recovery for Ms. Smith.

We have developed this approach over many years and have found that it provides a fair resolution to the challenge that exists when the ending value of an illiquid exempt market investment that has been unsuitably recommended to an investor cannot be determined. We have also found that this approach is often acceptable to firms. Occasionally, however, we have heard criticism that this solution is unacceptable to some firms and is evidence of our failure to understand certain firms' business models or of an organizational bias against exempt market dealer firms. It is our position that this is not evidence of a lack of understanding or bias, but rather a disagreement about what is fair in the circumstances of such cases.

In light of some of these critiques, we have met with industry organizations to discuss this issue and request their input or suggestions of an alternative valuation methodology, but none has yet been suggested to us. We remain committed to working with industry to improve our approaches and practices wherever possible and are now seeking public input on this matter.

Consultation questions

1. 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?
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How to provide comments

In writing

Please submit your written comments on or before **November 21, 2024**. If you are sending your comments by email, please send us an electronic file containing the submission in Microsoft Word Format.

Address your submission to:

Mark Wright, Director, Communications and Stakeholder Relations
20 Queen Street West, Suite 2400, P.O. Box 8
Toronto, ON M5H 3R3
Fax: 1-888-422-2865
Email: publicaffairs@obsi.ca

By electronic survey

Stakeholders can also provide their responses this consultation by [electronic survey, here](#). This survey is not anonymous, and all commenters will be asked to identify themselves.

Next steps

All written responses received will be published, and comments received through the electronic survey will be summarized and published.

OBSI will carefully consider all submissions received as we work to consider possible updates to our loss calculation methodology and we will consult with our board and regulators on any proposed changes. We expect to announce the results of this process and any plans for future consultation in early 2025.