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Ombudsman for Banking Services and Investments
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OBSI consultation on loss calculation for complaints involving unsuitably sold illiquid exempt market securities – request for public comment
https://www.obsi.ca/en/news/posts/obsi-consultation-on-loss-calculation-for-complaints-involving-unsuitably-sold-illiquid-exempt-market-securities-request-for-public-comment/

This is a very important consultation. I hope and pray other retail investors will be able to respond in the short timeline allowed for submissions.

I note that, per OBSI, there have not been any Firm refusals since Dec. 1, 2020
https://www.obsi.ca/en/news-publications/firm-refusals/

Some EMD's assert the OBSI loss calculation is unfair but without providing a credible alternative. This industry griping has been noted in several Independent Review Reports and been discounted.

The simplified example in the consultation

The example in the consultation has a number of characteristics worth highlighting. It does not provide any information as to why the complainant decided not to accept the Dealer's offer or what the offer was.

The Dealer involved is not solely an EMD given the securities in the account. The KYC is only partially disclosed - no info on investor finances/ net worth, time horizon, or investor knowledge/experience is provided. The account objectives are 100% medium risk tolerance and 100% growth.

The illustrative example does not explicitly state that a check was made on the complainants eligibility to purchase exempt market securities. I must assume this is step #1 in the OBSI investigation. If the complainant is not eligible, there is no question that the complaint is not only valid but is not in accordance with securities laws.

The simplified example provides a breakdown by security type and states the account holdings are not a portfolio designed to meet the growth objective via portfolio construction. Rather, we are informed each security is purchased without consideration of the overall portfolio. For me, this is a highly unusual way to invest as it must have been for the Registered Representative.

The S&P TSX Composite index is used as a portfolio substitute for the 100% growth objective but since the index is costless and frictionless it seems to me that a low cost ETF should be used instead, plus associated brokerage commissions. Since the objective is 100% growth, is it reasonable to pick a 100% Canadian index with no international investments as the investments that the complainant would have purchased?

It would have been useful to also provide an example using a registered EM Dealer with a single exempt product that was deemed unsuitable.

The investor is clearly an Accredited Investor since exempt products have been purchased. Hence client has significant wealth and risk capacity.

The illustrative case says complainant responsibility was not a factor in this case. This leaves open the question as to the process used by OBSI when they believe a complainant is partially responsible under the CFR regime.

We are not informed as to the level of diversification by asset class/ industry but since it is an account based on individual transactions, concentration is apparently not a suitability issue.

The example states that the investigator determined that the Firm did not provide advice on a portfolio basis. I do not understand this given securities laws, CFR and common sense. There are rules for making suitability determinations, rules on overconcentration / liquidity, rules for risk profiling etc. and the account is not with a discount broker where the Dealer only executes orders. The advisor is apparently licensed as a registered representative, not a salesperson. Did the client understand and consent that concentration and liquidity analysis would not be done on a portfolio basis? If in fact such consent was not obtained, the portfolio as a whole should form the basis for the OBSI loss assessment.

30% of the account is invested in medium risk equity growth securities in partial satisfaction of the 100% growth goal … BUT this raises the question about risk tolerance. Does 100% medium risk tolerance KYC equate to a 100% equity growth account including exempt products? If it does not, should not the entire account have been considered, not just the high risk securities which includes illiquid securities? If it were, it would still be unsuitable but the calculated loss would be offset by gains (if any) in the suitable securities.

Conclusion

Notwithstanding these comments, the basic OBSI loss calculation process is sound and includes validating KYC accuracy and credibility. The process involves making the person whole; putting them in the position they would be in if they had been sold suitable investments.

The opportunity loss calculation is standard ombudsman practice but not standard Canadian industry practice. CSA investment Dealer complaint rules are antiquated (except for Quebec) which adds to the challenges OBSI is forced to address.

Without a price for an illiquid security, the fairest solution is to return the unsuitable exempt security to the Dealer, like a refund. Loss calculation is partly an art and a science but the process goal is always fairness to both sides of the dispute.

I would like to make a point on investor mitigation. While it may not be unreasonable for an investor to be held accountable in part for losses in some cases, it depends on the financial competency of the investor, whether she/he suffers from diminished capacity or is incurring severe health issues/ hospitalization. Under CFR, it is the Firm which has the primary responsibility for recommending suitable personalized advice, so OBSI should always assess whether the advisor suggested *sell* of the unsuitable investment. If the advisor failed to recommend an exit strategy for the complainant, the Firm should be held 100% accountable. Such timely advice is part of the reason investors pay fees.

Although the emphasis is implicitly on EMDs, risky, illiquid securities can be sold off- book by other registrants. I would recommend that the loss calculation methodology for illiquid off- book transactions by registrants be covered in the public OBSI loss calculation methodology disclosure.

Based on a review of PCMA public commentary, I conclude these Dealers need to be educated on the role of a modern financial ombudsman service. OBSI should run a webinar for the EM industry and hopefully eliminate comments such as *complainants should be required to pay for the ombudsman service to deter frivolous investor complaints*. This is Stone Age thinking.

I also recommend that the OBSI Board form a committee on Best practices in complaint handling and loss calculation whose mandate would be to ensure OBSI staff continue to use best practices in complaint resolution.

I hope this feedback helps.

Permission is granted for public posting of this letter.

Peter Whitehouse

REFERENCES

EMD Loss Calculation | Ombudsman for Banking Services and Investments
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 used.

See section on suitability determination

https://www.ciro.ca/media/3008/download?inline

FundEX refusal investigation report
https://www.obsi.ca/media/mznnxjlw/fundx-mr-and-ms-s.pdf

Risk Rating | Ombudsman for Banking Services and Investments
https://www.obsi.ca/en/how-we-work/our-approaches/risk-rating/