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

Ombudsman for Banking Services and Investments
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The exempt market and regulatory exemptions are on fast track. This consultation is very timely. I cannot provide the fulsome feedback I would like in the 8 weeks allotted but I present some high level thoughts.

See Ontario's exempt market https://www.osc.ca/sites/default/files/2022-12/sn_20221207_45-718_ontario-exempt-market.pdf

The consultation does not provide any statistics on exempt market complaints which is surprising given the high profile of this consultation. In the simplified example provided, Ms. Smith's investment time horizon is not revealed, which is critical in such investigations especially for exempt securities.

The CFRs introduce a requirement under paragraph 13.3(1) (b) that an action **subject to a suitability determination must put the client's interest first**. As noted in the Companion Policy, to meet the criteria for a suitability determination under section 13.3, suitability cannot be determined **only on a trade-by-trade basis** but must be determined on the basis of the client's overall circumstances, given the relationship between the client and the registrant, and the securities and services offered by the registrant.

It is also CSA's expectation that registrants determine appropriate concentration thresholds for their clients. CFR is fully applicable to Exempt Market Dealers. The OBSI loss calculation process should consider CFR in its design.

In the simplified example provided, how did the Dealer conclude that the complainant had a 100% medium risk tolerance profile given that they sold her risky exempt market securities? This suggests Ms. Smith has significant wealth and the risk capacity to bear losses. Why did it take 3 years to discover the high risk nature of 60% of the holdings? How was harm determined? Is the exempt security a high-risk /high -reward a bond/mortgage? "***Our investigation also shows that the firm recommended individual investments to Ms. Smith, rather than providing investment planning and advice on a portfolio basis.***" Who pays for advice and signs up for an account without advisor consideration of the portfolio?

The simplified example provided is perhaps too simple-it is not a convincing one in my opinion.

Exempt Market Dealers have been beefing about OBSI but have yet to present a better, fairer, more efficient loss calculation model. The arguments about E&O insurance unavailability suggest they may be undercapitalized and/or have deficient sales, on-boarding and compliance practices. When OBSI obtains binding authority, exempt market Dealers will have to step up to the investor protection plate.

The 2016 Independent Review pointed out 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)*."

OBSI's loss calculation approach makes a lot of sense for illiquid securities. Value the illiquid security as NIL if a price cannot be determined. The unsuitable exempt security should be turned over to the Dealer. Determine suitability- if unsuitable, calculate harm done by using an opportunity loss model. **Great care should be employed in determining what investments the complainant would have invested in. If an index is used, the cost of acquiring and holding the index should be considered and it should reflect the complainant's history of investing to the extent it can be determined** (Would it not be fairer to use the actual returns of the 40% suitable securities as a proxy for the return of the 60% unsuitable portion of the holdings instead of the S&P/TSX Composite index?).

https://www.obsi.ca/en/how-we-work/our-approaches/emd-loss-calculation/
This text leaves open the process used when the Dealer does not accept taking back the security. **OBSI should be transparent on the approach it uses.**

In response to question 2b, I would recommend that OBSI prepare a feedback report ,based on complaints data, to exempt market Dealers that should improve due diligence on eligibility, improve KYC data capture, accelerate use of TCP nomination to protect vulnerable investors and modernize complaint handling processes. **OBSI should also publish complaint cases suitably redacted that allows stakeholders to assess OBSI's implementation of its loss calculation methodology**.

When a systemic issue is identified by OBSI regarding the advice and sale of illiquid exempt securities, OBSI should, without undue delay, inform the JRC, so that it can take steps to ensure all similarly harmed investors are informed and compensated as appropriate.

Sellers of illiquid exempt securities should not be permitted to use NDAs (gag orders) in complaint settlements to restrict complainant victims from communicating with others that may have been similarly harmed.

If OBSI is going to continue to give short response times to consultations and have a binding mandate, I suggest the Consumer and Investor Advisory Council be reconstituted.

Although not directly part of the consultation, I note that the maximum compensation amount of $350K has not been updated in years and now lags all other major financial ombudsman services globally. OBSI should establish a periodic review to assess whether the limit is adequate to fulfill its objectives and those of the CSA. **As the risky exempt market continues to grow and prosper, OBSI should be ready with a meaningful limit**.

This letter may be publicly posted.

Respectfully,

Stan Gourley